Banking by David Goldman

Rates rise to the breaking point

Thousands of additional bank failures may result from the interest rate increase.

Roughly 1,000 savings banks, in addition to the 500-plus now considered unsalvageable, will fail if short-term interest rates rise to the 8½-9% range, Federal Home Loan Bank Board analysts calculated earlier this year. Such failures would bring the ultimate cost to the U.S. government, which guarantees their deposits, to the range of $150-200 billion, as opposed to the mere $50 billion now sitting on the FHLBB's desk.

EIR called attention to this time-bomb in the banking system early this year, before the interest rate fuse had burned close to the powder. Now, with 90-day certificates of deposit yielding just 9%, the trouble begins.

Nor is the problem limited to the cited 1,000 savings banks, which are paying short-term market rates to fund a portfolio of fixed-income mortgages. In the weakest parts of the U.S. banking system, the farm and oil belts, commercial banks employed the increase in their bond portfolios during the big bond market rally of 1985 to cover for losses in their lending operations. By selling bonds at a profit, banks in the Dallas Federal Reserve district cut their losses in half, a survey by the Chicago Federal Reserve showed.

Now, that source of apparent profits has evaporated, precisely at the point that the oil belt's banking crisis has come to a head.

The actual total of Texas bank failures this year to date is 116, not the reported 42. The bailouts of the BancTexas group and First City Bancorp were, in effect, closures of those holding companies' banks, under the euphemism of "assisted transfer." BancTexas had 11 subsidiary banks (fully independent banks, not branches) and First City had 61. In addition, two private banks failed in Texas this year, which do not show up on FDIC statistics. Thus, the actual number of bank failures in Texas this year is the FDIC "official" failure list of 42, plus the 61 banks associated with the First City bailout, and 11 associated with the BancTexas bailout.

Federal Deposit Insurance Corporation Chairman William Seidman is predicting that about 200 banks will fail this year. Last year's then record high of bank failures was 144; 158 had already failed during 1987, as of Oct. 5. Of the 13,937 banks regulated by the FDIC, 1,609 were on the "problem" list as of the agency's mid-year review. The rise in banks' cost of funds will force a large proportion of these banks out of business immediately; the indirect effects, e.g., in the real estate market, will claim an even larger number.

What pops out of the woodwork may, however, eclipse the known dangers. First Bank of Minneapolis's admission Oct. 12 that it lost $700 million by "misjudging" the bond market extends the pattern of major speculative losses arising from the April-May plunge in U.S. bond markets. Merrill Lynch, First Boston, and other big players registered multi-hundred-million-dollar losses during that period.

With the assistance of foreign central banks, the Federal Reserve stabilized bond prices. Now that the yield on U.S. long-term Treasury bonds has risen to about 10¼% (as of Oct. 16), 2½% higher than a year ago, and bond prices have crashed correspondingly, it is inevitable that major institutions will face huge losses. Some of these might be of sufficient size to trigger a crisis of confidence.

Among the major brokerage houses, Salomon Brothers has already reacted, by laying off 800-1,000 employees and closing both its municipal bond and money market units. Salomon dominates the U.S. Treasury securities market. Kidder Peabody will lay off 100 employees. Reportedly, Deutsche Bank, Germany's largest, will close down its New York bond-trading operations, due to the "instability" and "unpredictability" of U.S. markets, Frankfurt sources report.

Much more difficult to gauge is the potential for trouble in the nearly $200 billion per year Eurobond market, which, since the 1982 banking crisis, has dominated international lending.

The deregulation of the London securities market in October 1986 persuaded numerous firms to commit capital and staff to expanding their Eurobond operations. A year later, the *Wall Street Journal* wrote Oct. 14, only "three types of players generally remain in the market here: the bruised, the badly bloodied, and those in a body bag."

Banks "securitized" their assets after 1982, hoping that holding tradeable debt, rather than book loans, would allow them to bail out in case of trouble. The folly of "securitization" became clear in December 1986, when a $200 billion section of the market, in floating rate notes, stopped trading. The failure of one significant Eurobond market-maker could turn literally hundreds of billions of dollars of bank assets illiquid overnight.

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