Banking by John Hoefle

The case of the Bank of New England

Keeping brain-dead banks alive to save the derivatives bubble, is nothing new.

The world's central bankers and finance ministers have devoted considerable attention over the last several years, to developing systems to minimize the impact upon the system as a whole, of the failure of a major derivatives player. The effort, spearheaded by the Committee on Payment and Settlement Systems of the Bank for International Settlements, has focussed on moving the interbank settlement system from settling accounts overnight, to real-time settlement, under the theory that the faster the settlement, the faster the damage of defaults can be contained.

The danger that the failure of a major derivatives dealer could trigger a global financial crisis, was demonstrated in 1990, with the collapse of the Bank of New England. At its peak, BNE was the tenth-largest bank in the United States, with assets of $32 billion. What was not widely known, was that the bank also had $36 billion in derivatives.

In the late 1980s, the "Massachusetts Miracle," as the New England real estate bubble was known, popped, and BNE, which had lent heavily to real estate speculators, found itself facing overwhelming losses. By late 1989, it was clear that BNE was dead, but it would not be closed until January 1991, more than one year later. It is what happened during that year, which is relevant to today.

Rather than close the insolvent bank, regulators actively worked to keep it open. In December, they threw out the chairman of the bank, replacing him with a new one of their own choice, and rescinded the bank's dividend to stockholders. During the month, Federal auditors pored over the bank's books, finding the situation much worse than the bank had claimed. The result was a steep rise in admitted non-performing loans, from $500 million on Sept. 30, 1989, to $2.5 billion on Dec. 31. The bank reported a $1.2 billion loss for the quarter, dropping its equity capital below $500 million, and its capital-to-assets ratio to 2%, well below the required 6%. Large institutional investors, who controlled some $9 billion of the bank's deposits, began to head for the exits.

By February 1990, the new chairman, H. Ridgley Bullock, declared the bank to be "off the critical list." That statement was a lie, designed to calm public fears and prevent depositor runs. In reality, BNE was comatose, kept alive by billions of dollars of loans from the Federal Reserve Bank of Boston. By the time Bullock made his statement, the bank had already received nearly $1 billion from the Fed, with hundreds of millions of dollars more pouring in every week.

Slowly, the problems at the bank were publicly revealed. In March 1990, the Comptroller of the Currency and the Fed issued formal cease-and-desist orders to the bank, and in July, the bank admitted, in its second-quarter filing with the Securities and Exchange Commission, that it might need government assistance to survive. This, after some $18 billion had already been funnelled into the bankrupt bank.

The end for the Bank of New England came abruptly. On Jan. 4, 1991, the bank announced a $450 million loss for the fourth quarter of 1990, a loss which wiped out its $225 million in equity, making the bank officially insolvent. Not surprisingly, the announcement triggered massive depositor runs at the bank, with long lines forming at its offices.

Two days later, on Jan. 6, 1991, Federal regulators officially closed the bank. Federal Deposit Insurance Corp. Chairman William Seidman estimated the ultimate cost to the agency of the failure at $2.3 billion, at the time the second most costly bank failure in U.S. history, after the 1988 failure of First RepublicBank Corp. of Dallas.

Why did Federal regulators pump billions of dollars of public money into an insolvent bank, keeping it open for a year after it should have been closed? The answer lies with the bank's $36 billion derivatives portfolio. Had regulators closed the bank at the end of 1989, causing the bank to default on its $36 billion derivatives, that could very well have led to a domino-like collapse of the global financial system. So, the brain-dead bank was kept open, to defuse the broader derivatives danger.

During November and December 1989, before BNE publicly revealed the size of its fourth-quarter losses, BNE was able to trim its off-balance-sheet exposure by $6 billion. But, as word of its financial problems spread, banks around the world refused credit to BNE, demanding cash up front to settle derivatives deals. The money from the Fed allowed the bank to make the deals necessary to unwind its derivatives exposure. The Fed also used its clout to induce banks, securities firms, and the derivatives exchanges to work with the bank.

By the end of 1990, BNE had reduced its derivatives portfolio to $6.7 billion. A week later, the bank was closed.

© 1998 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.