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Financial Leaders Feel Anxiety

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NEW YORK—Some of the most powerful leaders of the world's major financial center are openly fearful that strains in the money market could result in at least a few bank and industrial failures in the next six months.

"There has been a loss of confidence in the (financial) machinery most of us took for granted," said Robert V. Roosa of Brown Bros. Harriman. "There is a fear, a kind of foreboding." It is not too much," Roosa added, to say these concerns are similar to the kind that prevailed in the 1930s.

Most are not yet ready to draw an analogy with the Depression years. But in a series of interviews with commercial bankers, private bankers, securities underwriters and government officials, The Washington Post without exception found a deep-seated anxiety about the economic future of the nation.

Choosing his words carefully, "because "Im not an alarmist and I don't feel like an alarmist," Chase Manhattan Bank President David Rockefeller conceded that "the situation is uncertain enough so that one shouldn't discard the possibility of a panic."

Plainly, Rockefeller thinks and emphasizes that the chance of a money panic or crisis is extremely remote. But to avoid one or the other, he warns, will require "unusual prudence and Caution on the part of the bankers," as well as government action that will find "the hair line" between tight money and a money crunch that could "topple important companies in major industries."

The banking system, Rockefeller said, "must exercise its own restraint,

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avoid speculative action and improve the quality of its loans."

Henry Kaufman, partner of the huge underwriting firm of Salomon and Bros., takes an equally sober view. "For the first time, you have concerns about the viability of the banking system," Kaufman said.

The financial community's agitation is well understood at the U.S. Treasury and the Federal Reserve Board in Washington, although officials are anxious not to add to the problem with provocative statements of their own.

Federal Reserve Board Chairman Arthur F. Burns, who is known to believe that banking problems, as well as the problems of the whole economy, are serious, nonetheless thinks that financial men historically are more prone to exaggerate than industrialists.

But Treasury Secretary William Simon said in an interview that "banks have been paying too much attention to profits. . . they (the bankers) have been much more liberal (with loans) than their forebears, and they will have a sobering lesson as they tidy up their internal affairs."

The immediate trigger for anxiety among financial men was the failure late in June of the Bankhaus Herstatt of Cologne, Germany, quickly following the difficulties of the Franklin National Bank of New York, the 20th largest in the United States.

Both banks (among other misadventures) had speculated in foreign exchange, misjudged the markets and lost heavily. Herstatt was closed by German authorities, while the Fed bailed out Franklin with an estimated $1 billion loan.

Some other banks abroad had run into difficulty within the past several months, including two in Germany, the Union Bank of Switzerland, several

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DAVID ROCKEFELLER ROBERT V. ROOSA
. . . one sees uncertainty; the other a loss of confidence.

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merchant banks in London and an Israeli bank with a British affiliate.

But the Herstatt failure was a shocker and an embarrassment, because that small bank was obviously over its head in trying to make a fast dollar in selling foreign exchange, and some of its biggest customers here now admit that they should have known better.

An official of the Morgan Guaranty Trust Co., which lost $13 million in the Herstatt fiasco, confessed "we felt like bloody fools.'

Why did giant banks like Morgan Guaranty, Bank of America, First National City Bank of New York—among others—do business with a small operator like Herstatt?

"Pure greed," answered an insider. "Everyone had heard rumors about bad management at Herstatt. But if we were making 25 cents more out of Herstatt, we just hoped to get paid before they went broke."

The edginess in the financial district goes beyond wonderment about companies, public utilities and banks—it extends to countries. Two weeks ago, rumors swept Wall Street that the government of Japan might face serious financial problems similar to those bedeviling Italy.

A failure of a business firm in Japan underscored that country's enormous oil debt and growing balance of payments problem. And although anxieties about Japan h ave cooled somewhat, Japanese banks have to pay a premium over New York rates to borrow money, which is the market's way of saying that the risk is greater these days in lending to a Japanese bank.

Difficulties for Italy, Japan, Great Britain and other countries are the first manifestations of the vast shock to the world economy touched off by the quadrupling of oil prices last year.

This year alone, the oil-importing countries will have to pay an extra $60 billion for oil to the cartel countries, a process which by 1985—according to the World Bank—will create reserves for the producing countries of $1.2 trillion.

The immediate problem for the banking system focuses on the Eurodollar market. There, banks are being inundated with Arab money ("petrodollars") placed on deposit for a very short time and drawing very high interest. But those same banks are called upon to lend money for extended periods to hard-pressed countries like Italy.

