EIR Economics

The straw that broke the banking system's back

by Kathy Burdman

"It's difficult to say what killed the patient," said a high administration official about the Financial Corporation of America on Aug. 16. "It looks like their losses, like those of Continental Illinois, are in the domestic U.S. economy, not international. But in fact, the international banking environment has been so poor that it may have been fatal, and the domestic losses are only the proverbial straw."

Wall Street celebrated the 13th anniversary of the Aug. 15, 1971 monetary disaster over the near-dead body of a $33 billion-asset financial institution, the Los Angeles-based Financial Corporation of America (FCA), a holding company for savings and loans. The July 25 bankruptcy of Continental Illinois was not the end, but only the beginning of the U.S. banking crisis, which so far seems to have been concentrated in banks and S&Ls with bad domestic U.S. loans and investments.

The same source indicated that there may be a write-off of U.S. banks' "good" international loans coming up this fall as well. The regulators are about to make a major change in the Continental bank reorganization to force Conti to write off Ibero-American loans for the first time. "This will force the other banks to also write them down," he said.

Trouble erupted Aug. 15, when the Securities and Exchange Commission forced FCA to shift its accounting methods and take a large loss on a portfolio of U.S. domestic mortgages. By so doing, FCA had to announce that its expected $31 million profit for the second quarter had turned out to be a $107.5 million loss, the largest ever reported for an American thrift institution.

FCA's stock, which had climbed as high as $26 per share and traded around $9 the second week in August, slumped to only $5 on Aug. 15, and trading was suspended as the entire stock market fell by more than 15 points on the Dow-Jones Index.

A run began on FCA's deposits, as the market for FCA's large certificates of deposit collapsed the next day, Aug. 16. "There appears to be no bid, no market, for [FCA subsidiary] American Savings & Loan's paper whatsoever," money market traders said. FCA itself apparently stopped even trying to sell deposit certificates by Aug. 17, and traders in New York and California said they couldn't get a quote.

The Financial Corporation of America has $15 billion in large certificates of deposit which mature at the end of September, and if investors are still unwilling to trade FCA's CDs at that time, it could lose enough deposits to be shut down. "FSLIC [the Federal Savings & Loan Insurance Corporation] can't be seen bailing out these large depositors," one source said.

Conti itself is in more trouble. The SEC has now charged management cooked the books to show profits by covering up bad loans, and the Federal Reserve revealed Aug. 14 that Conti increased borrowings from the Fed by another $1 billion, to $7.5 billion, indicating that the run on Conti is continuing despite the government bailout.

Busted from Peru to Peoria

Whether the Fed and FSLIC would actually let a huge institution such as FCA go belly-up or not, a bailout would be a tough job, too. The FSLIC for its part has only $6.3 billion left in its insurance fund.

If FCA is bailed out, what of the rest of the savings industry? Many S&Ls have been forced to pay higher interest

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rates to attract funds since FCA's problems became known, and large institutional investors are moving cash out of all S&Ls and into U.S. government securities. Worse, many other S&Ls reportedly have been engaging in the same accounting practices just halted by the SEC at FCA, and may have to make similar income reductions.

"This is only the first," said a well-placed financial source. "Keep interest rates at these levels for another six weeks and another dozen of them will go down."

Five years of Paul Volcker's high rates created the South American debt crisis, which has collapsed general confidence in banks. That forced banks to pay higher rates for deposits.

This came home. As banks have been forced to pay higher and higher rates for deposits, they have simply elected to pass this on to their debtors—domestic as well as foreign.

As *EIR* Contributing Editor Lyndon H. LaRouche, Jr. put it on Aug. 17, at this point it could well be a domestic loan crisis, such as a crisis in part of U.S. banks' more than $220 billion in agricultural debt, which brings down the banking system. A high proportion of U.S. farmers are overtly bankrupt, and there is no IMF to bail those debtors out to save farm banks. Neither will any part of the over $800 billion worth of U.S. domestic mortgage debtors, reeling from high rates, be bailed out to save the S&Ls.

