Banking by David Goldman

Will toothpaste go back in the tube?

Panicked central bankers now want to "re-regulate" the offshore markets.

Crédit Suisse director Hans-Georg Rudloff's March 18 warning that uncontrolled deregulation of offshore financial markets placed the banking system "before the gravest financial collapse in history," provoked outraged editorials in the British financial press, which scolded Rudloff for talking out of school. A senior Federal Reserve official dismissed Rudloff's claims as "highly exaggerated."

Nonetheless, central bankers are quietly, if desperately, seeking agreements to reestablish regulation over the markets. At a moment when major banks' "off-balance-sheet liabilities" exceed their shareholders' capital by up to ten times over, the Fed, Bank of England, and other regulators want the banks to put capital up against expected losses.

For the obvious reasons, listed below, the effort is doomed to failure.

Federal Reserve vice-chairman Manuel Johnson and staff director Ted Truman are quietly making bilateral contacts with other central banks, seeking to contain the crisis before it blows sky-high. In January, the Fed and Bank of England reached an agreement in principle on assigning reserve requirements to the trillions of dollars of "off-balance-sheet" liabilities.

A congressional delegation leaves for Japan on April 11, meanwhile, to discuss "international financial flows, coordination of Third World debt negotiations, and market regulation" with Japanese officials. Headed by Sen. Jake Garn, the senior minority member of the Senate Banking Committee, the group's activities complement the Federal Reserve's bilateral contacts, according to consultant Richard Medley, whose firm organized the tour.

A 70-page London *Economist* World Banking Survey detailed the exotic horrors of banks' "off-balance-sheet exposure," but concluded that better supervision by the regulators would contain the problem. "Off-balance-sheet liabilities"—which involve the same risk as ordinary liabilities, but are protected by *no* shareholders' capital—exceed commercial banks' capital by 6 to 11 times, the *Economist* survey shows. Total off-balance-sheet liabilities (foreign exchange commitments, contracts and other option arrangements, letters of credit, futures and forward contracts, and interest rate swaps), make up the following percentage of total equity capital at these major U.S. banks:

Citicorp:	1,087%
Bankers Trust:	921%
Chemical Bank:	841%
Chase Manhattan:	684%
Manuf. Hanover:	606%
Morgan Guaranty:	479%

Failure of less than one-tenth of Citibank's "off-balance-sheet" liabilities, decried by regulators as the main danger to the banking system, would finish off the bank. In addition, Citibank has Ibero-American loans equal to approximately 80% of its primary capital, while other American banks are exposed to the extent of 70-120% of their primary capital.

The problem, Prof. Peter Kenen of Princeton University points out, is that the commercial banks made tens of billions of dollars in profits creating such liabilities during the past four years; without them, many commercial banks, e.g., Bank of America, one of the most enthusiastic, would have shown very little profit. At a point where banks must take enormous write-offs of Third World and other debt, eliminating the revenue-stream from such off-balance-sheet operations might bankrupt the system as a whole.

"That is one of the reasons people are moving very slowly and cautiously, via the capital adequacy route," Kenen explains.

Even assuming that the regulators asked the banks to put up only 1% equity-capital against their "off-balance-sheet liabilities"—against 7% for their normal liabilities—the seven largest American banks would have to raise $14 billion in capital. At a moment when the bankers' own paper on foreign markets is either frozen, as in the case of banks' so-called Perpetual Floating Rate Notes, or trading at an extreme discount with respect to safe Treasury securities, the prospect of such a gigantic recapitalization is dim.

The City of London, meanwhile, acknowledges the crash danger, but continues to insist that re-regulation can prevent the worst. The March 23 London *Financial Times*, in an editorial entitled "Risk Control in Financial Markets," cited Rudloff's call for "a stronger regulatory effort at the international level," but downplayed his warning of imminent crisis. "Nevertheless, there is clearly a need for greater discipline . . . a scale of [risk] weightings for off-balance-sheet liabilities," the *Financial Times* concluded.

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