Domestic Credit by David Goldman

Doomsday for U.S. banking system

"Securitization" means that the transformation of the U.S. banking system is now complete.

Now that the annual volume of federally and privately issued mortgage-backed securities will converge on $400 billion a year, and every stray receivable from auto loans to credit-card balances is being packaged for resale in the form of bonds, the transformation of the U.S. banking system is complete.

Commercial banks and finance companies no longer make money by lending to consumers: They have become a mere intermediary for the investment banks, which package such loans as collateral for bonds. Savings banks no longer hold home mortgages; they resell their mortgages to a public or private packager, and use the proceeds to buy the bonds themselves.

Bonds collateralized by the sort of assets banks used to hold in their own portfolios now dominate the U.S. credit markets. In addition to about $230 billion of federally guaranteed mortgage "pass-through" securities (because home-mortgage payments "pass through" to bond holders), private mortgage securities are being issued at a $133 billion annual rate.

Half of all mortgages issued during the third quarter were purchased for "securitization," against only a third during 1985.

Now that General Motors Acceptance Corporation has sold off some $4 billion in auto loans (via First Boston Corporation), in the largest corporate financing in history, and Salomon Brothers has packaged banks' credit-card receivables for sale as "CARDS" (Certificates for Amortizing Revolving Debt), there is not much in the store left to hypothecate.

Securitization is supposed to spread risk around and make everyone safer. In the case of home mortgages, it is supposed to provide a buffer against swings in interest rates, because the collateralized mortgages bear a floating rate, as do the bonds packaged out of them.

On the contrary, it subjects the entire asset base of the credit system to wild swings based on the market-valuation of such securities. It creates circumstances under which a sharp rise in interest rates, let alone the predictable solvency problems at an agency which guarantees home mortgages, could massively devalue the assets of the thrift industry, throwing thousands of thrifts into immediate insolvency.

Why, indeed, have banks chosen to package and sell off such high-yielding risk assets as credit-card receivables and auto loans, let alone home mortgages? The entire purpose of a banking system is to permit the holders of a bank's capital to make more money than they might by investing in Treasury or high-grade corporate bonds, by risking it in such loans.

The answer is simple: The banks are bankrupt and forced to raise cash. By "securitizing" the debt, the banks do raise money fast; but the bankruptcy is spread to the rest of the credit system.

For example: The Federal agencies which guarantee payment of the nearly trillion dollars of mortgage-backed paper outstanding have capital to cover about 1% of the bonds they guarantee. Residential mortgages more than 90 days past due rose to 1.07% of all mortgages outstanding in the second quarter of 1986, from 0.91% in the same period in 1985. The rise in delinquencies is attributed by commentators to the weakness of regional economies. Since 31 of America's 50 states are now in severe depression, the regional problems of oil, farming, steel, and so forth add up to a national disaster. As the delinquency rate worsens, the capital of the federal agencies will be wiped out, Congress will have to put in additional funds, and bondholders will wonder how much the guarantee of the U.S. government is really worth.

If interest rates rise as well, not only will the delinquency rate for floating-rate mortgages soar, but the mortgages themselves will lose value, since the floating-rate formula lags market rates by months.

What happens, then, to the savings banks who substitute "liquid" bondholdings for mortgages in their portfolios? One of the advantages of being a bank is the ability to lie about the quality of one's assets; a bondholder is told the value of his assets by the market each day. During the 1979-81 rise in interest rates, savings banks could at least hold old mortgages on their books at face value.

Now, they will be in the same position as the commercial banks, who are covertly selling off loans to developing-sector borrowers on a gray market, at 20-60¢ on the dollar. Rising consumer loan delinquencies, combined with rising interest rates, will wipe out much of the value of the "securitized" assets, and the financial institutions holding them will have to report the decline in value on a quarterly basis. That will trigger hundreds of simultaneous insolvencies.

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