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Banking by David Goldman

Popping the off-balance-sheet bubble

U.S. and British regulators plan reserves against "off-balance-sheet" lending.

American and British bank regulators announced Jan. 8 that they would jointly require banks to put up capital against so-called "off-balance-sheet liabilities." *EIR* in September had projected the British move; the fact that the Federal Reserve went along with it indicates how terrified the regulators are of a banking crisis.

This obscure, and apparently technical measure, represents the most important decision by the central banks since Paul Volcker threw the world into reverse gear by raising interest rates sharply over the Columbus Day weekend in 1979. There are $1.25 trillion of such "off-balance-sheet liabilities" on the books of the top 10 American banks alone, half-again more than those banks' total assets.

The bankers' capital was exhausted by bad debts no later than 1982, and commercial banking business as such disappeared. Instead, banks went over to loan guarantees and securities-peddling. That is the "off-balance-sheet" universe.

EIR warned in its Fall 1986 *Quarterly Economic Report,* "The banks can and have financed any amount of financial-market speculation they want. They did it on purpose. It is impossible to estimate how much interest the banks are really earning on their Third World, energy, and real-estate loans. The regulators have docilely granted them leeway to keep such bad loans on their books, writing off the capital value over whatever period of time suits their accounts. But if interest isn't being paid, where is the money coming from to pay their depositors? Part of the answer is, simply, that the banks have made up the difference by soliciting fees and commissions by diving into whatever speculative markets are available.

"Reports issued in May and June by the world's highest financial authorities admit, in effect, that the world banking system is insolvent, by the standard used by every bankruptcy-court judge in the United States. The Bank for International Settlements (representing the industrial nations' central banks) and the Group of 10 (representing their governments) issued identical reports recently, warning that the banking system might run 'out of control,' because the banks' liabilities exceed their assets by about 250%."

The precise amount of reserves the banks will have to put up has not been specified, prior to a 90-day waiting period for banks' comments.

It does not really matter. Most of the banks are in no shape to put up capital, whatever happens, following the collapse of the "floating-rate Euronote" market in December. On Dec. 4, trading was suspended on almost $17 billion of floating-rate notes (FRNs) in London. One among many forms of "creative securities" which have proliferated during the past several years, the affected area involves so-called "Perpetual FRNs," a device through which the major banks have increased their capital.

Faced with a trillion dollars of bad Third World debt, and hundreds of billions of dollars of bad oil, commodity, shipping, real estate, and related loans, the major banks issued capital notes whose interest rate changes with the market, but whose capital will never be repaid—hence, "perpetual" notes.

The run against this offshore bank paper known as FRNs has not yet affected the banks' deposits. However, big international money, reportedly led by the Japanese banks, has unloaded paper issued by some of the world's top international institutions, fearing that "it may never be paid back," London's *Financial Times* warned Dec. 4.

London sources called the market collapse the worst-ever crisis of confidence in the 20-year-old Eurobond market, the $200-billion-a-year offshore pool which turns international hot money into "legitimate" investments. This may have forced the regulators' hand. The financial system has been held together with mirrors; once this particular mirror cracked, the credibility of the entire arrangement had gone.

The implication is that a handful of banks will take over the overwhelming majority of banking business, and that the present merger trauma around Bank of America will become the order of the day for most of the international banks. The *New York Times* wrote Jan. 9, "A few of the biggest banks might benefit under the plan, since it rewards banks that hold liquid and secure assets, including cash. . . . Banking experts said that the Morgan Guaranty Trust Company and the Bankers Trust Company—which are known to hold higher levels of liquid assets than other major banks—would not be affected by the plan and might even be able to lower their capital levels."

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