

The biggest Ponzi game in history

by David Goldman

The news is not that American banks will show the worst net loss in history during the second quarter, exceeding \$10 billion. The news is that the banking industry will continue to show such losses for the third quarter, the fourth quarter, and so forth, until such time that it ceases to exist, as matters stand.

The bankers' argument that the immense loan-loss reserves registered by the major banks represent a salutary housecleaning, is equivalent to thinking of Auschwitz as the ultimate weight loss camp. Most analysts argue that the booming stock market liked the loan-loss reserves, led by Citibank's \$3 billion set-aside, so much, that it will like even bigger losses better. It is argued that the Americans are now emulating the German and Swiss banks, which wrote off their Third World loan exposure early, and gained by it. A majority of the same European bankers who wrote off their Ibero-American loans early in the 1980s, expect the worst crash in the banking system's history—as Italy's Carlo De Benedetti, Switzerland's Hans-Georg Rudloff, and other prominent bankers have insisted in recent public statements. Since these bankers are the intermediators of a large portion of the unguaranteed foreign deposits which make up some 40% of the major banks' deposit base, turned over an average of every week or so, these views might otherwise attract attention.

In fact, Citibank's \$3 billion addition to loan-loss reserves covered less than a fifth of its more than \$15 billion in loans to the developing sector, let alone its exposure to oil and gas drillers, real-estate developers, shipping lines, and a dozen other loss-making industries. Other banks, notably

Bank of America and Manufacturers Hanover Trust, set aside reserves against a much smaller portion of their overseas exposure, and only under pressure, following Citibank's action. Their present capital base could not withstand a writeoff proportional to Citibank's.

The second-quarter loss alone compares badly to the last time the banking sector lost money. That it was in the year 1934, when it lost \$600 million, or roughly half the second-quarter loss, when adjusted for inflation. But when will the losses stop?

Washington analysts fear that Brazil's failure to pay interest on its \$100 billion debt may spark the re-emergence of a Third World debt crisis with a vengeance, forcing the major U.S. banks to register multibillion-dollar losses for each of the next succeeding quarters. If Brazil fails to pay by October, the entire Brazilian debt to U.S. banks, which roughly equals the shareholders' capital of several big banks, must be written off, forcing several banks into virtual insolvency. The Treasury still holds to the long-discredited "Baker Plan," under which Third World nations would turn their economies over to creditor management in return for new credits. A newly reorganized World Bank, the International Monetary Fund's sister institution, was to become investment banker to the Treasury, under President Barber Conable.

Thus far, the banks have provided no new credits, except to pay interest back to themselves in the cases of Mexico and Argentina; the countries have shied at handing their national patrimony (e.g., Mexico's oil reserves) to their creditors, and offered chunks of their economy worth only a few billion

dollars; and the World Bank reorganization has turned into a nightmare for Mr. Conable, who now faces a class action suit by senior staff who object to this reorganization. American sources suspect that the prominent role of Belgian central bank official and World Bank director Jacques de Groote in fomenting opposition to Conable's much-vaunted reorganization, indicates that the European central banks are sending a message of mistrust to the U. S. administration.

Treasury Assistant Secretary for International Affairs David C. Mulford, who ran the international desk of White, Weld when it dominated Wall Street's connection to the Swiss money-laundromat, is badly worried, according to friends. He still intones the same Baker Plan formulas in public addresses. But he reportedly will take the opportunity of a privately organized meeting on international monetary affairs in Vienna Sept. 2 to air his fears concerning the consequences of the continuing Brazil moratorium.

The Ponzi game

President Reagan's threat to veto banking legislation otherwise supported by retiring Federal Reserve Chairman Paul Volcker, shows how the administration plans to handle the mess: by doing for the commercial banks what it has already done for the savings banks. The administration and its Fed chairman-designate Alan Greenspan have fought Volcker and New York Fed President Gerald Corrigan over banking deregulation for years. What makes the administration's position most suspect, is Congress's failure (as of *EIR*'s deadline) to approve a federal debt ceiling, and enable the Treasury to continue borrowing. If the Congress does agree before the July 27 "drop dead" date (see *Domestic Credit*), it will likely be with restored automatic sequestration, preventing the administration from using emergency funds to bail out the banks, and leaving the Federal Reserve's printing press as the final and sole defense of the financial system.

