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Derivatives bubble springs a leak

by John Hoefle

Death is stalking the world's financial centers, amid signs that the global derivatives bubble has begun to disintegrate. From London, to Paris, to Tokyo, to New York, major shifts are under way, with events which would have been dismissed by many as improbable if not impossible, now making headlines.

What is occurring, is that the era of speculation is coming to an end. The derivatives bubble, upon which the delusions of prosperity over the last decade have largely been based, has sprung fatal leaks, of the sort which must ultimately lead to its disintegration. As with any pyramid scheme, the derivatives bubble must grow rapidly in order to continue; once that growth stops, collapse is inevitable.

Reflections of this process abound. In the City of London, Barings Bank has failed, S.G. Warburg is seeking a buyer to avoid the same fate, and Lloyd's of London is in dire straits. In Paris, the French government is engaged in what seems like a perpetual bailout of Crédit Lyonnais, the largest bank in the world outside of Japan. In Tokyo, the Bank of Tokyo and Mitsubishi bank are merging to form the world's largest bank, hoping to ride out the brewing storm. In New York, the commercial and investment banks are suffering, amidst rumors that a major New York bank is insolvent.

Dramatic drop in trading

These events are all related, reflections of a *systemic* crisis. Just as the rising tide of the speculative bubble lifted the financial boats to new heights, the receding tide is now grounding them. The run on the derivatives markets began when the Federal Reserve Board raised interest rates in February 1994, and turned into a rout in December with the blowout in Mexico, with investors scrambling to unload their holdings.

The effect of this on the major international derivatives exchanges has been dramatic. Trading was down 24% during the first three months of 1995 on the London International Financial Futures and Options Exchange (LIFFE), compared to the first three months of 1994, threatening to end the streak of 12 successive years of trading increases on Europe's busiest derivatives exchange. During the quarter, LIFFE had only one day in which 1 million or more trades were conducted, compared to 12 such days in the first quarter of 1994. The decline continued in April, when only 8 million futures and options were traded, a 35% decline from the 12 million traded in April 1994.

This drop in trading has taken its toll on the City's brokers, in the form of reduced income and staff layoffs. Exco, Prebon Yamane, and Martin Bierbaum are among the brokers which have reduced their staff. Chase Manhattan Bank announced on May 2 that it would cease executing and clearing exchange-traded futures on the LIFFE, following a similar move by Tullett & Tokyo the previous week. The remaining brokers have cut their commissions in a fight for business, ensuring more problems to come. Nevertheless, LIFFE has announced plans to expand its trading floor, displaying the remarkable detachment from reality for which the derivatives world is justifiably famous.

The Chicago Board of Trade also experienced a drop in trading in the first quarter, with volume declining 8%, and open interest declining 12%, over the first quarter of 1994. Trading in Treasury bond futures, the CBOT's largest contract, likewise dropped 8% in volume and 7% in open interest during the period.

Trading on the Chicago Mercantile Exchange continued to grow in the first quarter, but the rate of growth dropped dramatically. During the first quarter, CME trading volume increased 12% over the first three months of 1994, comparing

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favorably to the LIFFE and CBOT, but falling far short of the 54% growth the CME experienced in 1994. January 1995 saw an increase in volume of 37% over January 1994, but the year-to-year growth fell sharply after that, to 6% in February and a barely perceptible 0.3% in March. The bottom fell out in April, when trading volume fell to its lowest level since December 1993. Trading volume was down 29% over April 1994, and 39% over March 1995.

Whether this dismal performance will be repeated remains to be seen, but the April disaster was enough to pull the January-April trading increase down to just 1.3% over the same period in 1994; so a decline in May would likely put the CME negative for the first five months of 1995.

The effect of this decline on the brokers in Chicago is similar to what is happening in the City of London, with traders cutting back on staff and commissions. Goldman Sachs, Smith Barney, and ED&F Man are among the dealers who have trimmed their staffs, and dealers have cut by 15-20% the commissions they pay to the traders who execute the trades in the pits.

While the decline on the listed exchanges is significant, the bulk of derivatives trading is done over the counter, or directly between the big banks and investment houses.