"These banks can't go on indefinitely lending long and borrowing short," Rockefeller said. The worry is that if some major bank gets into trouble, as petro-dollars slosh around the world, it could set off a chain reaction. Or if the Italians actually go bankrupt, institutions all over the world would be hit hard.

Rockefeller urges that loans necessary to cope with the oil crisis be made a multigovernmental rather than a private responsibility. Others, like Peter Peterson. chairman of Lehman Bros., are skeptical, even of this approach. "How are they going to pay the money back?" he asks.

Anxiety has also produced what the bankers call a "quality syndrome" in financial activity. The most dramatic symbol is that investors, large and small, are moving money into U.S. Treasury bills—which pay less than 8 per cent—while the highest quality commercial paper sold by some of the biggest industrial firms in the country pays 12 per cent.

In todays fearful world, many investors thus pass up the extra yield so as to obtain the ultra- blue-ribbon quality of U.S. Treasury bills.

Another evidence of the same trend is the reluctance of purchasers of large certificates of deposit to place funds in small and medium-sized banks. Thus, big banks in New York and Chicago lately have been flooded with money, while those outside of the two major money centers have been losing CD funds.

While losses in foreign exchange speculations have hit many other banks here and abroad, the underlying problem for the U.S. banking system runs much deeper.

In a nutshell, many banks appear to have over-extended themselves in a search for growing business and profits during the past few years, spurred on by assurance that—with money relatively easy—they could borrow new funds without trouble.

If money was easy to borrow, it was easy to lend. But the end results, as credit availibility tightens, is that many of the loans now on the books of banks may be of questionable quality.

ockefeller acknowledged that with inflation and the expansion of bank credit, bank loans have grown more rapidly than bank capital—and that much of the system's capital represents borrowings from other banks.

"The Franklin difficulty and the Herstatt failure increase anxiety," ockefeller said, "and if on top of that, credit restraint by the Federal eserve and other central banks were to produce significant failures in other industries, that in turn would increase the losses for the banking industry, and it is always possible—although I think it remote—that we could have some kind of a crisis or panic.

"My own judgment is if the government and the banking system keep their heads, this can be avoided."

Federal Reserve Chairman Burns is known to have prepared "contingency plans" to wield the enormous power of the Fed whenever he thinks the financial system is in jeopardy. Those plans are said to be quite concrete, would be put into effect when the Fed decides that many bankers—not just one or two—are unwilling to lend to solvent, credit-worthy borrowers.

Figures just published by Dun & Bradstreet for May show the dollar level of U.S. bankruptcies at an all-time high. "There'll be another new record for June," an observer in New York said.

Although rumors are a dime a dozen in New York, no one prefesses to know of a specific bank or company that may have to close its doors.

"That's the eerie thing about it," said a money market expert. "It's like being in a hurricane: you know that something is going to happen. But you also know that most will survive."

Rockefeller made the point that "loan losses in the banking system have increased in recent months and years, and that is undesirable and needs to be corrected."

Rockefeller's prescription for banking prudence at this point is for a more careful scrutiny of loans. "Given hindsight," he admitted, "there is no question that some loans that were perfectly good when they were made don't appear to be good today. There is no question that many loans which appeared to be profitable are in a shaky position, particularly in real estate."

Kaufman suggested that banks had become "performance-oriented," like some of their neighbors in the securities business, partly due to inflation.

"Part of it was due to the lack of an effective stabilization policy—the lack of an effective stabilization policy by definition permitted the huge increase in debt," Kaufman said.

Analysts point out that in the period of monetary ease which prevailed up to 12 or 18 months ago, almost anyone could borrow money on reasonable terms. Just a year ago, the bank prime rate, now 12 per cent, was only 7½ per cent. Eighteen months ago, it was 6 per cent.

"But when you move to a period of monetary restraint," Kaufman pointed out, "after having created a huge amount of debt, and having gotten the market acclimated to the idea that it can borrow and borrow and borrow, then you can run into some problems, because you want to slow down the borrowing."

In such a wringing-out process, now being rigidly followed by the Fed, somebody is bound to get hurt. And in the climate engendered by the Herstatt failure, banks are not only being more choosy about their customers, but are being careful about the other banks with whom they will do business.

