
After the 'Big Bang'

'Off-balance-sheet' nightmare in London

by David Goldman

If it works up the courage, the Bank of England will announce before year-end the first disclosure requirements for "off-balance-sheet liabilities," the \$3 trillion bubble that threatens to bring down the world banking system.

Bank regulators sounded urgent warnings about the explosion of such liabilities in public statements culminating with the June 1986 annual report of the Bank for International Settlements. The public statements stopped after that, when the central banks decided that merely discussing the problem might provoke panic. Not so their concern: The Oct. 27 deregulation of the London market locks in a chain of financial obligations which, if broken, could bring down the entire banking system.

The most immediate fear on the minds of Bank of England senior staff is that cutthroat competition among new entrants into the London market will force several weaker institutions under. Since these institutions play the off-balance-sheet game along with the stronger ones, their default will leave big holes in the capital of the others. Even worse, their failure to honor obligations might collapse securities values across the board, and bring down the entire banking system.

Danger of collapse

"Off-balance-sheet liabilities" are simply financial guarantees which banks do not list on their books as liabilities, and against which they do not put up shareholders' capital. What terrifies the central banks is that the securities houses have dived into such guarantee business in a huge way over the past year; since Merrill Lynch, Salomon Bros., et al. have a fraction of the capitalization of the commercial banks, the danger of a chain-reaction collapse is that much greater.

Better, Bank of England staff believe, to cull the runts at the beginning, under central bank direction. Sources close to the British central bank say that all the institutions in the London market will be asked to disclose their off-balance-sheet obligations, and demonstrate a minimum capital adequacy with respect to these liabilities. The presumption is that institutions which have already stuck their necks out too far will be forced into mergers, before having the chance to go under in a more damaging fashion.

Off-balance-sheet liabilities are the nasty side of "securitization," namely, the replacement of international lending by commercial banks, with circulation of tradeable paper.

Securitization took off in 1984, after the collapse of the \$20 billion Continental Illinois Bank of Chicago. Like most major commercial banks, Continental Illinois turned over roughly 40% of its deposits on an average business day, and depended heavily on foreign deposits to fund its loan portfolio. The bank was doomed the moment large depositors, most of them overseas, decided to pull their money out. The same banks which had "recycled" several hundred billion "petrodollars" during their 1970s heyday, discovered they were vulnerable to deposit runs that could drain them overnight. While the Federal Reserve and the Federal Deposit Insurance Corporation found the means to contain the crisis at Continental Illinois, it was less clear that they could do so twice, let alone 5 or 10 times.

Growth of dirty-money flows

The bankers pulled in their horns, and major overseas depositors—drug dealers, OPEC countries, multinational corporations—subscribed to telex services monitoring the major banks, purporting to warn them the moment that their deposits might be in danger. Meanwhile, illegal capital flows increased at the expense of legitimate world trade. While world trade fell back to 1978 levels, the volume of the international drug traffic rose from about \$200 billion then to over \$500 billion today, not counting additional scores of billions of dollars deriving from flight capital, tax evasion, and other slightly-less-dirty money.

The dope traffickers discovered that even Swiss bank accounts were not sacrosanct when U.S. authorities could prove their case to the Swiss. However, "bearer bonds" issued across national borders ("Eurobonds"), without registration of name of purchaser, could sit undetected in a safe-deposit box anywhere in the world, drawing interest from big-name borrowers. Obliging, First Boston-Crédit Suisse and Merrill Lynch International substituted the circulation of securities, mostly unregistered bearer paper, for the normal accumulation of bank deposits and issuance of bank loans.

Over \$200 billion a year in Eurobonds replaced what had been, before 1984, an equal volume of bank loans. The problem is that the securities market could not, properly, replace the function of commercial banks. Banks are supposed to take deposits from a wide variety of sources, and

lend them to a wide variety of borrowers, obtaining the right maturity-structure of deposits, and the right distribution of loan-risks. Of course, the banks borrowed overwhelmingly short-term funds, subject to sudden withdrawal, and bankrupted their own borrowers through usurious policies, whence the system broke down.

In effect, the broad market of bondholders was asked to take the same kind of risks that the banks could no longer take. The institutions and individuals who buy bonds, particularly Eurobonds, were in no position to balance a portfolio for risks associated with wildly fluctuating interest rates, currency exchange rates, etc.