FCA 'blown away'

What will happen to FCA, and will the regulators bail it out? American S&L has been forced to borrow from the Federal Home Loan Bank, the S&Ls' Fed, and to liquidate assets to pay depositors. FCA chairman Charles Knapp, said on Aug. 15 that he held an "informational meeting" with the Federal Reserve itself to get FCA access to the Fed discount window, unusual for an S&L. Conventional wisdom is that the Fed will bail it out as with Conti or sell off the S&L to a big commercial bank, Citibank being the most-named institution.

"FCA won't be bailed out," was the assessment, of an official source, however. "Their depositors are not normal retail [ordinary citizen] depositors, but a lot of large, hot-money speculators drawn by Charlie Knapp's ridiculously high interest rates. "FSLIC can't be seen bailing out these large depositors," he said. "FCA may just blow away."

Volcker and Donald Regan have tried to dismiss the Conti bankruptcy as an "isolated incident" of a bank with a few bad domestic loans. Maybe they'll explain FCA as a few bad domestic mortgages.

But the cause of FCA's troubles, as with Conti, was this generalized collapse of confidence in U.S. bank *deposits*. Just like Continental, FCA has only found it possible to attract deposits by offering exorbitant rates to large depositors, many of them other banks.

Just like Conti, FCA began suffering a deposit run, which began in the spring. *EIR*'s Alert Service had reported July 24, "According to sources at FCA, FCA Chairman Charles Knapp has just hired 400 salesman with a $2 to $4 million per month quota, raising funds in the form of Certificates of Deposit from large institutions. Knapp was willing to pay an effective 13.65% for three-month money, about a percentage point more than the commercial banks pay for small CDs, and half a percent more than the top banks are paying for six-month money in London. . . . The sudden push for high-priced CDs, for which more is being paid than FCA can possibly earn, looks like the penultimate phase of a Ponzi game."

In fact, the company actually suffered a deposit outflow of $1.4 billion in large institutional deposits, which Mr. Knapp's CD salesman succeeded in partially replacing by new sales of $818 million in large CDs to "retail depositors"—private depositors.

On Aug. 13, Knapp revealed that the company had lost $582 million in deposits throughout the month of July, despite the effort. FCA said that its American Savings & Loan Association unit, in particular, was "not in compliance with government liquidity regulations in July because of a savings outflow," and probably will not be in compliance in August either.

Out of $25 billion in deposits, FCA has $21 billion in large certificates of deposit of $100,000 or more, over $15 billion of which are due to be repaid or must be rolled over by Sept. 30. More than 47% are held by institutional depositors, such as trust funds and banks.

FCA made money by charging up-front fees of 3 to 8% for loans, and obtaining them by lending to developers no other S&L would touch. Knapp made his career by seeking hot money from institutions. Much of FCA's cash was used to (unsuccessfully) play the market in Government National Mortgage Association securities.

Knapp's gamble caught up on him, with a mortgage delinquency rate of 15%, against an industry average of less than 1%.

Controlled disintegration?

Bank regulators are getting shockingly tough on the banks and "aiding and abetting the shakeout in the banking market," said an official. The regulators are attempting a "controlled airing of the sins" of the banking system to stop a total crisis of confidence. "They must want to air out the system now, shake it out now, because depositors and investors are so suspicious of the banking market, before they lose faith in the entire market."

Fed chairman Volcker has told U.S. banks to make major renegotiations in their Ibero-American debt and possibly suffer losses in their stock and deposits.

This is "disastrous political timing" for an election year, one official noted, "especially given that none of these problems were new. . . . If all of the S&Ls in the United States had to air all their sins, the industry would be dead tomorrow; it couldn't exist."

The official would not comment as to whether Volcker intends this "disastrous timing" to destroy President Reagan's re-election.