# Astounding Growth of Derivative Side Bets

by John Hoefle

While much of the world continues to crash around us, the virtual economy continues to expand like mad, with J.P. Morgan Chase leading the pack, as usual. As of Sept. 30, J.P. Morgan Chase had $43 trillion (and a few hundred billion as loose change) in derivatives, an amount roughly equal to the annual gross world product (also known as the world GDP), and about four times U.S. GDP.

Rising to number two in this virtual sweepstakes is Citigroup, whose $17.5 trillion in side bets topped Bank of America's $17.1 trillion. Only two other U.S. commercial banks topped the trillion-dollar mark: Wachovia, the former First Union, had $3 trillion; and "Dope, Inc."-heavyweight, HSBC North America—the U.S. arm of Hong Shang—had $1.8 trillion.

The numbers are from the Comptroller of the Currency's Dec. 21, 2004 report. The Comptroller's figures include holding company derivatives not counted by the Federal Deposit Insurance Corporation (FDIC); reported were $86.9 trillion in derivatives held by the 25 bank holding companies most active in the market.

The banks and their regulators assert that the net amount at risk in this $87-trillion pile of IOUs is a mere $804 billion, and that the "netted current credit exposure" is just $183 billion.

The banks have seen a significant dropoff in revenues from cash and derivatives trading from $3.8 billion in the first quarter, to $2.6 billion in the second, and $1.3 billion in the third. The biggest hit has come in interest-rate trading, which went from a $1.5 billion gain in the first quarter, to a $1.4 billion loss in the third. Some of that has been offset by increased revenue on commodities trading, which rose from $89 million in the first quarter to $405 million in the second quarter and $1 billion in the third.

A total of 87% of all derivatives were interest-rate bets, followed by foreign exchange bets at 9%. Credit derivatives continued to climb, to $1.9 trillion.

As reported in the FDIC Quarterly Banking Profile for the third quarter of 2004, the banks' derivatives holdings have increased at about 25% a year for the past three years, and the level of reported derivatives outstanding has more than doubled since the end of 2000, when it stood at $40.8 trillion.

Since the end of 2000, reported derivatives have soared $44 trillion (108%), while assets have grown $2 trillion (32%) to $8.2 trillion, loans have grown $1.1 trillion (28%) to $4.8 trillion, and equity capital has grown $292 billion (55%) to $821 billion. Thus derivatives are now 10 times assets, 17 times loans, and 103 times equity capital.

## Rosy on the Outside

Meanwhile, the same FDIC Quarterly Banking Profile reported record profits for U.S. Banks, thanks to what it called a "combination of continued strength in consumer loan demand and a growing demand for commercial loans." These insured U.S. institutions earned a record $32.5 billion in net income, the sixth record in the last seven quarters.

Looking at the fine print, though, suggests that the picture is not as rosy as the headlines report. While the level of unpayable debt grows steadily, the banks have been drawing down their level of loan-loss reserves. Six times in the last seven quarters, the amount of money the banks set aside as provisions for loan losses has declined, and the $7.3 billion the banks set aside in the third quarter was the smallest since the third quarter of 2000, when the loan portfolio was 23% smaller.

The situation is worse at the big banks (defined as $10 billion or more in assets), where net charge-offs exceeded provisions for the seventh quarter in a row, and the overall level of loan-loss reserves declined for the fourth time in five quarters. When net charge-offs exceed provisions, it means that the banks are not adding enough in reserves to cover the loans they are writing off, and in the third quarter, the big banks provisions covered only 93% of their writeoffs, pocketing the difference as "profits."

The banks also reported an $84 billion (9%) increase in equity capital in the quarter, but $48 billion of that (58%) came the growth in "goodwill," following on the heels of a $36 billion increase in goodwill in the second quarter. The FDIC defines "goodwill and other intangibles" as: "intangible assets including servicing rights, purchased credit card relationships and other identifiable intangible assets."

What else would you want backing $85 trillion in derivatives?

As for another leading virtual banking vehicle: U.S. junk bond issuance hit a new record in 2004. Some $139 billion in new junk bonds were issued in the United States last year by mid-December, topping the previous record of $137.8 billion set in 1998, according to Thomson Financial. Only $136 billion in junk was issued in 2003.

The leading issuer was Citigroup, with $20.5 billion, followed by CSFB with $18.3 billion, and J.P. Morgan Chase with $15.5 billion. According to Deutsche Bank, the proportion of extremely speculative triple-C rated debt hit 17% of all junk issued this year, up from 8.7% in 2003. Analysts say that much of the new junk is issued by companies using low interest rates to refinance older, higher-rate debt.



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