EIR Economics

Federal regulators fear a banking panic

by John Hoefle

The fear of a public panic is never far from the minds of federal banking regulators these days, as evidenced by an extraordinary press conference on the health of the banks held by regulators in Washington on Oct. 23. Federal Reserve System governor John LaWare, in his capacity as chairman of the Federal Financial Institutions Examination Council, called it to denounce the recent "Banking on the Brink" study by Roger Vaughan and Edward Hill. Joining LaWare were Andrew Hove, acting chairman of the Federal Deposit Insurance Corp. (FDIC), and representatives of the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

"In our judgment," LaWare said, "the estimates in Messrs. Vaughan and Hill's study are alarmingly high and almost totally out of line with our analysis and realistic expectations. Public confidence in the banking system is essential for the smooth operation of the economy, and it is not in the public interest to have that confidence undermined by misleading research conclusions."

LaWare's attack on the study for alarming the public and undermining public confidence in the banking system is a continuation of the deliberate policy by federal regulators of concealing the insolvency of the U.S. banking system as a whole, and of the big banks in particular. Were the public to learn the truth about the banking system, the resulting panic would quickly overwhelm the regulators' covert bailout of the big banks, and bring down the entire house of cards.

The 'December Surprise'

The regulators' "speak no bankruptcy" policy continued at an Oct. 26 hearing of the Senate Banking Committee, called to discuss the possibility of a "December Surprise" rash of bank failures beginning Dec. 19, when the 2% tangible capital-to-assets ratio mandated by the FDIC Improvement Act of 1991 takes effect. On that date, banks which fail to meet the 2% standard will have no more than 90 days to find new capital, sell themselves to healthier institutions, or convince regulators they are on a path to do so; otherwise, regulators will be required by law to close them down.

Committee chairman Don Riegle (D-Mich.) opened the hearings by noting that the FDIC had projected that 200 banks with assets of more than $80 billion would fail in 1992, but that through the end of September, only 80 banks with assets of almost $22 billion had been closed. This discrepancy has caused many observers to accuse the agency of slowing the pace of closings for political purposes.

Such accusations were quickly denied by Hove. "The fewer than expected closures of banks thus far in 1992 have been due to low interest rates and the ability of some troubled banks to improve their condition," Hove claimed, citing the mythical $16.7 billion increase in the total equity capital of the U.S. banking system during the first six months of 1992, thanks to two quarters of mythical record profits. Hove further claimed that the 85 banks with total assets of some $29 billion, which the FDIC had closed through Oct. 16, represented "an extremely high number by historical standards."

There will be no "December Surprise," Hove testified. As of June 30, only 263 FDIC-insured banks with assets of $98 billion were considered undercapitalized, compared to 432 at the end of 1991. Of those 263, only 60 banks with assets of $25 billion were considered "critically undercapitalized," and 14 of them, with assets of $6.7 billion, had been closed by Oct. 16. That leaves 46 banks, with assets of some $17.3 billion, on the list. But, as Hove noted, those numbers will change before the deadline.

Hove projected that 100-120 banks with assets of some $37 billion would fail in 1992, meaning that another 15-35 banks, with assets of $8 billion, are expected to close by Dec. 31. The agency expects another 100-125 banks, with

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assets of $76 billion, to fail in calendar year 1993. During the entire 1992 to 1996 period, Hove said, the assets of failed banks should total $268 billion.

The Fed's LaWare continued the regulatory coverup, claiming that the slowed pace of bank closures was solely due to "conditions at each bank." He criticized the Hill-Vaughan study for its "extremely pessimistic" assumptions, "serious errors and shortcomings," and poor methodology. While there are a few problems, LaWare said, "a turn-around in the commercial banking industry seems well under way," and that process would be accelerated were Congress to reduce the "regulatory burden on banks."

LaWare denied that the Fed had been subsidizing the banking system through lower interest rates. "We do not make monetary policy for the benefit of any industry," he stated, directly contradicting statements by Fed Chairman Alan Greenspan earlier this month and in July, that the purpose of the Fed's series of interest rates cuts was "to facilitate the adjustment process" and help the banks "rebuild their balance sheets."