It is entirely possible that the federal government, which has backed deregulation with a series of implicit and explicit guarantees, will be unable to spend money, long before it is called upon to do so on behalf of the financial system.

Former Federal Deposit Insurance Corporation chairman Irvine Sprague explained the administration's motives in a critique published July 15 by the *Wall Street Journal*:

The drive toward concentration of the nation's economic resources in megabanks already has turned into a stampede—but this apparently is not fast enough to satisfy the Reagan administration. Undersecretary George Gould has been quoted as saying that the Treasury Department has concluded we should foster the creation of 5 or 10 giant banks in combination with large industrial companies, setting up powerful institutions to compete in world markets. . . . Megabanks already enjoy substantial advantages from the government, and to foster the Gould suggestion with added government aid would require pushing the banker's

cherished "level playing field" right off the cliff. Growth—even to gigantic size—through the marketplace is fine, but to do it with further government aid, encouragement, or intervention would be outrageous. Big banks today have an absolute guarantee against failures—they can pursue any course of action, be it sound or reckless or even indifferent, with the certain knowledge that should failure approach, bailout will not be long behind. The government has never allowed a big bank to fail, and it never will. With the single exception of Penn Square, a tiny shopping-center bank in Oklahoma City that exploded overnight into a \$500 million embarrassment, no bank with more than \$200 million in assets has ever been closed and paid off.

The administration presumes that creative bookkeeping techniques associated with banking deregulation will permit the megabanks to report income, despite the collapse of their loan-portfolio quality, while the government's implicit, absolute guarantee of their deposit base will discourage the depositors' run which otherwise might be expected. In May, when Citibank announced its \$3 billion addition to loan-loss reserves, Chairman John Reed boasted that the bank would rid itself of the other \$12 billion of developing-sector loans, through secondary-market trading of such loans. Eager investment bankers in London, Switzerland, West Germany, and elsewhere, welcomed the chance to earn fees by "securitizing" Citibank's Third World debt holdings.

It won't work

Misled, perhaps, by their positive experience with rising U.S. securities markets, none of these enthusiasts have stopped to ask whether worthless paper will trade on the secondary market.

Two economists for the New York Federal Reserve Bank, Eli Remolana and David Roberts, released a study July 12 through the Group of 30, a private advisory body to the IMF, now chaired by former Bank of England Governor Lord Richardson. It won't work, warn the two Fed staffers. The boom in secondary-market trading of Third World debt promoted by Citibank and other institutions would "complicate an already difficult rescheduling process without providing overriding benefits for debtors or creditors," the paper says.

Analysts who agree with Roberts and Remolana say the problem is that the paper just isn't worth anything without some kind of official guarantee, and the U.S. Congress is not going to put up the money, not while it can't agree to guarantee savings deposits or bail out farmers. "Nobody wants to put up real money," one analyst said. "Investment banks would love to securitize my grocery receipts, but how do you securitize something that's trading at a discount" without an official guarantee? It is one thing to promote a Ponzi scheme involving worthless Third World debt, by guaranteeing in some fashion (as Group of 30 founder Peter Kenen has proposed) debt written down by 40% or more, with some gov-

ernment money. It is another thing entirely to promote a Ponzi scheme with the mere aura of government endorsement, but without the hope of government money.

Overblown estimates of the size of the secondary-market, ranging up to \$12 billion for 1986 debt swaps, circulated in the wake of John Reed's announcement of Citibank's strategy; estimates collected by the Fed economists were as low as \$2 billion. Citibank's grand plan, its justification for the mega-losses, never got off the ground, and never will.

