U.S. RTC model would collapse Japan's bankrupt banking system

by Richard Freeman and John Hoefle

The Japanese government has announced that it will attempt a bailout of its banks, modelled on many—though not all—of the major features of the Resolution Trust Corp. The U.S. government created the RTC in 1989, and employed it until it was shut down in 1995, spending hundreds of billions of dollars to bail out the U.S. savings and loan/thrift institutions. The Japanese plan is called the "Total" or "Bridge Bank" plan. Under it, the new Heisei Financial Restoration Corp. will take over insolvent banks and assume their "impaired" or bad loans. Preliminary reports indicate that there are several large Japanese banks, with a huge volume of non-performing loans, that will not be classified as insolvent, however.

William Seidman, the first chairman of America's RTC, and other financial advisers, have recently travelled to Japan, extolling the "success story" of the RTC in "solving" the S&L crisis.

But there are three principal reasons, detailed in this article and the one following it, why the Japanese should reject the RTC approach:

1. Contrary to popular myth, the RTC bailout was not a success; rather, it helped create a huge speculative bubble, which is now driving the U.S. banking system toward a catastrophic collapse. During 1985-93, the United States experienced a breakdown, not just of its thrift institutions, but of its entire banking system. The most bankrupt banks during that period were the major money-center commercial banks, led by Citibank, which was then the largest. *The United States engaged in a bailout of the whole $5 trillion-in-assets banking system, of which the RTC bailout of the $1 trillion-plus-in-assets S&Ls was just one important, but smaller piece*. What is critical to understand is this much bigger bailout of the entire U.S. banking system, including the U.S. government's attaching a life-support tube of money flow from the Federal Reserve's discount window to the commercial banks, and also the massive expansion of the deadly derivatives market. Without these broader measures, the RTC portion of the total bailout would have collapsed.

2. The RTC part of the bailout worked through the RTC taking over the non-performing loans of the failing thrift institutions, as well as the assets underlying the bad loans (see the accompanying article for details). Without the manipulation of the real estate market to support prices, the RTC real estate asset sales would have been a failure, and the RTC plan would have been a failure.

But, while the United States was able to manipulate a reflation of real estate prices in the early 1990s, that would be highly unlikely in Japan today. The world is in the throes of the biggest financial disintegration in history. The idea that in the midst of this disintegration, a Japanese bridge bank would either hold directly, or supervise the commercial banks' holding of hundreds of billions of dollars of troubled real estate assets, and be able to sell them on an "upturning" real estate market, is absurd. The anticipated "upturn" is not coming. Any such Japanese plan, whatever its technical features, must depend on the sale of hundreds of billions of dollars' worth of real estate.

3. The Japanese banking crisis cannot be surgically isolated from the systemic world crisis, overhung by $130 trillion in derivatives, which could explode at any moment. Japan must write off—not save—hundreds of billions of dollars worth of paper. This requires the measures recommended by Lyndon LaRouche: a Chapter 11-style bankruptcy reorganization of the world financial system, and a new, development-oriented Bretton Woods monetary system. The fantasy that the Japanese section of the integrated financial system could be administratively saved without writing off this paper, as LaRouche proposes, is a pipe-dream.

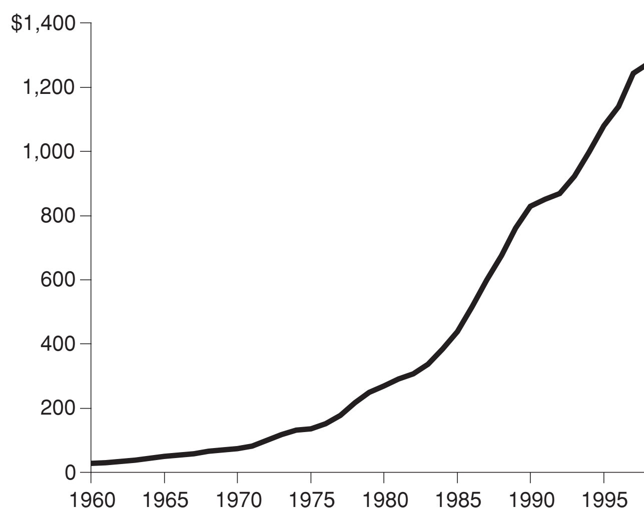
In sum, the gimmicks that worked in the U.S. real estate market in the early 1990s, at an immense cost, cannot be repeated now, without a hyperinflationary explosion. Before Japan engages in an RTC-style bailout of its banking system, with the starting cost placed at $250-500 billion, its leaders should study what really happened in the U.S. banking crisis of 1986-93.

