Click here for Full Issue of EIR Volume 18, Number 25, June 28, 1991

Banking by John Hoefle

Gonzalez: Fed runs 'backdoor bailout'

U.S. taxpayer dollars are keeping brain-dead banks on their feet—but just barely.

The Federal Reserve has been engaged in a systematic "backdoor bailout" of the U.S. banking system, according to an analysis of Fed discount window loans recently prepared by the House Banking Committee.

The study examined data on all insured depository institutions which borrowed money from the Fed's discount window between Jan. 1, 1985, and May 10, 1991.

House Banking Committee chairman Henry B. Gonzalez (D-Tex.) requested the data in a May 9 letter to Fed chairman Alan Greenspan. "The Committee will mark up legislation very soon which could affect the lending activities of the Federal Reserve," the letter said.

Gonzalez was particularly interested in loans to institutions which borrowed from the Fed within three years of their failure, and banks which had a "CAMEL" (Capital adequacy, Asset quality, Management Earnings, and Liquidity) rating of 5—a rating reserved for institutions with an extremely high probability of failure, immediately or in the near term.

On June 11, the House Banking Committee released the study, "Analysis of Federal Reserve Discount Window Loans to Failed Institutions." Analyzing the 530 institutions which got Fed discount window loans within three years of their failure, the study found:

- Ninety percent of all institutions which received "extended" credit from the Fed subsequently failed;
- The Fed routinely extends credit to banks with a CAMEL 5 rating;
- A CAMEL 5-rated institution which borrowed from the discount window remained open for an average period of 10-12 months thereafter;
- Borrowing from the discount window increases dramatically as an institution's financial condition deteriorates;
- The Fed takes as collateral the highest-quality assets of the institution in an amount substantially in excess of the loan.

The study found that "the extended credit offered by the Federal Reserve appears to operate in practice as a form of open assistance or forbearance."

The study also found that 60% of the failed banks were borrowing money from the Fed at the time of their failure, and had over $8.3 billion in such loans outstanding at the time of collapse. Nearly $8 billion of this money had been loaned to institutions while they had CAMEL 5 ratings.

When these banks fail, the Fed turns to the Federal Deposit Insurance Corp. for repayment.

"This is a massive form of forbearance—granted in secret by the Federal Reserve—at a huge cost to the insurance funds and the taxpayers," Gonzalez said. "We hear many complaints about the ills of money brokers who move money into failing institutions, but their operations pale beside the mega-buck operations of the Federal Reserve."

He added, "The Federal Reserve's loans have kept brain-dead institutions open for extended periods, increasing losses for the FDIC."

Controls must be placed on the Fed's discount window operations if the Congress is "serious about limiting losses to the insurance fund, ending the too-big-to-fail policies, and halting the costly practice of extended forbearance for poorly run banks," warned Gonzalez, who supports legislation to limit discount window borrowing for any given bank to five consecutive days in any three-month period.

Among the banks selected as case studies were First RepublicBank Dallas and the Bank of New England.

First RepublicBank Dallas, with assets of $16.4 billion, was the largest of the failed banks. The study showed that the Fed loaned the bank $2.6 billion in extended credit on March 15, 1988, continuing the lending until the bank failed on June 29, 1988. Peak borrowing during the period was $3.3 billion.

As *EIR* reported at the time, the bank was insolvent for several months prior to the initial loan, but action was delayed until after the March 8 Texas primary, to avoid embarrassment to the state's "favorite son," George Bush.

Lending at the Bank of New England peaked at $2.3 billion. BNE also received over $1 billion in Treasury deposits, and received substantial loans arranged through its sister Connecticut Bank & Trust.

Gonzalez is also investigating whether the Fed, directly or through surrogates like J.P. Morgan and Bankers Trust, bailed out Chase Manhattan Bank, reported Christopher Whalen in the June 17 *Barron's*. "Evidence in the public domain supports the contention that a bailout of some big money-center bank did indeed take place," he wrote, and noted that on Dec. 26, 1990, discount window loans to banks from the New York Fed totaled $3.5 billion; such loans hit $2.4 billion on Jan. 23, 1991, and also topped $2 billion on March 6.

© 1991 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.