

Banking by David Goldman

The fraud in banking profits

A Chicago Federal Reserve study shows the hidden potential for massive bank losses.

Last week's *EIR* cover story documented how the major banks covered up massive losses, by writing guarantees amounting to almost triple their assets, piling up long-term liabilities in return for one-shot fee income. The seven top U.S. banks, with assets of \$550 billion, racked up so-called "off-balance-sheet liabilities" of \$1.4 trillion, generating somewhere between \$14 and \$28 billion in fees. Without this fee income, these banks would have shown little profit during the past four years.

Another, potentially much larger, dimension of the same problem emerges from the fine print of a Chicago Federal Reserve study of 1986 banking profits. The study, released March 27, notes that "the profitability of the U.S. banking industry fell during 1986, with the decline particularly pronounced at institutions serving distressed sectors of the economy. . . . Bank earnings performance varied significantly by sector, with the agricultural and energy-related institutions significantly underperforming the rest of the industry."

The study adds, "Declining interest rates sharply increased the market value of investment securities in banks' portfolios, supplying a boost to reported earnings for those banks with operating profits squeezed by nonperforming loans and high charge-offs."

Namely, the prostrate banks of the

energy and farm belts bet the store in the securities markets, and, thanks to falling interest rates, won big. Rising rates will blow them out of the water; and that is precisely what has happened, with a nearly 5% decline in the value of long-term Treasury bonds since the beginning of April, due to actual or anticipated Japanese liquidation of U.S. investments.

The Chicago Fed shows that the banks in the Dallas Federal Reserve district, as a group, showed a loss equal to 0.37% of their total assets last year. However, securities-trading profits amounted to 0.51% of total assets. That is, without securities-trading profits, losses would have amounted to 0.88% of total assets. If their securities fell back to end-1985 prices, losses would amount to 1.39% of assets. However, since their nonperforming loans shot up to 5.4% of assets from 3.7% of assets, and write-offs associated with such loans will be felt heavily during 1987, the potential decline is much, much larger.

In short, the Dallas Federal Reserve district banks are set up for losses equal to 2 to 3% of assets during 1987, which means general bankruptcy.

The Dallas Federal Reserve District is in the worst position of any sector, but the specter of collapsing securities prices haunts the system as a whole. The following table gives the

banks' dependency on securities profits last year:

1986 Return on Assets (ROA)		
Fed District	Total	Securities
Boston	.90	.11
New York	.70	.13
Philadelphia	1.06	.06
Cleveland	.94	.16
Richmond	.99	.15
Atlanta	.83	.11
Chicago	.76	.11
St. Louis	.90	.10
Minneapolis	.81	.48
Kansas City	.22	.18
Dallas	-.37	.51
San Francisco	.36	.32

Although the Dallas Fed District banks were the only sector to run a net loss, securities-trading profits made up half or more of all profits in three other districts. Notable is San Francisco, whose miserable results reflect problem-wracked Bank of America. In the Kansas City district, which reflects both oil and agricultural problems, securities-related profits amounted to virtually all bank profits; and in the Minneapolis district, reflecting agricultural lending, securities-related profits were roughly two-thirds of all profits.

The data prove that "securitization," i.e., reversion to speculative practices infinitely worse than those of 1928, was not limited to the big international banks, but also a strategy of desperation among the weakest American institutions. The failing commercial banks of the most depressed American regions did precisely what the great majority of U.S. thrift institutions did: borrow heavily short-term in order to buy long-term securities. Once the price of securities crashes, as it appears to be doing at the moment, the trading profits will disappear, and these institutions' haste in ridding themselves of long-term paper will produce a crash of bond prices worse than the worst days of 1930-31.