Domestic Credit by Richard Freeman

Conti's not the only one

Bad loans, excessive leverage, and a shaky deposit structure are jeopardizing other top American banks.

Continental Illinois of Chicago held a closed-door meeting with New York bank analysts Aug. 2 in an attempt to cover up the severity of the bank's problems. Conti's top management, according to one participant, "promised that Continental will exercise much better control and judgment over its loans."

But most of the bad loans Continental has to worry about have already been made. Continental is now simply the most prominent—though not necessarily the worst—case of a bank in trouble.

The London *Financial Times* on July 30 spotlighted Conti's problems because London banking circles want to see the major money-center bank for America's industrial and agricultural heartland to go down.

Continental announced in July that its second-quarter losses were $61 million, and that its non-performing loans total $1.3 billion, which is 3.7 percent of its total loan volume outstanding. But Conti is not honestly reporting its books. For example, Continental reported it is categorizing $170 million in loans to Nucorps Energy as current and performing, even though Nucorps went bankrupt July 27. One would assume that performing loans are at least paying a small amount of interest, but that is a meaningless idea for a bankrupt company. Conti replies that its loans to Nucorps are not bad because they are secured against Nucorps' assets. But these assets, such as drilling rigs, are unsellable at even half the price in today's collapsed market.

Conti also classified a large portion of its $150 million loan to the troubled Mexican Alfa group as performing, even though Alfa was forced to tell the world on Aug. 3 what everyone has known for three months—it is incapable of paying interest.

Conti's non-performing loans are thus probably four to five times the cited $1.3 billion. Since this is much larger than Conti's reported capital of $1.7 billion, were a significant portion of these loans to have to be written off, then Conti's losses would exceed the value of its bank capital, the technical definition of bankruptcy.

Senior American and British bankers reported Aug. 4 that Continental Illinois, which had to withdraw Aug. 2 from the pool of top 10 commercial banks that jointly circulate their certificates of deposit of $100,000 or more, can not raise money through issuing CDs in either the United States or Europe. At the closed-door Aug. 2 meeting, Conti reported that it was obtaining funds from Europe; but as one source commented "We live in a 24-hour market. If Americans won't touch Conti's CDs, why assume that Barclays should?" Conti would have to pay an unaffordable 250 extra basis points if it were to market its CDs.

Lastly, Conti is very much overleveraged. Raymond Dalio, president of Bridgewater Associates calculates in a recent report that Conti's loan-to-deposit ratio is 111.1: for every $100 in deposits, Conti has $111.10 in loans. This emphasizes the significance of Conti's use of borrowed funds, including CDs, to make loans.

Dalio's view is that the entire domestic banking system is in Conti's shoes. "The American loan-to-deposit ratio is the worst it has been since 1929," Dalio stated Aug. 4. "Most American banks have many more bad loans on their books than they are willing to say."

First, almost four-fifths of all earning assets for banks are loans today, he reckons, whereas in 1945, American banks had only one-fifth of their assets as loans. In the 1940s and 1950s, banks had the majority of their assets in the form of Treasury bills or investments. Thus, the non-loan cushion in the event of loan defaults is now very small.

Second, Dalio reported that at the largest money-center banks, 50 percent or more of deposits are made by foreigners. In the case of Citibank, 72 percent of deposits are held by foreigners. Should foreign depositors withdraw 5 to 10 percent of their deposits from American banks, loans will have to be called in. This could bring down the American banking system.

Dalio commented, "I call this the failure period. Banks are writing off loans of failing companies that defaulted at a faster rate than any time since 1929. . . . The situation will get worse. I can't see anything that would turn it around. We're in the worst banking situation since 1929."