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U.S. banking crisis enters a new phase

by Chris White

The national banking crisis, simmering as it were on the back burner for a while, seems now to be on the verge of erupting into a new phase. Actions taken during the week ending Friday, April 22, by leaders of the two principal regulatory agencies, the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC), signal that the simmering crisis is about to bust out of what has looked to many like a bank-by-bank, region-by-region affair, into a full-blown national banking crisis.

The developments were twofold. Speaking Thursday, April 21, to an audience in Boston, FDIC chairman William Seidman told his listeners that his outfit is abandoning the "double track policy" it has maintained since the spring of 1984 collapse of Continental Illinois, the largest bank rescue operation in U.S. history. Under what Seidman calls "the double track" policy, the FDIC, as it did in the case of Conti Illinois, has stood behind, not only insured deposits of banks, but also shareholders' capital in bank holding companies.

Henceforth, as per statutory mandate, the federal insurer will revert to only providing coverage for qualified insured deposits. Seidman talked about "fairness" and other nice things. The plain fact is that neither the FDIC, nor actually anyone else, has the money available to continue the policy that has been in effect since 1984. Seidman told his listeners that the FDIC's actions in Texas, in the cases of First RepublicBank of Dallas, and First CitiBancorp of Houston, signaled the beginning of this new policy.

Earlier in the week, officials of the Federal Savings and Loan Insurance Corporation and the Federal Home Loan Bank Board had gone to the press with the 1987 financial balance sheet of the agency they are responsible for. They reported that the FSLIC had moved deeper into the red during the year, reporting a loss of over $6 billion, and an increasing negative net worth of between $11 and $13 billion. FSLIC's books cannot be approved by auditors until the congressional General Accounting Office has completed its review. At this point it is the GAO which argues that the higher figure is the correct one, the thrift industry types who argue for the lower one.

No one was fooled by the evident sincerity of chairman Danny Wall's emotional insistence that the system was so sound he had advised his mother to put her savings into thrifts. It didn't seem too becoming for the chairman of the regulatory board of the nation's bankrupt thrifts to cast himself in the role of a real-life imitation of the well-known "Joe Isuzu" ad—"strike my mother dead if I tell a lie." Nor was there much concern about the discrepancy between the FSLIC's and GAO's numbers. Congress empowered FSLIC, a year ago, to borrow about $10 billion from money markets over a three-year period to cover the deficit. Either number for the reported deficit is in excess of the borrowing power of the insuring agency.

Safety net revealed inadequate

The combination of the two reports indicates the fire that is beginning to burn away under the banking system's regulators, and more particularly under the administration's officials reponsible for monetary and financial policy. Both agencies are no longer up to fulfilling the mandate which has been given them. The next time the banking crisis erupts, which in the view of circles in London and Switzerland, could be as early as May or June of this year, the inadequacy of the nation's banking insurance, or "safety net system," will begin to be evident for all to see.

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Publicly, it is the thrift system, which, at this point, appears to be the most vulnerable of the two. These appearances, however, are really deceptive. Certainly the loss-making thrifts are financially over the edge. Certainly the cost of liquidating what will rapidly be 500, then 800, then 1,000 failed thrifts will be minimally a whole order of magnitude greater than the $20 billion or so the regulators insist they will have to put up.

In reality, the commercial banking system, with 0.13% return on its assets for last year, is in far worse shape than the thrifts will ever be. Thrifts have been forced into international money markets to obtain funds, to compensate for the destruction of their earnings by Volcker's high interest rate policy of 1979-82. That dependence leaves the system vulnerable as never before to the effects now of interest rate increases, since the cost of borrowing funds will rapidly outstrip their earnings on fixed-interest mortgage security assets. Leaving that part of the problem aside, the thrifts, tied in as they are to the wage and salary side of the economy, to the construction business, and to the real estate which collateralizes their lending, are in much better economic shape than the commercial sector of the banking system.

The commercial banks essentially moved out of its traditional business of lending during the course of 1982-83. Instead of lending for wealth-creating projects, the advocates of what was then called "creative" or "innovative" financing, moved whole-hog into what is called "securitization," which means buying and selling each other's paper, or taking in each other's dirty laundry. Their earnings were thus divorced, finally and completely, from the returns which come from economically vectored lending for wealth creation, seen as an increase in a nation's physical capital, to depend on commission earnings from the sale, and resale of one or another form of interest-bearing paper. In the intervening period, they built up, from nothing in 1982, a pile of between $7 and $10 trillion worth of so-called "off-balance-sheet liabilities."

In so doing, they outsmarted themselves with their so-called "creative financing." The upcoming banking crisis, expected in some quarters to hit New York's Manufacturers' Hanover and, because of its Texas liabilities, Chemical Bank, as well as perhaps the tottering Bank of America, will prove that their banking system has become the biggest victim of such creative financing schemes. Interrupt the paper pass-through churning system, at one, two, three, however many vital points, and the system as a whole collapses, like any other chain-letter swindle scheme. U.S. commercial bankers have signed up for real-life classes provided by themselves to learn about the meaning of "reversed leverage."

One set of measures could be adopted, as soon as the decision were made to do it, and could put a stop to the whole nonsense. It's the core of presidential candidate Lyndon LaRouche's financial and economic reorganization program. Divide outstanding debt and obligations into two classes: that which can be protected, because economically viable in terms of the potentials of the system as a whole under a return to wealth generating policies of economic growth, and that which cannot. Let the latter category go, while redirecting credit, through the issuance of gold-reserve-backed Treasury notes, at a level of about $2 trillion per annum, into the banking system for productive investment in industry, agriculture, infrastructure development, and development of export markets.

The alternatives are so silly they are ridiculous. The consequences of such incompetent stupidity are devastating. They include merging the FSLIC and the FDIC, ridiculous on the face of it, because neither agency can do what it is expected to have to do anyway. Or, liquidating chunks of the system, which will bring down the whole thing, and precipitate full-blown depression. Or, liquidating the Federal Home Loan Mortgage Corporation, to permit its $200 billion pile of mortgage securities to be put behind the FSLIC. This removes the implicit "full faith and credit" backing of the U.S. government from mortgage markets, so it, too, would, in a manner of speaking, only make things worse. Or, which is what is being done, regulatory backing for selected private reorganizations of the most egregious of the basket cases in the thrift and banking system, in the hope that this will plug the holes in the fabric of the system for just a bit longer. Here the problem is that the holes are rapidly running out of surrounding fabric.

But that hasn't stopped the Federal Home Loan Bank Board from backing the Bass Brothers of Dallas in an attempted recapitalization of Irvine, California's Financial Corporation of America. Nor has it stopped the first phase of implementation of the pathetic "Southwest Plan" for the S&Ls, around the case of Pelican Homestead S&L of Metairie, Louisiana. Nor has it stopped the similar FDIC-mounted effort in regard to the tottering Texas commercial banks.

Where does the money come from?

Where does the money come from to finance such efforts? It's borrowed, of course. It might seem strange to attempt to recapitalize whole chunks of the banking system with borrowed funds. It might even be said that this would only make things much worse. The regulators think it's cheaper. And George Bush and his friends don't want to incur the penalties, primarily political, of presiding over the destruction of the U.S. banking system before next November's elections.

Meanwhile, the interest rate on the Treasury's "long bonds" is back over 9%, and heading back to the level of 10%-plus, where it was right before the crash of Oct. 19. That weekend there were emergency meetings in anticipation of an Oct. 19 failure of the $30 billion Financial Corporation of America. When interest rates were lowered to stem the market melt-down, FCA was temporarily reprieved. Next time around, the regulators are not going to be so fortunate, nor will George Bush.