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Danger of Derivatives Blowout Raised In Senate Hearing on U.S. Banks

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On June 20, Senate Banking Committee chairman Paul Sarbanes (D-Md.) convened a hearing on "The Condition of the U.S. Banking System." Beginning with intonations of reassurance by Federal Reserve Chairman Alan Greenspan, the hearing reached a higher level when Senators confronted Greenspan with the threat to the banking system posed by financial derivatives contracts. The derivatives bubble had been documented in written testimony by *EIR,* submitted to the hearing along with excerpts from Lyndon LaRouche's evaluation of the crisis, presented at a Warsaw seminar on May 24 (see p. 60 for LaRouche's presentation).

Greenspan's opening statement expressed some concern about deterioration of the quality of both U.S. banks' assets and loans, but said that great improvements have been made in "risk management" and control systems.

After other top U.S. banking regulators testified, the reality of the exploding telecom debt, information technology debt, etc., was injected by New Jersey Democratic Sen. Jon Corzine: "The main question I'd like to hear, is some view about the interconnectedness, the systemic exposures . . . particularly I think in light of non-financial institutions increasingly involved in the lending process. . . . This is certainly a problem that is of concern in New Jersey with one of our telecommunication companies, and, I think, with Nortel as well. I know that derivative risk is interconnected, and systemic of nature, and has a credit element, and I'm concerned that we're not focussed as much on this . . . as might be, if one were worried about the deterioration of credit quality on a system[-wide] basis. And I guess you could [apply] that to some of the global sovereign institutions, with what one might be concerned about in Argentina or Turkey."

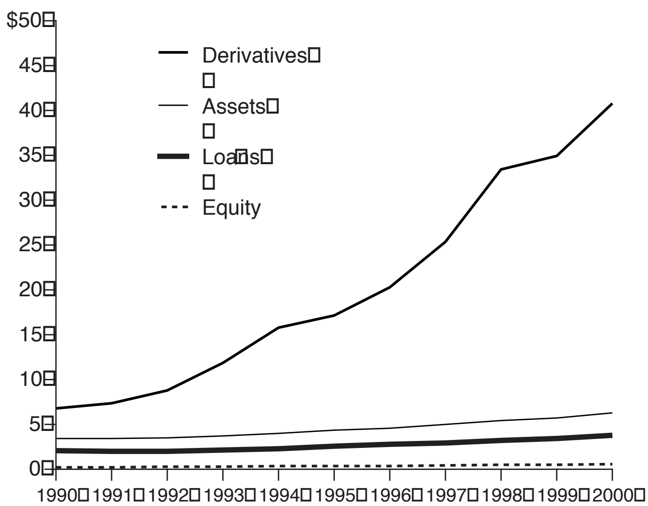
Greenspan said nothing; Federal Deposit Insurance Corp. Chairman Jay Hawke replied only that the office of the Comptroller of the Currency has a national credit review process. Corzine persisted: "Do you also look at derivative credit exposures in that process?"

Hawke's answer was revealing of the time bomb of bad debt and related derivatives concentrated in a few huge banks. He said the derivatives volume has increased, but this is no cause for alarm, because "derivative activity is focussed in a very small number of very large banks, and we and the Federal Reserve, I'm sure, watch that very carefully in the banks that we supervise."

FIGURE 1

Derivatives Cancer Takes Over U.S. Banking System

(Trillions $)



Source: FDIC.

EIR's testimony, by banking expert John Hoefle, gave the committee a brief history of the last 30 years' abandonment of traditional banking to unprecedented speculation, and its consequences. **Figure 1,** part of the *EIR* testimony, shows the extraordinary growth of the huge derivatives bubble, dwarfing banks' assets, loans, and equity. Excerpts of Hoefle's testimony follow:

The Casino Is in Trouble

Derivatives are often technically complex and obtuse, and the difficulty in figuring out exactly how they work has been used by their advocates to argue that the government and its regulatory agencies should keep its hands off, letting the experts run the show. After all, the most common reaction by someone encountering derivatives for the first time is, "I don't understand this."

The real problem is not that they don't understand derivatives, since many people grasp their essential nature immediately; the real problem is the dichotomy between what their common sense tells them, and what the experts claim.

For those among you who have faced this problem, we can only say, put your faith in your common sense rather than in the sirens of Wall Street.

To understand the nature of the derivatives market, we must leave the world of mathematics, with its deviations, standard and otherwise, and enter the world of parasites.

