Banking by William Engdahl

Merrill Lynch under fire

A new Bank for International Settlements study scolds about certain financial "innovations."

The Bank for International Settlements has issued an extraordinary report which hits at Merrill Lynch and other international investment banks. The "central bank for central banks," based in Basel, Switzerland, entitled the report, "Financial Innovations in International Banking."

The study, carried out by Sam Cross of the New York Federal Reserve, warns that the process of global "financial innovation" transforming world financial markets in the past several years opens a Pandora's Box which threatens the very control of central banks over monetary policy.

"The financial system," the report declares, risks breakdown in regulatory oversight over the "consolidated international operations of non-bank financial" organizations. The report criticizes the rapid and concentrated expansion of such "innovations as interest rate swaps, forward rate agreements and Euronote issuance facilities" by a relatively few large organizations producing unhealthy concentration of credit risk.

A well-placed City of London financial source reports that Merrill Lynch is a principal target of the new BIS report warning against the excesses in world financial "innovations." According to this source, a major target of the BIS alarm signal is certain financial conglomerates involved in so-called "securitization."

The term refers to a practice in which a financial institution agrees to market securities of a borrower without accruing any direct liability.

"Under the 'securitization' process, as U.S. laws now stand," the London source continued, "firms such as Merrill Lynch, Salomon Bros., or Citibank have virtually infinite lending potential as they are not required to hold any contingency reserves by law." Merrill Lynch is one of the largest firms involved in this unregulated off-balance-sheet practice, according to the source.

Other prominent players under fire from the BIS include Salomon Bros. and Goldman Sachs.

The international banking system has created more than $3 trillion of so-called "off-balance-sheet liabilities" off the books, that is to say, without reserves of capital in the event of loss. These include such obvious forms of risk-taking as guaranteed note issuance facilities, under which the underwriter agrees to buy any paper which its client cannot place among investors; interest-rate and foreign-exchange swaps, in which the underwriter "matches" holders of different currencies, but must stand surety in the event that one of them fails to perform; and an entire bestiary of guarantees against future interest rate shifts.

Known as "caps," "collars," and so on, these forward interest rate agreements amount to a guarantee of a future interest rate, in return for an up-front fee.

Merrill Lynch's $1.6 billion of market capitalization, impressive by securities industry standards, is nonetheless trivial compared to that institution's level of risk in the market. In effect, it is functioning with the risk level of a major international bank; its competitors have $10 billion of capital or more, and are in enough hot water as matters stand.

What is most extraordinary about the BIS pronouncement is that the central bank has taken the extreme measure of preaching the dangers of collapse from a public pulpit, in the midst of the most dangerous financial situation in postwar history, in order to abort the speculative bubble that has run out of control during the past several years.

In addition, the BIS has gone over the head of the U.S. Treasury, whose chief banking regulator, the Comptroller of the Currency, recently issued extremely watered-down guidelines for dealing with the off-balance-sheet monster.

During 1985, Crédit Suisse-First Boston and Merrill Lynch were, respectively, the number-one and number-two underwriters on the Eurobond market. Crédit Suisse handled $19 billion of Eurobonds, and Merrill Lynch handled $8 billion. Between them, the two partners control one-seventh of the entire market.

As noted, Merrill Lynch continues to operate in tandem with the Crédit Suisse-First Boston combination, as in the case of Spain. There is a revolving door between the overseas offices of Merrill Lynch and Crédit Suisse. On Jan. 23, 1984, ten top officers, including three board members, of Crédit Suisse-First Boston's London offices shifted to Merrill Lynch's London offices.

The former chairman of Crédit Suisse-First Boston, Eurobond market "founding father" Michael von Clemm, recently resigned from the company he helped found, and turned up shortly afterwards as chief of the London office of Merrill Lynch.