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International Credit by EIR Staff

Banks' paper crashes on world markets

The discount against U.S. banks' medium-term paper is as bad as during the 1982 Mexico crisis.

Federal Reserve specialists are monitoring the collapse of U.S. banks' publicly traded offshore paper on a minute-to-minute basis, following the Brazil and Ecuador declarations of debt moratorium. U.S. banks obtained tens of billions of dollars of new capital by issuing floating-rate notes on the offshore, or Eurobond, market. These notes are now yielding at about two-fifths of a percentage point more than Treasury securities of comparable (usually 7-10 year)
increase when bond prices fall.)

That "spread" between bankers' paper and government paper measures, in a handy way, how much riskier investors think it is to put their money with the banks. In fact, the problem is much worse than even the sharp decline in prices for bank paper would indicate: Eurobond dealers are sitting on large amounts of bank paper they want to liquidate, but fear a collapse of the market should they attempt to do so.

Normally, bankers' paper pays a mere one-tenth of a percent above Treasury paper. But Brazil's debt moratorium raised the short-term prospect of a bank crash, and Japanese institutions, in particular, unloaded their holdings of American bank paper.

Banking sources report that their paper collapsed after New York's Citicorp announced that it might put its Brazil loans on non-accrual status. Regional banks' paper was not affected.

Only once before in postwar banking history did the "spread" between Treasury and bank paper reach the present level, namely, when Mexico nationalized its banks and declared de facto bankruptcy.

By one measure, therefore, things are right back to the worst period of the Third World debt crisis. But the condition of the banks is infinitely worse.

As the London *Economist* ticked the problems off in its March 21 World Banking Survey:

"• In 1986, 145 American banks failed or were helped to merge—the most in half a century. Another 1,484 were officially reckoned troubled at the end of the year, a third more than 12 months earlier;

"• Two of Canada's 14 banks failed, the first failures since 1923. Japan's sixth largest mutual bank had to be rescued, the biggest since the war. Hong Kong banks are falling like flies.

"• The percentage of loans that American banks write off as uncollectible has grown by 50% since 1982 to 0.86% in the first half of 1986. The proportion for Britain's four big clearers has almost doubled between 1982 and 1985;

"• Off balance-sheet commitments of banks have ballooned—to $1.4 trillion at America's seven biggest banks by September 1986, on balance-sheet commitments totaling less than $550 billion; Moody's Investors Services and S&P have degraded three big banks in the last six months—MHT and Citicorp in America, Paribas in France—and are reviewing Merrill Lynch."

For the past six months, *EIR* has warned that the supposed cure for illiquid bank assets, namely "securitization" of assets, had left bankers with a mountain of bad paper on their books, which might turn illiquid the moment anyone decided to cash it in. The *Economist* survey admits as much: "Bond financing in international markets has grown from $39 billion in 1980 to $225 billion in 1986, while syndicated bank loans have shrunk from $80 billion to about $50 billion. . . . The process increases risk . . . by plunging many banks long familiar with assessing credit risk (the chance that a debtor will default) into sizing up market risk (the chance that the price of something will change unexpectedly), with which they are less familiar."

Without the English understatement, that means that a relatively small collapse in value of the trillions of dollars of Eurobonds, options, futures, and other exotic inhabitants of bankers' portfolios, could wipe them all out overnight.

As *EIR* reported last week, close to $170 billion of floating-rate notes stopped trading in the third week of March, leaving bankers with that much illiquid paper on their books. The Eurobond collapse, meanwhile, had instantaneous repercussions on the U.S. bond market: Offerings of collateralized mortgage obligations plunged in that week, because this relatively new form of mortgage-backed security is predominantly floating rate. Since overseas, including many Japanese, investors support the market for mortgage-backed securities, the collapse of overseas floating-rate securities wiped out the domestic floating-rate sector as well. Exactly $5 billion worth of this paper was issued in March, i.e., a weekly rate of about $1.25 billion; only $375 million were issued in the third week of the month.

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