That is where off-balance-sheet liabilities come in. The commercial banks, along with the big securities houses, went into the business of writing guarantees for such "securitized" debt. Dozens of new types of securities emerged over the past two years, but all with the same feature: In return for a fee up front, a financial institution will guarantee the exchange-rate or interest-rate risk attached to a particular security. Investors can now buy securities with an interest-rate option attached (which pays a cash premium if interest rates rise, and the security's value falls, past a certain point), or "capped" or "collared" securities, in which a financial institution will pay the excess interest should the overall interest rate rise past a certain point, or a currency swap (in which a financial institution acts as an intermediary between debtors who must pay in different currencies), and so forth.

There is also a lively secondary market between the guaranteeing financial institutions, which sell each other the guarantees they have written for the bewildering variety of securities involved.

The problem is that the entire system depends upon a chain of institutions all honoring their obligations. In a world where currency rates fluctuate 40% or more within months, no one can lend money across borders without "hedging" the exchange risk. The same applies to interest-rate fluctuations. Therefore, the new wave of securities must be hedged with guarantees that become off-balance-sheet liabilities on the books of commercial banks or securities firms.

However, one man's speculation is another man's hedge. If, for example, Merrill Lynch writes a put option (the right to buy at a pre-specified price) for German marks, on behalf of, for example, Goldman Sachs' new bond issue in French francs, so that German investors may buy the bond issue, all seems well. What if Merrill Lynch cannot meet its obligations when the mark (hypothetically) soars against the French franc? The value of the bonds in question will instantly collapse, along with the value of all other bonds of the same type, for fear that other guarantors will default as well.

Potential for chain-reaction

The default of one brokerage house, eliminating the guarantees attached to a single bond issue, could collapse the illusion that trillions of dollars of debt instruments are hedged

against currency, interest-rate, or default risk. Of course, the results would be much, much messier: If one brokerage house fails to pay on its options or futures contracts, it leaves many others exposed to losses due to currency or interest-rate fluctuations, triggering possible new failures.

That is all a minor affair next to the consequences for the banking system. That is what really terrifies the Bank of England. Banks have the privilege of telling auditors what they think their loans are worth. If a borrower is in trouble, or thought to be in trouble, the bank need not write down the value of the loans until long after the borrower stops paying. As noted, the banks were forced to leave the banking business at the point that their developing-sector borrowers stopped paying, and their depositors began to panic.

To an extent not measured by the regulators, the commercial banks have replaced ordinary loans on their own books with purchases of securities, i.e., "securitized" loans. The same process at work in London can be seen among U.S. thrift institutions, which stopped issuing straight fixed-rate mortgages against deposits, for fear of being crushed between low-yielding mortgage portfolios and high-interest deposits. Now, at least 40% of their assets are "securitized" mortgages, of which the federal government guarantees close to \$1 trillion.

Whether the government can make those guarantees credible when the mortgage-guarantee agencies run out of money is another matter. But no one provides guarantees for the "securitized" offshore loans, and the corresponding off-balance-sheet liabilities on the books of the banks and brokerage firms. Fear of default by either the borrower, or the guaranteeing financial institution, will crash securities markets. But a crash of securities markets, in a "securitized" banking world, implies an instantaneous crash of the asset base of the commercial banks who have replaced their loans with securities. No longer can the banks pretend that a loan is still worth whatever the bank's accountant says it is. The value of a large portion of their portfolio is posted minute-to-minute on the exchange.

Deregulation of the London market has invited all the major U.S. commercial banks and securities houses to dive head first into "securitization," which they have done by committing \$7-8 billion of their capital to new offices, personnel, or equity in existing firms. They will all lose money by cutting each others' throats for the same business, as *EIR* reported last issue.

But the real danger lies in precisely what the U.S. institutions went to London for: to churn even faster the trillion-dollar-a-day trading volume of the now-global markets in currencies, securities, and commodities. Under these conditions, a problem anywhere in the globe can be translated into spectacular trading losses in every market in the world, and the portfolios of giant financial institutions can be wiped out before central bankers are awakened in the wee hours to hear the bad news.