Click here for Full Issue of EIR Volume 13, Number 50, December 19, 1986

Banking by David Goldman

The first cracks in securitization

The $17 billion floating-rate note market could light the fuse for $3 trillion in off-balance-sheet liabilities.

Trading was suspended on almost $17 billion of floating-rate notes (FRNs) in London on Dec. 4. One among many forms of "creative securities" which have proliferated during the past several years, the affected area involves so-called "Perpetual FRNs," a device through which the major banks have increased their capital.

Faced with a trillion dollars of bad Third World debt, and hundreds of billions of dollars of bad oil, commodity, shipping, real estate, and related loans, the major banks issued capital notes whose interest rate changes with the market, but whose capital will never be repaid—hence, "perpetual" notes.

The run against this offshore bank paper known as FRNs has not yet affected the banks' deposits. However, big international money, reportedly led by the Japanese banks, has unloaded paper issued by some of the world's top international institutions, fearing that "it may never be paid back," the London *Financial Times* warned Dec. 4.

London sources call the market collapse the worst-ever crisis of confidence in the 20-year-old Eurobond market, the $200-billion-a-year offshore pool which turns international hot money into "legitimate" investments. Bankers warn that the suspension of trading of bankers' capital notes could damage the liquidity of major British-based banks.

"Perpetual FRNs are a bit of a confidence game," a financial insider said. "They are an evasion of Bank of England rules" that allows banks to use the instruments as primary capital. "The first hint you can't sell, and people rush to get out." The present collapse of confidence, according to reports, was triggered by selling from nervous Japanese banks.

The collapse of the FRN market represents a crack in a $3 trillion dam. It may seem astounding that banks raised billions of dollars in new capital, by issuing notes which pay a fraction less than the daily quoted rate for offshore deposits in London.

Since the banks themselves are the major buyers of such paper, the banking system appears to have dealt with a threat to its solvency by taking in its own laundry.

However, the FRN "confidence game," as insiders call it, constitutes a mere fraction of a $3 trillion international bubble created by the major banks. The commercial banks issued $3 billion worth of guarantees for all kinds of securities, agreeing to bear the risk of default, interest-rate changes, or currency shifts. Virtually all the issuance of securities in the past three years has depended upon such guarantees.

International lending collapsed between 1982 and 1985, from over $100 billion per year to barely $10 billion last year. It collapsed because the banks' existing international loans, to Third World borrowers and others, became worthless.

The banks could not earn sufficient income to pay interest on their existing deposits, much less show a profit, because a large proportion of their existing loan-portfolios died.

What they could not earn in interest from dead loans, the banks took in by issuing loan guarantees and similar commitments, in return for up-front fees. The volume of loan guarantees in the United States has grown from almost nothing, to $500 billion in 1985, as a result.

In effect, the banks expanded their liabilities in return for one-shot current income, which is the most dangerous and irresponsible thing banks can do. For a bank, a loan guarantee is no less a liability than a loan; if the borrower fails, the bank will have to pay off the loan.

One particularly nasty feature of the "off-balance-sheet operations" is that they have permitted banks to sell off their best-performing loans in the form of securities, raising money in the short-term, while leaving a higher proportion of bad loans in their portfolios.

In particular, the New York banks have sold off their most dependable loans. According to London financial community sources, there is growing alarm over the process of "securitization" and growth of "off-balance-sheet" lending through which, increasingly since the outbreak of the debt crisis in 1982, major money-center banks have technically improved book profits to conceal loan losses.

The banks, hurting badly for current income, accepted an up-front fee, in exchange for such guarantees.

At the same time, they loaded up their portfolios with securities issued on the strength of guarantees provided by other commercial banks, like the "perpetual FRNs" whose market sank into the ground.

The banks' own portfolios are now vulnerable to a collapse of the paper pyramid they built themselves.

© 1986 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.