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Securitization comes to a timely but horrible end

by David Goldman

What came to an end March 28, with the Reagan administration's announcement of trade war against Japan, was the world banking system's life-after-death, following its actual bankruptcy during the 1982-84 debt crisis. The definitive answer to the often-asked question, "Which sector of the world credit system will collapse first?" is, "All of them at once," thanks to the ingenious methods the bankers employed to disguise their bankruptcy during recent years.

Since the Mexican bank nationalization of August 1982, and the run against Continental Illinois Bank in May 1984—the two signal events of the mid-1980s debt crisis—the banking system has survived through a set of financial practices more reckless than the worst shenanigans of the late 1920s. Collectively, these practices are known as "securitization," and they fall broadly into two categories:

1) Substitution of securities-issuance and securities-trading for lending, and

2) Substitution of fee-income derived from guarantees, for lending.

Because the banks usually guaranteed the interest- or exchange-rate of a security in which they also traded, both amounted to the same thing: a repetition of the worst speculative excesses of the 1920s, but with a degree of leverage the Wall Street of 1929 never imagined.

Because major banks had on their books, defaulted loans in excess of their shareholders' capital, it is probable that more than their entire reported profits during the 1983-86 period derived from "securitization."

A rough idea of the magnitude of the scam may be imputed from the following piece of data: America's top seven banks, with $550 billion in assets, accumulated *$1.4 trillion* in "off-balance-sheet liabilities," i.e., guarantees of all kinds, since 1982. Assuming that the banks' earnings on such guarantees ranged between 1% and 2% of the face amount of the sums guaranteed, their income from "off-balance-sheet activities" during the four years 1983 through 1986 would amount to $14-28 billion, comparable to their total dividend payments to shareholders.

What the bankers' trading profits might have been, is hard to estimate, in a market where roughly $2 trillion in transactions occurs every business day—more than the annual volume of world trade in physical goods. In the foreign exchange market alone ($300 billion volume in the four major trading centers), the average bank's *daily* turnover of foreign-exchange contracts typically runs to *two or three times the bank's total assets*.

The only indications of how awesome banks' dependency on such speculative trading-profits has become, take the form of recurrent "financial scandals," in which it recently has been found, that the entire profits of Volkswagen AG, or the entire content of the City of Stockholm's employees' pension fund, had been lost in foreign-exchange speculation.

Like the 1929 bubble, the "securitization" hoax had a precondition, namely, that the values of traded securities would keep rising, such that the portfolios of all participants, taken as a whole, would show a net profit. Why should the banks, as a group, continue to accumulate securities, were the posted value of all debt-securities to decline?

In fact, the collapse of the $200 billion or so floating-rate note (FRN) market offshore, began the end of securitization, as of mid-March, in the wake of Brazil's declaration of a debt moratorium. Each of the players in the securitization game cleverly told himself, "If I buy worthless paper trading on the market, I can protect myself better than if I make worthless loans, because I can always cash the paper in on the open market, just before it goes bad." The obvious problem is, that all the world's financial institutions are buying worthless paper, each expecting to be the first to cash it in when it goes bad. The London *Economist* complained March 28, "The woes in the FRN market show the ravages not only of fierce competition among issuing houses, but also of the securitization of debt. Secondary markets involve quicker suscepti-

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bility to financial shocks and investor whims than does the syndicated loan."

Like the 1929 bubble, the swindle works when securities values rise, but not when they fall. For the past two-and-a-half years, the U.S. Federal Reserve arranged for the post value of debt-securities to increase gradually, by the simple mechanism of bringing interest rates down, such that the Treasury long-term bond interest rate, the benchmark for all debt-securities, stood (at 6.7% at the end of 1986) at barely half its level of early 1984.

Federal Reserve chairman Paul Volcker has been hailed as a financial wizard, for bringing interest rates down, at the same time that the federal government borrowed over $200 billion a year to meet its revenue shortfall, and U.S. credit markets swallowed about $400 billion in mortgage-backed bonds, to finance the consumer-bubble masquerading as "economic recovery." Home mortgage credit, financing not merely housing, but (in the form of second and third mortgages) consumer purchases of imported goods, was the dirty secret of the administration's "recovery" fraud.

Volcker's accomplishment appears less impressive, when it is noted that two sources of funds made it possible to peddle what amounts to U.S. government junk bonds:

1) Japanese institutions bought $100 billion a year, for entirely political reasons, stemming from Prime Minister Yasuhiro Nakasone's commitment to America's central role in free-world defense; and

2) International narcotics traffickers, with a global cash flow exceeding $500 billion, placed a minimum of $60-80 billion a year in dollar-denominated "bearer bonds" (the least traceable of all financial assets) in offshore accounts, financing U.S. corporations. Since the narcotics-traffickers are more concerned with secrecy than rate of return, Volcker's job was not as difficult as it seemed.