Picture a dog with a very bad case of fleas, the dog representing the productive sector of the U.S. and the fleas representing the worst elements on Wall Street. During the 1970s and 1980s, the fleas built up huge trading empires, trafficking in the flesh and blood of the dog. The fleas were so successful that the once-powerful dog began to dramatically weaken, and no longer produced enough blood to allow the fleas to continue trading in the manner to which they had become accustomed. Being clever critters, the fleas came up with a solution which pleased them all: They began trading in blood futures. Since they were trading in futures rather than actual "product," they were no longer limited by the amount of blood they could suck from the dog. The level of trading expanded dramatically, and the fleas became rich beyond their wildest expectations. Right up to the point that the dog died.

That, in essence, is the nature of today's derivatives markets, and the global financial system as a whole.

During the 1990s, the use of off-balance-sheet derivatives exploded, with the derivatives holdings of U.S. commercial banks increasing from $6 trillion at the beginning of the decade, to $35 trillion at the end of 1999 and $41 trillion at the end of 2000. . . .

At the end of 1990, U.S. commercial banks as a whole had notional derivatives holdings 31 times their equity capital and twice their assets; by the end of 2000, the derivatives were 77 times equity and over 6 times assets.

That only begins to tell the story. At the end of 2000, J.P. Morgan Chase & Co. had $715 billion in assets, $212 billion in loans, $42 billion in equity capital, and a whopping $24.5 trillion in notional derivatives holdings, giving the bank derivatives holdings 34 times its assets, 116 times its loans, and an astonishing 580 times its equity capital. Put another way, a loss equivalent to just 1/580th of its total derivatives holdings would be enough to wipe out all of the bank's equity capital.

In the brave new world of derivatives, the big banks have blown up with some regularity. Most of these events have been handled discreetly, through mergers. From the merger wave in 1991, through the blowup of Bankers Trust in 1994, through last year's merger of J.P. Morgan into Chase, the landscape is littered with the detritus of derivatives failures.

Trying To Save Financial Bubbles

Between 1989 and 1994, the Federal Reserve adopted a policy of steadily lowering interest rates, to pump money into a bankrupt banking system and to finance the growth of the derivatives markets. In February 1994, in an attempt to bring the system back under some degree of control, the Fed began slowly raising rates and promptly blew up the mortgage-backed securities market, bankrupting Kidder Peabody, and wreaking havoc in the larger derivatives market, bankrupting Bankers Trust. Under the cover of scandal, Bankers Trust was taken over by the Fed and the Treasury; its derivatives problems were bailed out, and the bank sold to Deutsche Bank.

Over the next few years, the growth of the derivatives market accelerated. In the Autumn of 1998, the cumulative effect of the (mis-named) "Asian" financial crisis, combined with the Russian devaluation and debt default, sent the financial markets into a full-fledged panic. As speculators, more politely called "investors," fled to the haven of Treasury securities and other government-backed paper, the market for junk bonds, derivatives, and other forms of speculative paper dried up, bankrupting, among others, Long Term Capital Management, the giant Connecticut hedge fund run by ex-Salomon traders and Nobel laureates. Under the cover of saving LTCM, the derivatives market was bailed out yet again. Greenspan's Fed resorted to its old trick of dropping interest rates and flooding the market with money. Eventually the leaks in the bubble were plugged with cash and bodies, and the derivatives market took off again, larger, more dangerous, more unstable than ever.

Every attempt to bring this monster under control has failed. When the Commodities Futures Trading Corp. (CFTC) dared to suggest the need to revisit the issue of deregulation, the Fed, the Treasury, and the Securities and Exchange Commission came down on the CFTC like a ton of bricks, forcing out [CFTC Chairman] Brooksley Born and neutering the agency. At every turn, Greenspan and the Fed have acted to protect the big derivatives banks from their self-inflicted disasters, making a mockery of the claim that no bank is too big to fail. The Fed is committed to saving the fleas, no matter what happens to the dog.

Meanwhile, back in reality, the level of debt in the economy continues to grow, while the productive capability of the economy shrinks. The Nasdaq bubble, a joint venture between the insane notion that the Information Age can replace the Industrial Age, and the Fed's money machine, has collapsed, and only a continuing intervention is keeping the Dow alive. It is widely understood that the game is over. The insiders have moved most of their assets out of paper and into control of hard assets and crucial elements of infrastructure, such as energy and telecommunications. The end of the bubble era is the driving force behind the twin horrors of globalization and privatization, as the insiders move to grab control of post-crash income streams.

The question for the United States . . . is not how to save this doomed system, but how we can best manage its collapse and replace it with a new system which protects the General Welfare of the citizens of the United States.