The bailout of the commercial banks

Former U.S. Treasury Undersecretary John Hawke has said that the final reorganization/bailout tab paid for the RTC plan was $156.4 billion, of which $128.4 billion was borne by the taxpayer. This is a stupendous figure. Still, it seems to be an underestimation; it would appear that the actual figure was closer to $200 billion.

© 1998 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

FIGURE 1
U.S. commercial bank lending to real estate, 1960-97
(billions $)



Source: Federal Deposit Insurance Corporation.

But this was only the first step in the actions that were taken to bail out the entire U.S. banking system.

Although the S&L presidents were scapegoated for the crisis of those years, it was actually the commercial banks that were the principal organizers of most of the speculative real estate market, along with the Drexel Burnham/Anti-Defamation League/Michael Milken crowd of junk bonds dealers and swindlers.

Figure 1 shows the commercial banks' lending to real estate. Earlier in the 1980s, the commercial banks had been burned, as real estate properties in the "oil patch" region of Texas, Louisiana, Oklahoma, and Colorado took a nose-dive. The bankruptcy of Penn Square Bank of Oklahoma, through bad real estate deals, signalled the problem. But bankers have short memories, and they plunged right back into real estate, when the scare had passed.

The S&L problem with real estate loans, starting in 1986, and the RTC's fire sale of S&L real estate, softened the entire U.S. real estate market, and finally ignited the problem for commercial banks around late 1988 and early 1989. This became a major problem for commercial banks in and around New York, Boston, and California. Problems in commercial bank loans to the Third World also kicked in.

By mid-1990, it had become evident that more than half of America's top 15 banks were actually bankrupt, if their true condition, especially with regard to non-performing real estate loans, were declared. The net worth of several of these banks was negative or zero.

On Dec. 7, 1990, a secret Washington, D.C. meeting took place, according to reports given to *EIR,* involving the highest officials of the Treasury and Federal Reserve. The subject involved the insolvency of six of America's biggest banks: Bank of New England, which was seized by regulators in January 1991; Manufacturers Hanover Bank and Chemical Bank, which, because they were insolvent, were merged; Security Pacific, which was merged into the barely standing Bank of America; Chase Manhattan; and Citicorp.

Of the six, the worst off was Citicorp, America's biggest bank holding company at the time, with $217 billion in assets. The Feds already controlled Citicorp, having secretly seized the bank in November 1990, sending in teams of auditors to inspect the books, and beginning the search for capital to put a tourniquet on the bank's hemorrhaging finances. The move was kept secret, both to avoid panic and to allow a bailout to proceed without public scrutiny; but regulators took firm control of the bank and its lending and trading policies.

Officially, Citicorp had $15.2 billion in non-performing loans. But, because of its involvement with real estate operators such as the Reichmann Brothers' Olympia & York (which itself filed for bankruptcy in June 1992), Citicorp's actual non-performing loan portfolio is estimated to have been closer to $30-40 billion. On Aug. 2, 1991, Rep. John Dingell (D-Mich.), chairman of the House Energy and Commerce Committee, caused an uproar when he stated publicly what every person in the banking world already knew: that Citicorp was "technically insolvent." He added, "I suspect [it is] the recipient of the largesse of the borrowing window at the Federal Reserve."

On Nov. 7, 1991, four terrified regulatory agencies of the U.S. banking system—the Fed, the Comptroller of the Currency, the Federal Deposit Insurance Corp. (FDIC), and the Office of Thrift Supervision—issued a joint policy statement on the review and classification of real estate loans, telling examiners not to grade the commercial banks' real estate loans at their current market value, but rather on the basis of what their value would be if a recovery could be organized. In other words, the examiners were told to lie.

The issue concerned the bulging real estate portfolio of the commercial banks, which stood at $830 billion at that time. Conservatively, it can be estimated that 25-30% of that was no good, and so bad that it might fetch only 70-60¢ on the dollar, and in some cases, less. *An honest classification would have closed down many of America's biggest banks, while the systemic effects would have pulled down the entire world banking system.* At a Dec. 16-17, 1991 conference of 464 of the nation's top bank examiners, in Baltimore, Treasury Secretary Nicholas Brady warned the examiners not to classify loans by existing standards.

In October 1992, a book was published, *Banking on the Brink: The Troubled Future of American Finance,* by Cleveland State University associate professor Edward Hill and former Citibank economist Roger Vaughan. It summarized events which, for the previous several years, *EIR* had already

been reporting. The book stated: "Nearly 1,500 banks are in deep trouble. Together, these ailing banks manage assets with book assets of more than $1 trillion. *The list of invalids includes 14 of the nation's 57 largest bank holding companies.* . . . Perhaps 1,150 banks are now insolvent—and would be shuttered if their books reflected the true value of their assets" (emphasis added). The authors pointed out that many of America's giant banks had negative net worth.