In addition, although the true, underlying inflation rate of the American dollar continued to skyrocket, the *reported* inflation rate was suppressed, partly by outright statistical fraud, but partly also by the continued looting of developing-nations, through reduced export prices. *EIR* demonstrated in a study published November 1985, that Ibero-American nations' export prices fell by an astonishing 60% during the three years 1981-83, i.e., the peak of the debt crisis, as their currencies collapsed under International Monetary Fund devaluation programs, and listed commodity prices crashed on international markets. The London *Economist* commodity-price index at the end of 1986 was below its lowest point in the 1980-82 recession. The all-items index stood at 77.7 in fourth quarter 1986, against a 1980 level of 100.

Since the United States continued to shed industrial output throughout the 1982-86 "recovery" period, in favor of wasteful, largely-retail, low-paid "service" employment, the overhead charges on every unit of U.S. physical-goods output continued to rise sharply, indicating an underlying inflation rate of 25% per year. The true inflation rate corresponds, roughly, to the nearly 50% devaluation of the U.S. dollar against the currencies of major industrial countries since the summer of 1985. Of course, the "trade-weighted" devaluation of the dollar was considerably smaller, because the United States treats large portions of the developing world, in precisely the fashion that Nazi Economics Minister Hjalmar Schacht handled Eastern Europe during the first years of the Hitler regime, or Britain treated its imperial "sterling bloc" during the interwar years: as a captive trading bloc, shipping products to the imperial economy at prices below the domestic cost of production.

Now that the political cement of this Schachtian looting arrangement has crumbled, all aspects of the securitization fraud are crumbling simultaneously.

1) The dollar continues to fall despite the best efforts of central banks to contain it, demonstrating, once and for all, what *EIR* has maintained for the past two years, and what Crédit Suisse executive Hans-Georg Rudloff told the Swiss Bankers Association March 18: The central banks can no longer control a market, which was first created precisely in order to escape central bank regulation.

2) Long-suffering Japanese investors, who watched the yen-value of their dollar investments crash along with the dollar parity during the past 18 months, are dumping U.S. long-term bonds, creating a self-feeding dollar-collapse spiral, while

3) the Federal Reserve is finally compelled to tighten credit to support the dollar, as the March 31 increase in the prime rate signaled, further reducing bond values, while

4) rising interest rates bankrupt savings and loan associations, which have survived by funding long-term bond purchases with short-term liabilities, forcing the S&Ls to unload a large portion of their nearly $400 billion portfolio of mortgage-backed bonds, while

5) offshore investors, who moved heavily into U.S. mortgage-backed paper, scramble for liquidity and dump their paper as well, while

6) illiquid commercial banks dump such paper to raise money, in response to the Brazil and related crises.

In short, the general scramble for liquidity portends an uncontrollable crash of securities prices of all kinds, producing trading and portfolio losses at highly vulnerable financial institutions, measuring in the hundreds of billions of dollars. Since the reserves of all central banks taken together come to less than $300 billion, their capacity to bail out the institutions has no credibility among sophisticated financial observers.

The Japanese pullout

The less acute among future historians may blame the Great Crash of 1987 upon an imbecilic blunder by the Reagan administration, forgetting that incompetent swindles are usu-

ally brought to an end by someone's stupidity: The bankers can hardly complain that, having conducted their dirty business behind the pagan idol of the "invisible hand," they have reduced the unfortunate President Reagan to such damaged intellectual condition, that he may provoke the Japanese into withdrawing their subsidy.

The same bankers who benefited most from Reagan's bedazzlement before the "invisible hand," are most horrified at his present blundering. "Reagan is playing with fire by starting a trade war with the Japanese," one senior London banker fumed. "For all the talk of the magic of the marketplace, what the U.S. is doing is totally illogical, from the standpoint of market economics. If Japan withdraws its bloody funds from the U.S. securities and bond markets, these will be the funds that support the U.S. budget deficit. It's a fabulous sum. If the money is withdrawn, the dollar will collapse. And then, what you will see is an immediate reflex to jack up American interest rates again, up to 20-25%, to attract funds back. If the Japanese pull their money out, who will finance the U.S. deficit? There are zero savings in the U.S., U.S. consumers are in hock, and the rest of the world's savings have already been sucked into the U.S., to finance the U.S. budget and trade deficit."

As Swiss bankers' association spokesman Rudloff warned March 18, the central banks can no longer address the problem: The entire object of "securitization" was to permit bankers to take irresponsible risks, without meeting the normal capitalization and reserve requirements which central banks pretend to insist upon in regulated banking systems. One British banker warned, "A complementary problem, is that the central banks no longer trust each other. Also, none of the central banks have the reserves available, to deal with the footloose capital that is running around, across borders."

Rising interest rates

Citibank's symbolic increase in the prime lending rate from 7.5% to 7.75% on March 31, small as it was, sent an important message, for three reasons: First, it was not justified by any change in the bank's own cost of funds; second, it was the first interest-rate increase of any kind in 30 months; third, it occurred at the conclusion of the Federal Reserve's Open Market Committee meeting in Washington, at which the Fed was widely expected to increase rates, in order to stabilize the dollar.

