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Banks on slippery slope of deflationary collapse

by William Jones

Hearings before the Financial Institutions Supervision, Regulation and Insurance Subcommittee of the House Committee on Banking, Finance, and Urban Affairs on Sept. 19, gave a small glimpse of the extent of the crisis facing U.S. commercial banking. The hearings, called by Subcommittee Chairman Frank Annunzio (D-Ill.) to examine the state of the federal deposit insurance institutions after their reorganization in the aftermath of the blowout of a large section of the U.S. thrift industry, revealed an extremely tenuous situation facing the U.S. banking system and the insurance organizations which are to protect their depositors from eventual losses.

During the last few years, public attention has been primarily focused on the rapid collapse of U.S. savings and loan institutions. In spite of the major overhaul of the Federal Savings and Loan Insurance Corp. (FSLIC) through its merger with the Federal Deposit Insurance Corporation (FDIC), the crisis still remains an open sore, and no one even now knows how much it will ultimately cost. Although the banking industry's insurance funds are not to be used for propping up the savings and loan business, it was thought that putting the S&Ls under the care of the more stable FDIC would imbue confidence in the thrift industry. Some warning voices were raised concerning the danger that the merger would put the FDIC at greater risk and possibly endanger the relative stability of the banks' insurance funds. Little notice, was taken, however, of how fragile the FDIC itself actually was.

Part of the truth, which has been far more fully exposed in *EIR*, came out in the testimony on Sept. 19 of three economists, R. Dan Brumbaugh of Stanford University, Robert E. Litan of the Brookings Institution, and Andrew Carron of First Boston Corp., who had done a study of hitherto undisclosed bank problems. Already back in 1985, Brumbaugh—then an economist for the Federal Home Loan Bank Board—had shocked the Senate Banking Committee by testifying that FSLIC was in fact bankrupt, but that the true extent of its losses had been hidden by the way S&Ls and government regulators kept their books. More recently, the three economists analyzed the books of 5,000 of the nation's largest banks, using the same techniques that provided that early warning of the crisis in the thrift industry. "It is like the FSLIC crisis in the past, where the banking regulators have an incentive to underestimate the cost," said Brumbaugh.

"The annual number of bank failures has topped 200 since 1987, the highest bank failure rate since the 1930s, and shows no signs of falling this year, despite earlier predictions by the FDIC to the contrary. More disturbing," Brumbaugh continued, "many more weak, or even insolvent banks remain in operation." The study indicated that hidden bank losses could wipe out $10 billion of the $14.1 billion reserves of the FDIC, leaving the fund too weak to protect depositors against a major economic downturn. Using a risk-adjusted capital ratio of 6% as an adequate level, the study found that 28 large banks with $23 billion in assets were still open, but insolvent. Another 48 institutions holding $43 billion in assets had risk-adjusted capital ratios below 3%. Still another 150 banks with assets totaling $926 billion had capital ratios between 3% and 6%.

One-third of banking assets are soft

"In short," Brumbaugh told the assembled congressmen, "roughly $1 trillion of assets—or one-third of the assets in the nation's banking system—were being managed as of September by banks with substandard capital ratios. The data did not include the roughly 8,000 banks with assets below $50 million—the group of banks where most bank failures

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in recent years have been concentrated."

The issue of the capital ratio has been a bone of contention among the regulatory authorities—an issue which could determine the rate of collapse and the timetable for bank failures. Recently, Comptroller of the Currency Robert Clarke made a proposal that the capital ratio be reduced to 3% of assets. Clarke characterized a 3% minimum as the "floor" beneath the industry's new standard, in which capital requirements are based on the riskiness of a bank's loans. FDIC chairman William Seidman, on the other hand, has pushed for a 6% minimum, to better protect the FDIC from bank losses.

The lower figure might possibly help some of the insolvent banks to stay afloat a few months longer, perhaps serving to postpone a "run on the banks" until next year, but will thereby increase the volatility and the extent of the collapse when it does hit. Seidman's "safer" 6% capital ratio will assure that a ratchet of bank failures will come much sooner, with the more exposed banks biting the dust quite soon, perhaps as early as October of this year.

