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$3 trillion in off-balance-sheet liabilities are on the brink

by David Goldman

Through the summer of 1986, U.S. bank regulators issued grim warnings about bank and brokerage-house exposure in the form of off-balance-sheet liabilities, guarantees issued in exchange for immediate fees. Early in 1987, the Federal Reserve proposed guidelines for restricting the growth of such liabilities. At that point, discussion ceased, like the mention of an incurable illness in the presence of the soon-to-be-deceased. The central banks determined that the problem was inoperable, and chose to ignore it and hope for the best. Now it waits at their collective doorstep.

Several trillions of dollars worth of such guarantees are on the books of major financial institutions. A large portion of them went sour in the wake of Black Monday. The central banks do not know either the total volume of exposure, or the portion of that exposure ruined by the stock-market crash and related events.

However, what has popped to the surface during the past two weeks indicates that the order of magnitude of the present disaster exceeds the scale of the Third World debt crisis. The more than $3 trillion of guarantees include such major categories as

1) straight guarantees of loan repayment

2) interest-rate or exchange-rate insurance on loans

3) currency, equity, and bond options sold as "portfolio insurance" for the buyer

4) open foreign exchange and bond trading positions

5) "currency swaps," "interest-rate swaps," and other supposed means of diversifying risk, which leave the bank or brokerage-house holding the bag if one party to the transaction defaults.

End of bubble insurance

"Off-balance-sheet liabilities" are the history of the stock-market bubble, written onto the ledgers of major financial institutions. A precondition for the promotion of the securities-market bubble, which all major players viewed with suspicion, was the simultaneous expansion of "hedging" or "portfolio" insurance operations. Typical was the London option exchange, trading 64 varieties of guarantees of currency, stock, and bond values. Its volume rose by 180% during the 12 months since October 1986.

The major institutions, which ultimately write such insurance policies, and must pay on them in the event of trouble, are holding the bag. Their off-balance-sheet liabilities, in the case of the 10 top U.S. banks, now exceed 1,000% of their total shareholders' capital. The banks argue that such liabilities represent little risk, because the banks themselves adjust their own portfolios to compensate; e.g., if a bank guarantees payment in a certain currency at a certain rate, it should buy that currency forward, in a matching transaction.

The last two weeks have made hash of the entire business of hedging, because securities prices and currency rates have collapsed so quickly, that the insurers find themselves exposed to the point of bankruptcy. The model for the dissolution of the hedging market can be found in Hong Kong, where brokers who issued futures contracts to sell stocks at a fixed price, now refuse to make good on those contracts, for the simple reason that they lack the funds to do so. On the global level, the great issuing-houses, including major banks and stock-brokerage firms, cannot meet their obligations as insurers of the bubble. That is why hundreds of billions of dollars of tradeable securities are now illiquid.

The Eurobond disaster

Central to the problem is the great gray area of international finance, the $600 billion Eurobond market. The collapse of international bank lending after the 1982 Mexico debt crisis gave way to an era of wildcat securities-issuance on the international market. Last year, $220 billion anonymous, unregistered, untraceable bearer securities, known as "Eurobonds," were sold on the international markets. Designed during the 1960s as a vehicle for anonymous flight capital, Eurobonds came to dominate international capital-raising, as flight capital came to dominate the international markets.

Between December 1986 and February 1987, a large part of the Eurobond market ceased trading. The so-called "perpetual floating-rate note" sector died a sudden death in December, when Japanese banks, long the buyer of last resort for international paper, dumped them on the market. These notes, which offered interest paid in perpetuity, were a gimmick devised by big U.S. and British banks to increase their shareholders' capital. The Japanese and others looked at the Brazilian debt situation, then beginning the descent toward the February 1987 debt moratorium, and decided that the banks might be less perpetual than they seemed.

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The rest of the floating-rate note sector, another $100 billion worth, dried up during February and March, for the simple reason that the tiny increment over banks' own cost of funds offered in these notes did not pay banks to keep them.

Now, perhaps an additional $100 billion of Eurodollar paper has ceased to trade. That does not represent the extent of losses to the banks; it merely shows one surface symptom of the general failure of the system of guarantees associated with the 1982-87 bubble.