Acting Comptroller of the Currency Stephen Steinbrink completed this sideshow by warning that "even the strongest banking system cannot survive a crisis of public confidence" and voicing his concern "that reports of a 'December surprise' and allegations of undisclosed bank problems raise needless fears on the part of the public."

Dishonesty exposed

The dishonesty of the regulators' position was exposed by three witnesses in the second panel: Edward Kane, a professor of finance from Boston College; economist Dan Brumbaugh; and author Martin Mayer.

Kane testified that the accounting practices used by the banks "have much in common with the rigged scales butchers use to overcharge their clients. With a show of precision, they systematically and repeatedly mismeasure" the true financial conditions of the banks by allowing "large embedded losses to be hidden from public view." He accused regulators of "feigning ignorance about the extent of these hidden losses" and "allowing a risk-loving horde of living-dead institutions to prey on financial markets.

"The economic condition of crippled banks today parallels that of an AIDS victim who has been lucky enough to get over a bout of pneumonia," Kane said. "Although each crippled bank has received a welcome gift of time, its condition remains terminal."

Brumbaugh testified that while 92% of all banks, with 60% of all bank assets, were "healthy," the remaining 997 banks which are "unhealthy" contain 40% of all bank assets, or $1.5 trillion, a figure larger than the entire S&L sector at its peak. While these unhealthy banks do not pose an "immediate threat" to the FDIC's Bank Insurance Fund (BIF), he said, "one can easily think of plausible scenarios in the near future when large numbers of banks with significant assets could deteriorate precipitously and pose a threat to the BIF."

Brumbaugh noted that "the number of banks and assets in banks on [the FDIC's] problem list are at historically unprecedented levels. The assets on the problem list are more than half of all the assets in savings and loans and twice the assets in credit unions. Yet, the number of failures has been falling since 1988, and the length of time has grown between the point when a bank that ultimately fails is put on the problem list and is closed. Since 1986, the FDIC and BIF reserves have fallen from a reported $18.3 billion to a negative $5.6 billion, and the BIF is drawing down on the $70 billion authorized by Congress in 1991." The BIF "is now relying on loans from the taxpayer to meet its obligations," he said.

Most of the 997 "unhealthy" banks that have "tangible capital below 6% are showing definite signs of substantial trouble," Brumbaugh said, noting that a Brookings Institution task force concluded in 1989 that "adequate capital was 8% in market value terms and any level below that was weakly capitalized or worse." The 636 banks with $1.1 trillion in assets with tangible capital levels of 5-6%, on average, "do not meet the minimum net worth requirement" of 5% that was in place for the S&Ls in 1980, making them "extremely vulnerable to deterioration that in short order could pose a threat to the BIF," he said.

Another 181 banks with assets of $377 billion have tangible capital of 3-4%. This group, Brumbaugh said, "must include many banks that are deeply troubled. . . . Many of these banks almost assuredly pose an immediate threat to the BIF. . . . All of the remaining 180 banks with $51 billion in assets have depleted capital and on average are earning negative net income." He added, "Most, if not all, of these banks pose an immediate threat to the BIF."

Mayer charged that the Federal Reserve had "single-mindedly targeted the profitability of the banks as its policy objective for two years, encouraging them to exploit the steepest yield curve we have ever seen in this country—475 basis points between the cost of three-month money and the yield on 30-year Treasury bonds; 250 basis points and more between the cost of nine-month money and five-year money." As a result, banks "cut their expenses by laying off loan officers" and pumped their money into Treasuries and government-insured mortgage paper. "The Fed made a bad scene worse by assigning a zero risk weighting to government bonds and a 20% risk weighting to Fannie [Mae] and Freddie [Mac] paper. . . . Thus a bank needed $8 of capital to back every $100 of loans, but only $1.60 to back the ownership of $100 of collateralized mortgage paper, and none at all to hold government bonds."

Further, Mayer said, the Treasury has "effectively leaned on bank examiners to revise their already permissive rules for the valuation of commercial real estate loans and owned properties, and to let banks create fake capital by claiming that these loans and investments are worth just about twice their real value. . . . The fundamental truth about our banking system is that there simply aren't enough good bankable assets to cover the $3.5 trillion in bank liabilities."