

Banking by David Goldman

Global brokers in big trouble

Why many observers think that the October deregulation of the London market could bring it all down.

Although the bank regulators are shaking with fear about commercial banks' "off-balance-sheet liabilities," they rarely mention the expanding, quasi-bank functions of the major brokerage houses, e.g., Merrill Lynch, First Boston-Crédit Suisse, Salomon Brothers, and Shearson Amex. As underwriters of options, swaps, and similar forms of foreign-exchange or interest-rate guarantees, they have taken on a credit-creating function, and their activities are in many respects indistinguishable from those of the banks.

The difference is that their market capitalization is much thinner, even when the banks' full liabilities (including off-balance-sheet liabilities) are taken into account.

Brokerage house stocks traded on American exchanges reached a 52-week high point in mid-April 1986. It became known that they suffered a collective loss of between \$300 and \$400 million in their portfolios of U.S. government-sponsored mortgage securities, and the news forced their share prices down by 10% to 25%. Brokerage-house profits for the second quarter are likely to be roughly one-third of their year-earlier levels. Perversely, the drop in U.S. interest rates engineered by the Federal Reserve brought down the relative price of government-sponsored agency bonds, which pass through the income of home mortgages packaged by the Government National Mortgage Agency and similar entities.

Unlike most corporate bonds, most mortgages are renegotiable at lower

interest rates, and the eight-year low for home mortgages left the agency issues open to substantial renegotiation. The threat of renegotiation of the underlying mortgages lowered the price of agency bonds. Normally, they bear a yield about 1% more than Treasury securities. By late May, they were trading at about 2.3% more than Treasury securities, reflecting their lower price.

What is remarkable about the episode is that a misadventure in only one of the dozens of major sectors in which the large brokerage houses are active, was sufficient to wipe out two-thirds of their profits.

Although numerous factors have an impact on the risk of a brokerage firm's failure, the above numbers indicate that the market conditions which cause brokerage houses to sustain major losses on those operations which they conduct for their own account, could have a devastating impact on the industry. The major brokers are operating on the scale of the big international banks, with a fraction of the banks' miserably inadequate capitalization. Precisely what the real risk attached to the global brokerage firms may be, is difficult to discover from available data. Salomon Brothers wrote in an April 11 report on the investment industry:

"When viewing the broker/dealer balance sheet, riskiness is a blend of perceptions. To perform the market-making function of executing large transactions, capital is placed at risk by the assumption of substantial po-

sitions for the broker/dealer's own accounts. But the structure of a transaction in terms of financing and hedging can have a variable impact on the balance sheet. Meanwhile, futures, forwards, and other contractual obligations [what banks call off-balance-sheet liabilities—ed.] are not even encompassed on the balance sheet. . . .

"We do not want investors to throw up their hands after trying to glean information on the financial status of the broker/dealers. . . . We reaffirm our tenet that the most efficient method in estimating longer-term earnings for institutional broker/dealers . . . may very well operate like in a return on equity approach."

Salomon's evaluation amounts to a restatement of the old gag about the man who hurls himself from the top of a skyscraper; as he passes each floor, he is heard saying, "So far, so good." If the broker/dealers have done well puffing up a market bubble, one should expect they will do well when the bubble collapses, the argument goes.

On the contrary, some of the most sophisticated financial observers look toward the deregulation of the London market as the possible trigger for a global financial crash. On Oct. 27, brokers will no longer charge a fixed commission for stock trades, eliminating the bread-and-butter of London Stock Exchange business. Many firms may either have to merge or fail, as the survivors compete for profits deriving from "off-balance-sheet" activities. However, the failure of a major writer of options or futures contracts would destroy the hedges of many other firms, endangering their capitalization. Since the brokerage firms have taken on a bank-like function, the failure of one or many would destroy a volume of other firms' assets many times in excess of their own capitalization.