Meanwhile, the Federal Deposit Insurance Corporation's

The administration has just been handed an additional \$50 billion bill on behalf of the thrift industry alone. At some point, some major depositors will take a hard look at the quality of their guarantees, and the game will come to an end faster than you can say, "tulip bulb futures."

announcement that it would accept lower-than-usual capital ratios at commercial banks in economically troubled areas, affecting as many as 2,000 of the nation's 14,000 commercial banks, shows that the savings-and-loan approach has already worked through to the weaker elements of the commercial banking system. For three years, the Federal Savings and Loan Insurance Corporation has permitted a growing number—now over 500—of "zombie" savings and loans to continue operating, because it lacks the \$50 billion it would now take to close these institutions and pay off their depositors.

These institutions, with negative capitalization, continue to run losses; they are being supported by what Federal Home Loan Bank Board staffers call a "government-operated Ponzi game." The FSLIC ran out of its last cash a while ago, and staffers responsible for winding up the affairs of bankrupt institutions are now making paper airplanes. The insolvent, loss-making savings banks are being kept alive by the Federal Home Loan Board Bank, which is "hustling" deposits from deposit brokers, FHLBB officials say. Deposit-brokers take large sums of money from pension funds and other financial institutions, and break them down into deposits of \$100,000 or less, the maximum guaranteed by the now-bankrupt FSLIC. The insolvent, or "zombie" S&Ls pay premium interest rates, often 2% above going rates, for these deposits, which are guaranteed by the government, and use them to pay off old depositors.

FHLBB "hustling" in cooperation with deposit brokers

came in response to a \$6 billion net outflow from S&Ls in April, threatening to collapse insolvent institutions. S&Ls as a whole showed a \$0.9 billion net inflow during May.

Losses accelerate

Meanwhile, losses are continuing, even accelerating, among savings banks. Delinquent loans at thrift institutions rose to 6.2% of their mortgage portfolio in May 1987, against 4.2% a year earlier, and about 2% in 1985, the Federal Home Loan Bank Board reports. Analysts at the FHLBB, which regulates savings and loans, warn that the much higher delinquency rate implies a comparably higher level of losses during 1987.

The savings industry as a whole ran a loss during the second half of 1986, and will, analysts warn, run an even bigger loss this year. Collapsing real-estate values under the administration's 1986 tax reform are behind the surging losses of savings and loans, according to analysts at the Federal Home Loan Board Bank. "The tax reform act is having its consequences in the real-estate market. There are a lot of foreclosures of commercial property, and a lot of developers are walking away from deals after the tax advantages that motivated the deals ceased to exist. So, the S&Ls are taking a lot of property back," said one analyst. The tax reform bill eliminated the tax benefits which had prompted the building boom of 1981-87, which led to a 25% oversupply of urban office space in the United States.

Since the FSLIC is out of money, and the \$8.5 billion recapitalization program not yet passed by Congress would not even cover the bankrupt Texas thrifts, the generalization of the savings-industry crisis to the rest of the financial system is already a fact. FHLBB planners suggest that either the commercial banks' guarantor, the Federal Deposit Insurance Corporation, will have to bail out the savings banks, or the Federal Reserve will have to bend its charter, and buy up bankrupt S&L assets directly from the failing banks. Either alternative would have devastating consequences. The FDIC has prepared an internal working paper analyzing the thrift industry's problems and concludes that it could cost as much as \$40 billion to resolve them, twice the FDIC's current available resources. Earlier, the General Accounting Office, citing FSLIC data, put the tab for closing the most troubled thrifts at \$25 billion. But the FDIC study, prepared in the spring, concluded that that figure was too low. The FHLBB's "Ponzi game" with guaranteed deposits has raised the figure to perhaps \$50 billion.

An administration committed to a \$108 billion deficit target for fiscal-year 1988, now likely to run a \$200 billion deficit as matters stand, has just been handed an additional \$50 billion bill on behalf of the thrift industry alone, and the losses are accelerating in both the savings and commercial banking sectors. At some point, some major depositors will take a hard look at the quality of their guarantees, and the game will come to an end faster than you can say, "tulip bulb futures."