Citibank's own motivations for raising the prime, resemble those of a cannibal whose tribe has run out of missionaries, and now looks hungrily at his colleagues. Economist Alan Leslie of Discount Corp. points out that strains on Citibank's profits from such disasters as the write-off of the bank's massive loans to Brazil, urge the bank to extract more profits from borrowers. Citibank also leads the banks' (and administration's) demand that Brazil pay its interest no matter what the cost, a bull-headed attitude that horrifies the most predatory among European and Japanese creditors. Citibank expresses the swinish, self-defeating heteronomy of Calvinist greed in its most extreme form: Ex-chairman Walter Wriston, for example, is telling friends, that Brazil will try to default on whatever reduced interest payments might be offered, so it benefits the banks to take a tough stance from the beginning!

Despite the temporary stabilization of stock and bond markets following the roughly 4% decline of U.S. equity and debt securities on the two trading days March 27 and March 30, the increase in the prime rate places the credit system on automatic pilot, in the direction of a crash.

The great crash of offshore securities

EIR has followed the spreading paralysis of the trillion-dollar offshore securities market since December 1986, when so-called perpetual floating-rate notes issued by banks to increase their capital, stopped trading. Japanese banks, which had been major purchasers of U.S. and British banks' offshore notes, dumped this paper, as the Brazil debt moratorium came into view. Since then, not merely the $20 billion or so in bankers' floating-rate notes (long-term paper whose interest fluctuates with the overnight rate for bank deposits in London), but the $170 billion of floating-rate bonds of all kinds, have ceased to trade—including paper to which no credit risk is attached.

The London *Economist* wrote March 28, "Why the collapse? Most blame the latest slump on fears about Latin American debt. Floating issues of American banks heavily exposed to Latin America have sunk particularly deep. However, American banks are not alone. All parts of the dated market, high-quality sovereign paper included, have suffered. . . . Investors began to turn to rival instruments including the simply-named floating-rate collateralized mortgage obligations, which are groups of house mortgages bundled together. . . . They have two advantages over conventional FRNs. First, they are asset-backed and therefore of a generally higher quality. . . . Second, they offer more generous spread above LIBOR."

Mortgage-backed bonds, as noted earlier, flooded the U.S. credit market, with a $400 billion issue volume during 1986, and financed the U.S. consumer bubble. It is not surprising that offshore investors would move out of the FRNs, and into mortgage bonds; however, they have gone from the frying pan into the fire.

Specifically, they marched right into the insolvency crisis of the American thrift industry. The nation's 3,500 thrifts fall into three categories: 1) the tiny minority with healthy balance-sheets; 2) those who survived on the basis of the Volcker bond-market boom; and 3) whose who could not survive, even with help from the Volcker bond-market boom. About 500 of them fall into the third category, and these have already bankrupted the Federal Savings and Loan Insurance

Corporation (FSLIC), the government guarantor for their $900 billion in deposits.

Most fall into the second category. Finance Corporation of America, with more than $30 billion in assets, provides an excellent case study. Last summer, the giant S&L, which went to the verge of failure in 1984, borrowed $5.75 billion in short-term money, at the low interest rate of 6%, thanks to Volcker's successful solicitation of Japanese capital inflows. It used this 6% money to buy an equivalent amount of mortgage-backed securities, yielding nearly 9%, and made profits on the difference.

That sort of speculation shows an extreme case of the problems of the thrift industry, which earns money on the difference between the cost of short-term funds, and the earnings of mortgages or bonds in its portfolio. Since a large portion of thrifts' portfolios are made up of older mortgages with low interest rates, any rise in rates above the 8% or 9% level throws them into an operating loss.

During the great interest crunch of 1980-83, savings banks were crushed between the high rates they paid for deposits, and the low rates they received for mortages. This time, they decided to be clever. Like the Eurodollar bankers, who decided to buy securities, rather than issue loans to Third World borrowers, they thought, "If we hold mortgage-backed bonds, rather than long-term mortgages, we can sell them off if interest rates start to go up."

Like the "securitized" offshore banks, each individual S&L cleverly hopes to be the first to jump off the bandwagon, as the bandwagon heads toward the cliff. The howl in the story is that both they and the offshore banks have ended up to the ears in precisely the same paper: the mortgage-backed bonds that account for most of consumer-credit expansion in the U.S. economy.

The result is that problems in any sector of the wobbly world banking system, translate instantly into panic for all other sectors. If the failing Financial Corp. of America folds, or the bankrupt FSLIC cannot meet obligations after depositor-runs at thrift institutions, such an event will trigger a run against the deposits of major London-based Eurodollar banks, as these banks try to unload their mortgage-backed securities, further worsening the position of the thrift institutions, and so forth.

Whether such a run occurs in a matter of days, for example, in the context of the April 17 deadline for Washington's threatened trade sanction against Japan—or creeps up on the banking system through a gradual rise in interest rates—the swindle known as "securitization" has reached the end of the road.

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