Twilight of the banks

Chase Manhattan's threat to leave banking, and new deregulation measures, herald the end of the banking system.

Chase Manhattan Bank only mildly surprised the American Bankers Association annual convention in San Francisco Oct. 27, by threatening to abandon its banking charter unless banks were given the same freedoms enjoyed by the investment houses.

In a "securitized" financial world, where normal banking business broke down permanently in 1982, as all lending to Third World nations came to a halt, there are few advantages and many headaches in being a bank.

Banks issue loans against their own capital, and hold the bag if the borrower defaults; securities houses peddle other people's paper to investors, and bear no responsibility in case of default.

The ABA event occurred during a remarkable week. On Oct. 27, the London Stock Exchange's new computer system broke down upon the opening of the new deregulated market, while many British observers warn that the so-called "Big Bang" may lead to a financial panic.

On Oct. 30, oil markets virtually suspended trading after the firing of Saudi Arabia's oil minister Sheikh Yamani. And on Oct. 28, Chase Manhattan offered to leave the banking business.

William Seidman, chairman of the Federal Deposit Insurance Corporation, told the meeting in San Francisco that 150 of the 1,456 banks on the troubled list will fail next year. Ninety percent of the nation's 14,000 banks are healthy, said Seidman, but the "unprecedented growth of debt . . . has brought with it a decline in debt quality. We must proceed with care. The flashing yellow caution light is operational."

Seidman also expressed worry about Chase Manhattan's threat to give up its banking charter, in order to act like a combined investment bank and finance company. "It would create chaos in terms of the regulatory process we have now."

The 10 largest American banks already have "off-balance-sheet liabilities," financial guarantees assumed in return for upfront fees, in excess of $1.25 trillion, or roughly 150% of their assets. According to the books, the banks' capital should cover 7% of their liabilities, as security against loan losses; in fact, their true capital cover is barely 3%, much less than their true level of bad loans.

What Seidman means by regulatory chaos in the event of Chase's conversion to "non-bank" status would be a far worse situation, in which banks cease to assume liabilities on the books, and merely peddle paper to investors.

In this case, the banks' own capitalization would not have to bear the costs of loan losses; rather, the investors who bought loans re-packaged as securities would sit on the losses. The commercial banks have already begun such a process, by marketing some of their Third World debt much like the "junk bonds" which finance high-risk corporate mergers. They have marked down the value of their Third World loans by large amounts (ranging from 20% for Brazil to 80% for Peru), in order to unload them off their books.

Instead of mediating deposits that may leave at a moment's bad news, into loans which may turn sour, Chase Manhattan wants to borrow overnight funds on the market, and buy securities which can be sold instantly.

To a considerable extent, "securitization" has already produced such a situation, which is why Chase Manhattan's public threat to leave the banking business did not attract extraordinary attention. The banks have been busy doing this for three years.

The net result is that, rather than facing failure from loan losses that may accumulate over months, or deposit runs which may drain resources over days, they are now vulnerable to shifts in the securities markets that can take place in minutes.

If a bank borrows short-term money to buy securities which may lose several percentage points of value within minutes, it must assume that it will be first in line to unload them if anything goes wrong. Under conditions of real trouble in the securities market, in which the "asked" price disappears temporarily from the traders' video terminals, banks can find their total portfolio devalued by more than their total capital in a matter of hours, if not minutes.

All this makes the discussion of the administration's legislative agenda somewhat moot. Treasury Secretary James Baker, in a separate appearance in San Francisco Oct. 29, said that the administration wants a comprehensive banking bill, to close some of the loopholes allowing nonbanks to conduct banking business. Under the circumstances, that is something like closing the barn door after the horse is dead.