American banks, aware that there is less supervision by governments in Europe, are limiting the business they will do with banks abroad, fearful that there might be a collapse before they can collect their funds.

"Our approach is to scale down the size of our exposure with anybody," Roosa said.

And it's not just influential banks like Brown Bros. Harriman that are pulling in their horns. Many of the small and medium-sized banks that had tried to emulate the big ones with a branch in Nassau or London are trying to retrench, but gracefully. "Everybody," said one New York banker, "wants to be the second to close his branch in London—the business just isn't that profitable."

In addition, many banks have been pruning their loan portfolios, trying to peel away those that don't look solid. And, of course, they are toughening up on new commitments, as anyone who has tried to borrow money recently knows.

Some banks in the Midwest and South have now decided to limit their lending and borrowing to their own states or region. For example, one Texas bank, which had been on the verge of opening a London office, now has a policy of lending to people in Texas, and taking deposits from Texas residents only.

Summing up, one New York banker said: "It's a time to work all of the garbage out of the system. There have been a tot of half-baked operators around, and all of this is going to come to an end."

If there is a brighter side to the picture, it may be found in the financial community's awareness of the multifor example, that the foreign exchange faceted problems it faces. Traders say market since the Herstatt collapse has now gotten back to what might be considered the normal volume necessary for the needs of business corporations, investors and insurance companies.

The sheer speculation, in other words, has been wrung out, although the existence of floating exchange rates still makes dealing in foreign exchange an attractive prospect for quick profits. "But it's a hell of a lot healthier than it was before Herstatt," one expert said.

Two days after the Herstatt collapse, the average daily volume of foreign exchange and Eurodollar payments in New York dropped to $36 billion, from a level of $60 billion prior to the June 26 collapse of the small German bank.

Herstatt, with a capital of only $60 million to $70 million, was averaging $1 billion of that volume, making a profit of $25 per $1 million. "It was crazy for them to be dealing at this level," an insider said.

After Herstatt went broke, the management of similar small and medium-sized banks dealing in foreign exchange pulled in their horns, and the big banks here who had not hestitated to deal with Herstatt in effect told their own foreign exchange specialists: "Here's a list of 30 or 40 banks—don't deal with anyone else on foreign exchange."

But reflecting the concern still lingering from Herstatt's failure to make good on its commitments, banks here are now permitted extra time to withdraw checks through the New York Clearing House on the day following a transaction.

And finally, government insiders report that a common understanding is developing among the central banks that each national government will be the "lender of last resort" if a branch of any of its banks abroad gets into trouble.

Since one of the fears about the Eurodollar market—pressed hard to meet the need for cash to pay rising oil bills—has been the absence of a single "last resort" lender equivalent to the Federal Reserve here, this informal understanding, discussed at the last Basle, Switzeerland, meeting of the major central banks is considered a new major underpinning.

But like some others, Roosa thinks that additional steps may be necessary to eradicate the fear in Wall Street. He thinks Arthur Burns will have to emphasize even more than he has done up to now that the Fed. will fulfill its role of lender of last resort, to deal with problems of liquidity of American banks. And he suggests that banks should be subject to greater surveillance of the risks and speculations they may be undertaking.

Roosa, a former under secretary of the Treasury, found it hard to find a single term to sum up the mood in New York. "It's something more than apprehension," he said, "but maybe not acute apprehension. But it's certainly more than just nervousness. To say there is a fear of something like the 1930s is not overstating it."

He pointed out that there were various kinds of anxiety: stockbrokers ("they keep dropping off at a rate of 3 or 4 a month") and the capital market they manage are going through "a real depression"; the savings institutions "are close to a depression"; investors are beginning to lose confidence "in the capacity of people who serve them"; and banks "may have got too eager, and extended themselves into longerterm loans and syndications if they have the right match in their balance sheet between potentially a lot of illiquid assets, and liabilities, much of which they had to buy."

Perhaps offsetting any parallels to the 1930s, some market observers point out, are the existence of so-called "automatic stabilizers" which have been built into the financial system. These include bank deposit insurance, mortgage insurance, and unemployment compensation. Moreover, the federal reserve would be expected to be much more sophisticated than it was in the 1930s, when it shrank bank credit at a time the system needed support.

Like many other observers, Roosa thinks that markets would get a psychological boost if President Nixon were to resign. Kaufman suggested that Vice President Gerald R. Ford, if he succeeds to the White House, consider a coalition government with some prominent Democrats involved.