In principle a 6% capital ratio applies presently to banks generally; but in practice, it is not the case. In many banks, the 6% stockholders' money has already been set aside to cover past losses, so there is no protection left, commented Litan and Brumbaugh. The charge was confirmed by Clarke, who said at the hearing that a few banks' capital consists entirely of loan loss reserves. "Translated into English," said Litan, "they're gone."

The Brumbaugh testimony gives some indication of at least the tip of the iceberg. The FDIC's "problem bank" list, which counts all banks receiving substandard bank ratings from supervisors, indicates nearly 1,300 weak banks as of the first quarter of 1989. As the study points out, there are more than three times the number of problem banks now open for business than during the previous postwar peak year of 1976 (385) and more than six times as many as in 1981, when the nation was entering its deepest fiscal recession since the 1930s. "Quite clearly," admits the study, "the number of problem and failed banks could easily mushroom if the economy falls into recession."

Subcommittee chairman Frank Annunzio expressed alarm at the figures. "You gentlemen have painted one hell of a gloomy picture." When Annunzio asked if that meant that the FDIC is headed for failure," Litan replied, "For nervous Nellies like me, it means there's a problem out there that's worth worrying about."

FDIC chairman Seidman tried to allay fears that the insurance corporation would not have sufficient funds to cover eventual bank failures. "The Bank Insurance Fund is solvent and can meet the obligations as we foresee them today," he commented—conveniently ignoring the question of what he might foresee tomorrow.

The Vice Chairman of the Board of Governors of the Federal Reserve System, Manuel Johnson, was not quite as confident. He pointed out that at the end of 1988, the fund equaled less than 1% of all insured deposits. He pointed to the problems for banking stemming from the collapse in oil prices and "overbuilt real estate markets" in the Northeast and in pockets of the Southeast, which have "shown growing signs of weakness during the past year." "This factor," said Johnson, "combined with the rapid growth of real estate development lending by banks in those areas, suggests that some new problems will appear there."

But even Seidman had to admit that the junk bond exposure of some of the major banks could cause serious problems. "Banks have currently invested about $150 billion in leveraged buyout loans," said Seidman. "Rising interest rates or an economic downturn could result in highly leveraged businesses defaulting on these loans. . . . Should there be an economic downturn, defaults on such debt could increase the risk of failures and thereby increase costs to the FDIC." He assured the committee that the FDIC was taking "special supervisory action" to monitor banks' participation in high-risk junk bonds and highly leveraged loans.

The regulators might be uttering soothing words to calm the fears of the general public, but the banks are manifesting an entirely different awareness of the problem, and are scrambling to extricate themselves from the mess. The announcement on Sept. 20 that Chase Manhattan Corp. was boosting its reserves for possible loan losses to the developing sector by $1.15 billion—the highest levels of any major U.S. bank—now places them in the same category as Manufacturers Hanover, namely, those rare birds in the banking world who admit that they don't have sufficient reserves. Chase has also written off $125 million of real estate loans in Arizona, and is getting out of another major risk-ridden area, mortgage-backed securities.

In spite of the reassurances of Seidman, Clarke, and others, the banks themselves are admitting the problem—with their feet. But no matter how fast they scramble, the accumulated years of benign neglect in this fantasy world of financial "junk" are going to take their toll. One noted London analyst had the following comment to make: "It is the beginning of the end of the world as we have known it over the past decade. The Seidman testimony brought to the light of day the fragility of the insurance corporation. A period of global deflation has begun. The downward spiral is on."

Will the Bush administration be able to pull the chestnuts out of the fire? The scenario of careful "crisis management" relied on by Bush's current economic and financial advisers to take the administration smoothly through the economic crisis without a major upheaval, has pretty much played itself out. The stalemate in Congress over the capital gains tax and catastrophic health insurance indicates the Gramm-Rudman-Hollings sequestration will be brought into effect, hitting the U.S. budget like Hurricane Hugo, and leaving the administration financially crippled when the tornados start to hit the financial world. If the Bush administration is to effectively deal with a crisis of this magnitude, new gimmicks won't be enough.