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Banking by John Hoefle

Deeper into the morass

U.S. financial regulators are bending over backwards to protect the most rotten aspects of the banking system.

Were someone to suggest that the financial policy of the United States and other nations should be bent to serve the demands of casino gamblers, they would likely be laughed out of town (at least, out of most towns). But that is precisely what the Federal Reserve and the Congressional committees which regulate the banks, are trying to do, both by changing the law to permit the creation of huge new "financial services" conglomerates, and by heading off attempts to shine a light onto the shady world of derivatives. This protection of the speculative financial bubble, at the expense of the physical economy, can fairly be compared to a doctor nurturing a cancer, while letting the patient die.

The merger frenzy among U.S. banks reached new heights in the first six months of 1998, with the announcements of $240 billion in mergers. This figure, representing the aggregate price paid by acquirers, is higher than the full-year totals for 1995 through 1997, combined. The value of mergers announced in April alone, was more than the total in 1997, reflecting what the bankers call progress, and what saner minds call hysteria.

To facilitate these mergers, the so-called regulators are taking a steamroller to protections put into law in the wake of the 1930s banking collapse. In May, the House passed H.R. 10, which would repeal crucial protections in both the Glass Steagall Act of 1933 and the Bank Holding Company Act of 1956; the bill is now before the Senate Banking Committee. H.R. 10 would eliminate the barriers between commercial banking, securities dealing, and insurance, allowing the creation of a new class of financial titans.

For the moment, H.R. 10 is stuck in the Senate, due to opposition by Treasury Secretary Robert Rubin. Rubin has locked horns over the issue with Federal Reserve Chairman Alan Greenspan, a zealous defender of the bubble.

However, when it comes to banking, the law is increasingly irrelevant. After all, the merger of Travelers Group and Citicorp, blatantly illegal under existing U.S. law, is going ahead virtually unchallenged, with most of the regulators who should be quashing that deal, bending over backwards to apologize to the banks for allowing the law to interfere, under the theory that the "markets" are above the laws of mere nations.

Then there's the matter of derivatives. Even as the bankers demand that the nations of the so-called Third World implement "transparency" measures, the bankers and their pet regulators are fighting transparency measures at home, when it comes to derivatives. A rather mild proposal by the Financial Accounting Standards Board, to force uniform disclosure by corporations of their derivatives activities, has come under vicious attack by the Fed and the banks, and when the Commodity Futures Trading Commission (CFTC) suggested that a review of the over-the-counter derivatives market was in order, the Fed, Treasury, and Securities and Exchange Commission went ballistic, going so far as to demand that Congress pass a law prohibiting the CFTC from conducting such a review. Transparency, it would appear, is only for the prey, and not for the predators.

The banks' fear of derivatives transparency is understandable, since the perception that they are solvent depends upon keeping their true condition—hopeless bankruptcy—hidden. When you're so far over the edge that there's no way back, truth is not your friend.

Take the case of Chase Manhattan Corp. As of March 31, 1998, Chase had $8.2 trillion in derivatives, up from $7.7 trillion at the end of 1997. Backing up that $8.2 trillion, was a credit loss allowance of $3.6 billion, and equity capital of $22 billion. A loss equivalent to just 0.044% of its derivatives portfolio would be enough to wipe out the credit allowance, and 0.27% would be enough to wipe out all the equity.

Chase is hardly alone. J.P. Morgan had $6.6 trillion in derivatives at March 31, and the new Citigroup will have some $6.5 trillion.

To put the dangers into perspective, readers should recall what happened to the Bank of New England in 1990. The $32 billion bank, at the time one of the 20 largest banks in the country, collapsed in 1990, supposedly due to real estate losses. But rather than close the bank immediately, regulators kept the bank open for nearly a year, pumping in billions of dollars of loans from the Fed. The reason? Derivatives. It took regulators nearly a year to clean up the bank's $36 billion derivatives portfolio, before the brain-dead bank could be closed. Had it been a larger bank, one official commented at the time, there could have been a "meltdown." Today, with several banks having in the neighborhood of 200 times the derivatives exposure of the Bank of New England, that meltdown is a certainty.

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