The global derivatives market has grown from just over $1 trillion on notional principal values outstanding at the end of 1986, to $45 trillion at the end of 1994. The amount rose nearly threefold last year alone, in part due to the attempts by derivatives holders to hedge against their own derivatives holdings, and by the underlying grow-or-die imperative. There are signs, however, that this meteoric growth is slowing.

Growth in derivatives holdings slows

The derivatives holdings by U.S. banks, as reported by the Federal Deposit Insurance Corp. in its quarterly banking profiles, grew by $4.8 billion—a mere 0.03%—in the fourth quarter of 1994, to $15,774 billion, up from $15,769 billion in the third quarter. While the total derivatives holdings of U.S. banks grew by $3.9 trillion (33%) in 1994 compared to 1993, the growth slowed dramatically as the year progressed. U.S. banks' derivatives holdings grew $2,043 billion (17%) in the first quarter, $1,406 billion (10%) in the second quarter, and $446 billion (3%) in the third quarter. While there have been four quarter-to-quarter declines in the banks' holdings since the FDIC began keeping derivatives statistics in 1990, including a drop of $950 billion in the fourth quarter of 1992, the steady decline in growth experienced during the four quarters of 1994 is unmatched, and may well indicate that the peak is in sight, if not already reached.

The effect of the derivatives problems can be seen in the trading revenues of the top seven money center trading banks (Citicorp, Chemical, J.P. Morgan, Chase Manhattan, Bankers Trust, BankAmerica, and First Chicago). These seven banks reported gross trading revenue of $3.9 billion in 1994, a decline of 53% from the record $8.3 billion in trading revenue reported in 1993 and the lowest such total since 1989. For the fourth quarter of 1994, the seven banks reported trading revenues of $584 million, a 58% drop from the $1,409 million reported in the third quarter. The high point for trading revenue was the second quarter of 1993, when the banks reported $2,246 million in such revenue. It remains to be seen what the derivatives totals for the first quarter of 1995 will be, but the trading revenues of the seven banks jumped 54%, to $868 million, for the first quarter.

That rise in trading revenue was good news to the banks, but not all of them were happy. While Citicorp reported trading revenue of $344 million and J.P. Morgan reported $303 million, Bankers Trust New York Corp. reported a trading revenue loss of $78 million.

The troubles are just beginning for Bankers Trust, which posted a $157 million first-quarter loss, thanks to the $78 million securities trading loss and losses in Mexico and other Ibero-American countries. But the big problem at Bankers Trust is its derivatives portfolio, which at $1.98 trillion is more than 2,000% of its $97 billion in assets. To cover the losses, the bank has announced plans to cut expenses by $200 million this year and another $75 million in 1996, in part by eliminating 1,000 full-time employees and 400 temporary workers.

"The challenge is to adapt, not to reinvent. . . . Our risk management strategy is not exclusively tied to derivatives," Bankers Trust chairman Charles Sanford told the bank's annual meeting on April 18, noting that since the demand for the most lucrative types of derivatives has faded, the bank will put renewed emphasis on its foreign exchange and emerging market debt derivatives, as well as its computer modelling business. Given the bank's track record, that is hardly encouraging.

The U.S. investment banks have also suffered because of the derivatives crisis. Merrill Lynch, Salomon, and Goldman Sachs all hold more than $1 trillion in derivatives. Salomon and Goldman Sachs's financial problems have been widely reported, and Lehman Brothers is reported to be seeking a buyer to rescue it from a major liquidity crisis.

"But more alarming is the fact that a major money center bank in the U.S., whose name I will not reveal, as it is too sensitive, is at this point technically bankrupt, and only being kept going by extraordinary Fed actions," a senior European banking source told *EIR*.

"Look at the banks with the greatest exposure to Latin debt speculation to find out who it is," another European banking source said. "The Mexico crisis last December was of titanic significance for many U.S. banks. Surprisingly, this time Citicorp and Chase Manhattan were not the ones with the largest exposure in the Latin emerging markets. Number one was J.P. Morgan, followed closely by Bankers Trust. Look at those two to find the probable answer to your question of who is bankrupt."