EIR Economics

Worst bank losses in history are only the beginning

by David Goldman

This year's second quarter marks the first time in history that the U.S. banking system, as a whole, ran in deficit, and the big-bank losses which prompted the overall move into negative are, by any statistical measure, much worse than anything reported during the last Great Depression. They portend the worst banking crisis in history. Contrary to wishful thinking in the business press, the second-quarter losses, stemming mainly from loans to developing nations, do not represent a long-postponed housecleaning. The banks' developing-sector loans are a fraction of their total bad debts, and the mammoth losses just announced weaken their capacity to withstand further shocks to come.

Federal regulators officially admit that release of information showing the true condition of several of the nation's top ten banks could prompt a run against these banks. The truth came out through a side door, when plaintiffs against A.H. Robbins and Co., makers of the Dalkon Shield contraceptive device, petitioned a Richmond, Va. court to release the federal examination records of two of Robbins's banks: Manufacturers Hanover Trust, and Chemical Bank.

According to the July 10 *Washington Post,* lawyers for the Federal Deposit Insurance Corporation and the Federal Reserve, which examine the banks' condition, plan to argue against the release of such documents, on the grounds that "requiring disclosure could result in a financial panic affecting the stability of Manufacturers Hanover Trust and Chemical Bank if information disclosed was misunderstood by the public. Moreover, any such run on these multinational money center banks could reverberate throughout the nation's banking system and the world economy."

The claimants' committee are demanding the records on grounds that, for them, are entirely reasonable: the two New York banks are to lead a syndicate providing a $1.67 billion letter of credit to Robbins, to finance claimants' compensation. John J. Walsh, lawyer for the claimants' committee, asserted that "the publicly available information does not permit the committee to make the critical assessments of MHT's and Chemical's financial adequacy . . . or the meaningful risks regarding their ability to perform over that time period." He charged that their "enormous loans" to developing countries could put them out of business.

In effect, the regulators already admitted defeat with the Federal Deposit Insurance Corporation's announcement that it would accept lower capital ratios among banks in depressed states, imitating the earlier procedure of its sister organization, the Federal Savings and Loan Insurance Corporation, which has permitted "zombie" institutions to keep their doors open despite negative net worth, because it does not have the funds to close them. An estimated 2,000 banks of the nation's 14,000 FDIC-insured institutions are likely to take advantage of the loophole, and keep operating below what previously was a Federal safety norm for commercial banks.

Regarding the bank losses, the point is not what has been announced, but what has not. Losses announced, or expected, at major banks, break down as follows:

Chase Manhattan	$ 1.4	billion
First Chicago	$698.3	million
Morgan	$586.4	million
Citicorp	$ 2.5	billion
BankAmerica	$ 1.0	billion
Manufacturers Hanover	$ 1.05	billion
Total	$ 7.2347	billion

The six major banks cited above reflect only a fraction of the second quarter's losses. Abroad, most of the leading British banks have been forced to follow suit and set aside massive reserves for loan losses, while the World Bank itself—the sister organization of the International Monetary Fund—has announced that it will set aside its entire $1 billion 1987 profit to cover losses on its own portfolio of loans. That amounts to an admission of defeat on the part of the official monetary institutions, whose retaliatory powers once commanded the full attention of debtors. They would be paid if no one else was. Now, reality has borne down on them. Brazil, the largest Third World debtor, whose actions give the trend for the world debt crisis, stopped paying its private creditors in February, and its official creditors in May.

Together, the six banks listed above have written off less than a fifth of their total Third World loans; if they wrote them down to the level that the so-called secondary market would take them off their hands, their combined losses would have exceeded $20 billion, pushing close to their combined shareholders' capital. The loan-loss reserves which pushed them into the red do not even come close to addressing the apparent problem, i.e., the consequences of Brazil's February debt moratorium.

Bank regulators have stressed, in occasional moments of courage, that the worst danger facing the commercial banks is to be found not on, but off, their balance sheets. The 10 largest U.S. commercial banks have off-balance-sheet liabilities of $1.5 trillion, against assets of about $600 billion. These include straight loan guarantees (or guarantees of the interest-cost or exchange-rate associated with a loan), guarantees to purchase securities, so-called loan swaps, foreign exchange exposure, and so on. The banks respond that the risk associated with such "off-balance-sheet liabilities," which generate fee income, but for which they hold no capital in reserve, represents a much lower degree of risk than straight loans. That may well be true; but their exposure is so great, that a 3% loss rate on such liabilities would wipe out their entire shareholders' capital.

In February, the Bank of England and the Federal Reserve Board issued a joint set of guidelines, raising the prospect that the banks, at some remote future date, might be asked to put up capital to back their "off-balance-sheet liabilities," following a series of hair-raising warnings by bank regulators at semi-public conferences. After the announcement of mega-losses at Citicorp, the Bank of England-Fed proposals appears to have receded into the woodwork, for a highly practical reason: how are the banks, particularly the worst-exposed ones, to raise additional shareholders' capital, when their existing capital may not cover existing losses?

Bank of America's misery

Most exposed of the major banks is San Francisco's Bank of America, the country's second largest. BankAmerica has run two years of losses, without the special $1 billion write-off, forced on it by Citibank's earlier action. Both Japanese institutions and American pension funds have balked at BankAmerica's attempt to raise sufficient capital to avoid a failure that many analysts believe cannot otherwise be postponed beyond the end of this year. Senior officials of Japan's big commercial banks gagged at BankAmerica's request that they buy $250 million in BankAmerica notes as part of its effort to raise $1 billion in new capital. BankAmerica also wants Japanese financial concerns to purchase $100 million of convertible preferred stock. Japanese institutions reportedly said that the bank's insecurity prevented them from buying its equity, under Japanese regulatory standards. American institutions are also leery of a plan under which B of A would sell additional shares to existing shareholders, at a 5% discount.

The securities market bomb

Although the monetary authorities of the leading industrial nations (see *Foreign Exchange*) managed to avoid, or postpone, a major withdrawal of foreign funds from U.S. institutions this spring, the mere threat of such withdrawal nearly brought down big chunks of the brokerage industry. Total pre-tax profits for the brokerage houses are expected to fall to $400 million, from $1.3 billion for the same quarter last year, according to one analyst's estimate, making the second quarter the worst in several years.

Merrill Lynch's $275 million trading loss in mortgage securities last April made clear how vulnerable financial institutions are to a collapse of the securities-market bubble. In July, First Boston said that fixed-income trading losses would probably put it in the red for the second quarter. Salomon Brothers' earnings will be cut in half for the same reason.

These results are all the more remarkable, considering that the monetary authorities managed to stabilize the dollar in June, and the dollar fixed-income markets along with it. When this reverses—and the May trade deficit probably marks the turning point—the securities markets will go back into chaos. That does not merely imply losses for the brokerage houses, but for most savings and loans, and many troubled commercial banks as well. As *EIR* has insisted, the worst-off institutions plunged most heavily into rising securities markets, hoping to compensate for lending losses. That worked reasonably well when markets were rising. When markets crash, the savings industry's last prop will crash with them.

With $40 billion in accumulated liabilities to depositors at "zombie" institutions, the Federal Savings and Loan Insurance Corporation has kept the industry afloat through what senior staff call a "giant government-supported Ponzi scheme," where loss-making, insolvent institutions pay old depositors by paying premium rates for new guaranteed deposits. The run of the century is in preparation, thanks to federal regulators, in the U.S. thrift industry, at the commercial banking sector's moment of greatest weakness.