Big U.S. Banks Exhibit Death Wish

BANKING

In their market newsletters this year, New York's largest commercial banks have singled out as dangerous the continuation of Eurodollar lending to "credit-risky" Third World or OECD countries. But paradoxically, because of a deteriorating domestic lending and profitability picture, these banks must actually greatly increase such Euro-dollar lending this year, violating their own intentions and better judgment.

What is now accelerating as a lending policy for 1977, originally emerged strongly in early 1976 as a policy of the large commercial banks especially — the shakiest segment of the banking industry, the New York commercial banks. The domestic lending of the largest U.S. commercial banks *(1)* dropped by one percent for 1976 — a closing up of credit for commerce and industry — and quite a different pattern than the yearly 6 to 7 percent increase in domestic lending that characterized the late 1960s and early 1970s. At the same time, the net income on domestic loans of these same banks increased by only one percent for the entirety of 1976.

For the group of largest New York banks — the Big Six — the situation was even worse. Their domestic loan-booking dropped by 8 percent. Moreover, they experienced large drops in net interest income on their domestic loans, ranging from 1.5 percent to 9.5 percent, as indicated in the accompanying chart.

Sources of Bank Income, Big Six Banks
(percent change from 1975 to 1976)

Banks	Domestic Net Interest Income	Foreign Net Interest Income	Non-Interest Revenues	Aftertax Income
Bankers Trust	-9.5	31.0	24.5	- 9.0
Chase Manhattan	-9.0	1.0	19.5	-33.0
Chemical	-2.0	2.0	9.5	- 6.5
Manufacturer's Hanover	3.0	22.0	9.5	5.0
Morgan	-1.5	-5.0	21.0	5.5
Citicorp	-1.5	8.5	24.5	16.5

Source: Kidder, Peabody and Co.

(1) This group of large commercial banks includes: Bankers Trust, Chase Manhattan, Chemical, Manufacturer's Hanover, Morgan, Citicorp, Bank of America, Continental Illinois, First Chicago, First Bank System, First International Bancshares, and Wachovia.

As can be seen from the chart, only Manufacturers Hanover experienced a gain in net interest income. Within this category, the biggest loser of net interest income was the lending to commerce and industry. While figures don't exist for how large the Big Six net interest income loss is on the account of C and I lending, we can hypothesize that the loss averaged greater than 10 percent for the Big Six banks.

Thus, as domestic lending dried up, the largest commercial banks substantially increased their lending to OECD and Third World LDC nations for 1976. Overall, for the entire commercial banking group under consideration, the increase in foreign lending was 15.5 percent for 1976. Correspondingly, most of the Big Six registered substantial net interest income gains on their foreign loans as indicated in the chart.

The story doesn't stop here. By itself, the categories of foreign and domestic lending would *not* have produced an after tax profit for the largest commercial banks even though domestic and overseas lending generated 80 percent of total bank earnings in 1976. It was the remaining 20 percent earnings realized by *non-interest revenues* that actually, for most large commercial banks, generated the *margin of profit* for 1976.

Non-interest revenues is basically a category that includes a large component of speculative holdings, including earnings from bond trading, foreign exchange operations, and service charges, fees and commissions from a myriad of activities such as credit operations, issuance of letters of credit and equity from unconsolidated subsidiaries. The decline in interest rates in the fourth quarter of last year led to bank profits on the selling of mature Treasury issues, etc. Thus, bond trading income for 1976 rose by a huge 131.5 percent and income on fees, commissions and service charges rose by 15 percent.

The non-interest revenues were needed to generate a margin of profit partly because of the high level of loan losses. Whereas loan losses charged off against total bank loans outstanding last year was only 0.71 percent, when measured against earned bank income — a much truer measure — they exceeded 12 percent!

Precisely one-half of loan losses for 1976 occured in real estate losses:

Total loan losses: $1.23 billion
Real estate loan losses: $0.648 billion

The volume of loan losses reported here may be far too conservative, despite the fact that it has been compiled from bank annual reports and a special Kidder, Peabody and Co., banking report (Commercial Banking Industry," May 3, 1977). The chief cause for doubt is that the reported losses on account of non-performing foreign loans is much too low to be accepted without serious question. The figure commonly agreed on — of $135 million — is much smaller than the combined total of known defaults by Zaire and Argentina, which exceeded $500 million last year.

