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Looming banking crisis will dwarf S&L debacle

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The U.S. banking crisis, which for months had been falsely portrayed as "solved" by government officials and the press, has suddenly risen from the grave, and is once more stalking the financial and political markets.

The latest outbreak of publicity about the banking crisis, which has in reality been steadily getting worse, revolves around a study prepared by Edward W. Hill, a professor at Cleveland State University, and banking authority Roger J. Vaughan, of Santa Fe, New Mexico. The Hill-Vaughan study, which is being published by the *Washington Post,* presents the bleakest assessment to date by any of the establishment-certified banking analysts of the U.S. banking system. But the study, which would have you believe that less than 20% of U.S. banks are in trouble, is just another in a long line of studies designed to hide the extent of the crisis.

The study, entitled "Banking on the Brink," warns that a taxpayer bailout of the banking system is "virtually certain," and that by refusing to recognize the seriousness of the problem, the government is in danger of repeating the steps which led to the S&L debacle.

The study says that were the banks to accurately reflect their financial condition, "more than 1,000 of the nation's banks would be judged insolvent," and "perhaps 1,000 more on the lip of insolvency." But the remaining 10,000 banks, the study claims, are "strong, profitable and internationally competitive."

Bailout estimates double

The study estimates that the cost of bank failures could run as high as $95 billion, nearly double the worst-case estimate of $48 billion made by the Federal Deposit Insurance Corp. a year earlier, and significantly higher than the highest government figure, the $72 billion projected by the Office of Management and Budget in January 1992.

The Vaughan-Hill study contends that banks can expect to lose 80% of the value of their repossessed real estate and of loans more than 90 days past due, and to lose 60% of their loans that are delinquent less than 90 days or that have been restructured. They also project losses of 20-40% on all other real estate loans, even those which are currently being paid on time.

A taxpayer bailout of the banking system is well under way, but the cost will be measured in trillions, not billions, of dollars. But the contention of the study that more than 80% of U.S. banks are healthy, is nonsense.

The problem is not with a handful of banks, or even a couple of thousand banks. The problem, as *EIR* has repeatedly documented (see *EIR,* Jan. 10, 1992, "Why the Panic Over the U.S. Banks Is Justified"), is that the entire banking system is insolvent. The banks have been overwhelmed by the depression. Real estate values have collapsed dramatically, the level of non-payable loans has skyrocketed, and the enormous speculative bubble of off-balance-sheet activities has popped.

The only thing keeping the banks afloat at this point is politics. The Bush administration has bullied federal banking regulators into adopting a virtual "no such thing as a bad loan" policy, allowing banks to carry as performing loans, those which have no chance of being paid back. Loans which cannot be repaid, are simply being rolled over or restructured when they come due, preserving the illusion that they are viable. In addition, the banks are carrying real estate loans on their books at completely unrealistic values, as if real estate values had not dropped 25-50% nationwide. The result is a dramatic understatement about the extent of the banks' loan losses, and a corresponding overstatement about the

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banks' income. It is a virtual replay of the S&L fiasco, but on a vastly larger scale.

Banks spoon-fed profits

At the same time that the bad loans are being covered up, the banks are getting a massive gift from the government and the Federal Reserve, in the form of lower interest rates. The lower rates allow the banks to increase the spread between what they pay for money and what they charge for the money they lend. This extra interest rate income the banks report as profits.

The most striking example of the secret bailout of the banking system, is the way the banks are being spoon-fed profits by the Fed and the Treasury through the market for Treasury securities. The scam works like this: The banks borrow money from the Fed at 3% interest, then turn around and buy Treasury securities that pay 8% interest with the money. That gives the banks a 5% profit, without any risk and without the need to make loans in the economy. As a bonus, the banks are not required to set aside any equity capital against these Treasury securities, whereas they would have to set aside $4 in capital for every $100 in business loans. So they rake in money from the government to bolster their profits, while making their equity capital position look better. In the words of Sen. James Sasser (D-Tenn.), "In effect, the taxpayers are bailing out the banks."

The size of this bailout is staggering. At the end of June, for the first time in 27 years, the amount of government securities held by banks ($607.3 billion) surpassed the amount of their commercial and industrial loans ($598.5 billion). During the previous 12 months, the banks' holdings of government securities rose 21%, some $105 billion, while the banks' C&I loans fell 4%. During that same period, loans to individuals fell 2.9% and total loans fell 0.7%.

In fact, for many banks, especially the larger ones, the main source of income comes from trading in securities, speculating on currency fluctuations, and other activities more akin to placing bets in a casino than traditional banking. The 10 largest U.S. banks made 77% of their reported profits from such trading in 1991.

This shift to casino-style speculation has led to an explosion in the level of banks' so-called off-balance-sheet liabilities, a category which includes various types of futures trading, letters of credit, loan commitments and the like. In 1984, according to the General Accounting Office, U.S. banks had $1.364 trillion in off-balance-sheet liabilities. By 1985, that figure had risen to $1.8 billion, equal to 67% of all bank assets. By September 1991, according to a study by Weiss Research, the 20 largest U.S. banks had off-balance-sheet liabilities of $6.1 trillion, or 697% of their $899 billion in reported total assets. Citibank led the pack with $1.381 trillion in off-balance-sheet liabilities—more than the entire U.S. banking system had just seven years earlier.

Thanks to government gifts, false accounting, and regulatory corruption, U.S. banks have been able to report "record profits" of $7.6 billion in the first quarter and $7.9 billion in the second quarter of 1992. But this illusion of solvency is coming to an end, as the deepening depression destroys the ability of governments and central banks to manipulate the financial system. One after another, the bailout operations are unraveling.

Bailout operations unraveling

A prime example is the collapse of Olympia & York, the giant real estate developer which is now in bankruptcy. O&Y was in many respects a bailout operation, funded by the banks to artificially revive the foundering real estate markets in North America and Britain. Backed by billions of dollars in loans from the banks, O&Y acquired and developed numerous properties in New York City during the 1970s and 1980s helping, along with similar creations such as Donald Trump, to pump up the deflating New York real estate bubble. O&Y also took over the foundering Canary Wharf project in London, Europe's largest office development.

But now O&Y has collapsed, and with it the illusion of viability of the New York, Toronto, and London real estate markets. The banks will lose not only the money they lent to O&Y, but also the money they lent to other companies, using artificially inflated real estate as collateral.

The collapse of the big real estate operators leaves no one left to buy up all the real estate which has been dumped on the market. That, in turn, is further driving prices down in a self-feeding process which will not end until real estate values reach a level which can be supported by genuine economic activity, which means that many of the commercial office projects are headed for declines of up to 80% from their purported values at the height of the bubble.

That spells doom for the banks, which have some $858 billion in nominal value of real estate loans on their books. A drop in value of just 30% on the banks' real estate loans, would be more than enough to wipe out the banks' claimed $248 billion in equity capital. And that drop has, in reality, already occurred, leaving the banking system, as a whole, bankrupt.

The preference of the government and the bankers is to let the crisis remain out of the public eye until after the elections. They would rather that the discussions take place in the back rooms, since they all agree that the taxpayer must ultimately pay to bail out the banks, and such admissions are bad form in an election year.

But such a cutoff of public discussion only hastens the coming collapse, since neither the bankers, the government, nor the regulators have the resources to keep the system afloat. By hanging on to a dead system, they are foreclosing the possibility to shift to policies which could revive the economy. No matter how much the government and bankers loot the public, they will not be able to put their financial system back together again, and the harder they try, the worse the situation will get.