Major international banks and brokerage houses found they could make more money by guaranteeing Eurobonds, than by issuing them. Underwriting income, i.e., the issuers' fees associated with bond flotations, collapsed to virtually nothing during the past two years, as all major institutions dived into the business.

According to public announcements, $19.3 billion of Eurobond issues during 1986, and $17.6 during 1985, carried some form of bank guarantee, known in the trade as "bells and whistles." That is, a participating bank attached to the bonds, a currency-option, an option to buy gold, an option to buy Treasury securities, or simply guaranteed that the borrower would obtain a higher yield if interest rates were to rise.

Of 1986 issues, $4.6 billion carried an option to convert the principal, at maturity, according to the performance of gold, currencies, or stocks; $600 million carried an option to convert payments into another currency; $6.5 billion carried some kind of interest-rate guarantee; a small amount carried an option to buy gold; and so forth. Over and above the $19 billion of "bells and whistles" bonds, investors bought a huge stream of so-called "convertible bonds," bonds priced at a lower interest rate, which the investor, at his discretion, might convert into the stock of the same company.

As noted, perhaps $100 billion of "exotic bonds," as well as "convertible bonds," ceased trading during the stock-market frenzy following the Oct. 19 crash. With the stock markets in jeopardy, the value of a bond convertible into collapsing equity becomes unclear. More drastic are the problems associated with bonds containing an interest-rate or exchange-rate guarantee. The stock-market crisis originated with the sharp rise in U.S. interest rates forced by the falling dollar. Now that interest rates and the currency markets are swinging wildly in the wake of the stock-market crash and the end of the February "Louvre" agreement among central banks to stabilize currency prices, the meaning of such "guarantees" against interest-rate shifts disappears, along with the value of paper containing such guarantees.

A few Eurobond issues, ordinary fixed-income bonds issued by the largest, and supposedly soundest, corporations, benefited from the flight to such "quality" paper as government bonds, in the wake of the stock-market crash. The rest of the market, particularly the "exotic" issues, but also second-tier bonds, have now become virtually untradeable.

One modest bankruptcy of a second-tier brokerage house active in Eurobonds would force the liquidation of securities which now sit illiquid in its portfolio, forcing a price collapse of those, and similar, securities. Commercial banks, whose overseas offices count such securities as a substantial portion of their portfolios, would see the value of their portfolios collapse overnight.

Re-regulation

Some observers believe the central banks will step in and force the "re-regulation" of the wildcat overseas markets. The London *Financial Times* warned Oct. 24 of a "sea change in social and political attitudes," away from *laissez faire* and "market forces," toward greater government involvement in the economy. "If this week's market crash does not presage another Great Depression, it might still represent a turning point in the history of ideas. . . . It might be that economic policy is in the process of turning full circle," toward more "government intervention and managed markets."

The Swiss daily *Neue Zürcher Zeitung* warned Oct. 27 of the "end of deregulation," arguing, "The tumult on the stock markets has shown that in the context of global interdependence and advanced deregulation of the markets, the pursuit of nationally autonomous economic policy has increasingly become impossible, because the markets sooner or later force an adjustment. The problem is that the markets by no means present an efficient corrective. In the last few years, market developments have repeatedly become absurd, especially the extreme overvaluation of the dollar and its related correction, the development of interest rates, the inflation of stock market indices, and their ensuing collapse. . . . London market observers conjecture that economic policymaking circles could now conclude, that the tearing-down of the overregulation of the postwar period has gone too far, and will be replaced by a stronger involvement of governments in market developments. On the practical level, that means that the events of the last week will lead to a phase of re-regulation of the markets, beginning with the futures and options markets, but also in the form of sharply higher capital requirements for banks and brokerage firms."

But U.S. Federal Reserve officials, who have reason to be less sanguine than the Swiss, warn that the banking system cannot absorb higher capital requirements at the precise moment that it must absorb untold losses. Their proposals include no increase in capital requirements. From the standpoint of the market bubble, re-regulation is like prescribing a sugar-free diet, for a diabetic found dead of insulin shock at the candy-counter.

At this stage of the crisis, it is not difficult to forbid the banks to do, what they can no longer do anyway. The problem is to ensure that a large enough portion of the banking system survives, and can be made to do what it must, namely provide low-interest credits to revive hard-commodity production and international trade.