This notwithstanding, predictions that this year's loan losses, notably REIT's, will decline, must be dismissed.

This is because (a) foreign lending loan losses will inevitably accelerate (already this year Turkey is defaulting on payment of over $2 billion of supplier's trade credits, because of lack of foreign reserves); and (b) there is another heavy real estate boom underway in the U.S., which is very speculative, and which is increasing the banks' exposure to real estate losses.

This year, as EIR documented in a special banking survey two weeks ago, the pace of foreign lending and acceptance of foreign deposits by the U.S. commercial banks increased for the first quarter of 1977. Moreover, because of further U.S. commercial bank deteriorated domestic lending and profit positions, this shift must become more pronounced. This creates the paradox of thrusting U.S. commercial banks into greater Eurodollar-lending at precisely the point that they are desirous — for their own survival — of getting out of this market.

New York Commercial Bank Domestic Lending Shrinks

In the first quarter of this year, while national commercial bank lending to commerce and industry has experienced a moderate increase, there has been no pickup at all at Chicago and New York money center big banks, and in fact a further drop.

Currently, large corporations are going to the commercial paper market for funds, where interest rates are 1.5 point lower than are obtainable from commercial banks. The current excess of liquidity available to invest on the commercial paper market is a result of a combination of the lack of profitable productive investment outlets, simultaneous with a slosh of funds created by the rapid increase in money supply to finance the moderate level of economic uptake in the last two and a half months. This has created a very competitive commercial paper market, and acted to give a downward push on commercial paper interest rates. This has prevented the commercial paper rate from rising as fast as either the federal funds rate or the prime lending rate during the last few weeks. (So far, the commercial paper market financing has already increased by $5 billion this year)

Thus, the 1.5 percent spread between commercial paper and the prime lending rates seems certain to hold for a while, and since a spread of even one quarter of a percent is often enough to attract business, it doesn't seem likely that the large New York banks are going to get back their large industrial customers very quickly. In fact, the commercial banks have raised the lending rate from 6.25 to 6.75 percent within the last two weeks, and conservative economists interviewed by the May 25 *Journal of Commerce* — Glen Picou of Irving Trust and Dr. Allen Sinai of Data Resources — estimate that pressures will force the prime rate up to between 7.0 and 7.5 percent by the end of the year.

The other potential market for New York commercial bank lending — small and medium size industrial and agricultural customers — is now receiving its financing from other regional banks, who have stuck with such customers during the high interest rate period of late 1975 through September 1976. These medium and small size industries are not about to suddenly jump to the New York banks, who abandoned them when they needed cash badly.

The New York banks, of course, worked themselves into this situation. During the period 1974 through September 1976, the New York commercial banks were quite willing to forgo domestic lending for the beauties of the Eurodollar market. Then, beginning about November 1976, after many corporations had used various sources to restructure their debt, the banks found they had an "excess" of funds to lend one another and by about December 1976, the phenomenal growth of the commercial paper market began to take hold.

Since the current domestic lending situation is now significantly stacked against the New York big banks, these banks will have to go further into Euro-dollar lending, which has become very competitive since January 1977, especially with the heavy participation of the Germans and the Swiss. But that market — aside from greatly increasing non-interest revenues earnings, which have a natural limit — is where the New York commercial banks must increasingly place their money: *against their will and better judgment.* Thus, according to the Kidder, Peaboy and Co. special banking study, all commercial banks increased their Eurodollar lending by $8.7 billion during the first quarter of 1977 (only one-quarter of this was to non-OPEC developing sector nations).

If the May 6 Federal Open Market Committee (FOMC) meeting which set the 5.5 percent Fed funds rate can be interpretated as setting a policy of higher and higher federal funds rates to snap the inflationary bubble of the first four months of this year — represented by a 13.5 percent annualized growth in the wholesale price index — then the prospect for New York commercial bank domestic lending will become worse. Even if a regime of high interest rates is not immediately instituted, the New York commercial banks can derive no solace.