This went far outside the domain of the RTC, which was a minor player on this side of the issue.

Scams and derivatives

Federal Reserve Board Chairman Alan Greenspan and various Wall Street financiers put together a comprehensive package which rigged the functioning of the entire U.S. credit system toward one purpose: building up the biggest bubble in history, in an insane attempt to save the existing banking system. The financiers could not create an institution to bail out the commercial banks, like the RTC for the savings and loans. There were two reasons for that: 1) Congress would not stand for it; Congress had already spent nearly $300 billion in permanent and working capital on the S&Ls (some of the working capital would be paid back through the sale of real estate assets), and could not ask for another large sum. 2) Much now depended on reflating the real estate market. Were that not accomplished, the commercial banking system—as well as the S&Ls—could not be saved. Furthermore, Wall Street required the creation of a speculative bubble, whose earnings could be attached to the brain-dead banks. The banks' balance sheets had to be reflated. Congress could not do this by means of legislation.

The way the financiers approached the problem was not to reflate one market at a time, but to pump up the entire bubble, thereby reflating real estate, the stock market, and other speculative operations. The use of financial derivatives exploded.

We document some of the measures that were used. Some of these measures can't be used in Japan today, because they have already been applied there, without producing the desired results. To make them work today in Japan, would require Weimar-style hyperinflation.

The Wall Street financiers organized three principal measures in the United States:

1. *Putting the brain-dead banks on Federal Reserve life-support*. Under this plan, the commercial banks borrowed at the Federal Reserve discount window at a low rate of interest, and then the banks invested the borrowed money by purchasing U.S. Treasury bonds and bills paying a higher interest rate. It was a risk-free investment for the big commercial banks. To make it work, the Fed initiated seven discount rate cuts, bringing the discount rate down eventually to just 3%. **Table 1** shows the spread: The difference between the rate at which the commercial banks could borrow, and what they got for lending out or investing their money, in this case, in ten-year Treasury bonds. The spread, which was 1.56% in 1989, more than doubled to 3.66% in 1992.

TABLE 1
Spread between Federal Reserve's discount rate and 10-year U.S. Treaury bond
(percent)

	Discount rate*	10-year U.S. Treasury bond	Spread
1989	6.93%	8.49%	1.56%
1990	6.98	8.55	1.57
1991	5.45	7.86	2.41
1992	3.35	7.01	3.66
1993	3.00	5.87	2.87
1997	5.00	6.35	1.35

* discount rate charged by Federal Reserve Bank of New York
Source: *Economic Report of the President, 1998.*

Meanwhile, the commercial banks nearly doubled their Treasury holdings, from $145.3 billion in 1989, to $266.6 billion in 1993.

But, it wasn't just the annual extra earnings from holding Treasuries; the commercial banks got a second break: They didn't have to hold any reserves against Treasury holdings, while in other domains, they had to hold reserves equal to 4-10% of the value of the loans they made, depending on the type of loan. By putting money into Treasuries instead of other loans, they therefore made an extra $3-5 billion a year. The total estimated benefit of this double-side scam of being put on government life-support, while not having to put reserves aside on Treasury holdings, for the period 1989-93, were $35-40 billion. This bonus was not distributed across all banks, but was concentrated at the nation's largest banks.

There were other lucrative variants from this scam, as banks depressed the amount of interest they paid depositors who held savings accounts and certificates of deposit, while charging exorbitant interest rates on credit cards, etc.

2. *Government subsidies*. Failed thrifts, holding assets of $416 billion, were put up for sale during the RTC's period of operation (1989-95). While *EIR* is still attempting to obtain reliable precise figures, we estimate that one-quarter—and perhaps more—of these assets were snapped up by commercial banks. That is, the commercial banks were handed, as part of the RTC's sale of "good assets," approximately $100-125 billion in assets.

The commercial banks obtained these assets for a song. For example, the RTC might put on the auction block a "good S&L" with assets of $2 billion. If a commercial bank wished to buy it, it paid the purchase price of the stock, which normally would be in the range of $100-200 million—often only one-twentieth the value of the assets the "good

S&L" actually held. This gave the commercial bank ownership of the "good S&L" and control over its $2 billion in assets. Moreover, much of the acquisition cost that the commercial bank paid to acquire the S&L could come from the S&L itself, once it was taken over. The commercial bank could loot the S&L's coffers and tap its earning streams to pay for the takeover.

In this respect, the RTC bailout of the S&Ls was not so much for the benefit of the S&L sector, as to subsidize the commercial banks. The U.S. government/RTC picked up and disposed of the bad assets, and the commercial banks were enabled to buy the good assets, pruned of all problems, which could immediately start earning money for the commercial banks—i.e., a $100-125 billion subsidy.

3. *Derivatives*. Finally, derivatives were entered into the mix, perhaps the most crucial element of all. These highly leveraged, speculative bets started to become the mainstay of the banks, earning the banks increasing paper profits. In 1987, commercial banks held $2.96 trillion in derivatives; this rose to $6.81 trillion in 1990, $11.87 trillion in 1993, and $26.7 trillion as of March 1998.

One of the ways to measure the importance of derivatives to the banks' balance sheet, is to measure the amount of investment that banks make in "securities trading." This includes trading in derivatives, as well as in Treasury securities and other instruments.

In 1991, it became clear how important "securities trading" was in preventing the banks from collapsing. That year, J.P. Morgan Bank reported a profit of $1.15 billion, but it made $1.3 billion from securities trading. Without that prop, Morgan would have lost money for the year.

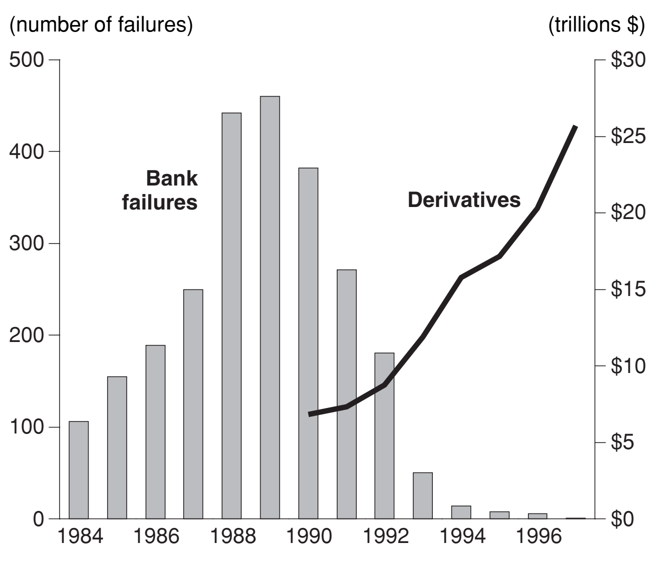
In the same year, America's 49 largest banks—banks with assets greater than $10 billion—would have registered an aggregate loss for the year without the trading gains; only 57% made profits with the trading gains.

By July 1992, U.S. banks had amassed securities with greater than one year maturity of $607.4 billion, which, for the first time in 27 years, exceeded the volume of loans to manufacturing and industry that the banks had made, at $598.5 billion. The banks junked their traditional function as providers of funds to the economy: They were no longer banks, they were high-rolling speculators.

Figure 2 plots the correspondence between the decline in the number of bank failures and the growth of their derivatives holdings. The commercial banks were restored to a semblance of health, through derivatives.

But the turn toward derivatives completely altered the landscape of the whole economy and financial system. It not only earned for banks large profits in their own right, but it reflated the total bubble of the U.S. and world economy. It helped raise the real estate market, where collateralized mortgage obligations, mortgage STRIPS, and other real estate derivatives products today total more than $1.5 trillion. It is the derviatives market, and some other speculative games, which helped reflate the real estate market. Without that, the RTC bailout plan would have ended in utter failure.

FIGURE 2
Bank failures and derivatives



The ugly reality is that derivatives are sucking dry the physical economy. This eliminates the basis for human physical existence, while also undercutting the derivatives themselves. The derivatives and related speculative activities, such as the highly leveraged U.S. stock market, are a cancer. They have rendered the U.S. financial system bankrupt.

In sum, in addition to the official Treasury Department figure of $156.4 billion as the cost of the RTC's bailout of the financial system, there is the approximately $35-40 billion that the banks got by being put on Federal life support during 1989-93; the approximately $100-125 billion subsidy the commercial banks were handed in the form of assets of "good S&L's"; and tens of billions of dollars of profits from derivatives and related products. The total cost of the 1989-95 bailout of the U.S. banking system was roughly $350 billion (were that to be done in today's market, it would cost $500-600 billion).

Further, it was this "total bailout" of the U.S. economy, which was used to reflate the financial bubble, including the real estate market, pulling up that market at a time when, had it not been done, the entire banking system would have gone under, bringing the RTC plan crashing down with it.

Can Japan bail out its banks?

If the Japanese try to bail out their banking system, committing $250 billion or more to the project, as the government has tentatively pledged, it will not work.

The principal reason is that, as we have shown, the RTC