Mergers, Derivatives Losses Reveal Bankruptcy of the U.S. Banking System

by John Hoefle

If one were to believe the profit statements reported by the U.S. banks, as dutifully aggregated by the Federal Deposit Insurance Corp. (FDIC), one might conclude that the banks were in reasonably good shape, despite certain ominous clouds on the horizon. After all, in the second quarter, the U.S. banking system as a whole reported a record $23.4 billion in profits, eclipsing the previous record of $21.7 billion set just three months earlier. With $45 billion in profits in six months, the banks have already posted a larger profit than they did for all of 1994, and are on a pace to hit a whopping $90 billion for the year. Assuming, that is, that they are still standing at year's end.

Recall that Enron, which ranked number seven on the *Fortune* 500 for 2000, actually moved up to number five in 2001, the year it died. What drove Enron's revenues up was not economic strength, but rather a profound economic weakness, which was masked by phony accounting to make the money-losing company appear profitable.

The name of the game, played by Enron and many others, is to artificially inflate profits while deliberately hiding losses, allowing failing companies to appear healthy.

The U.S. banks—especially the derivatives giants—are masters at this game, counting trillions of dollars of worthless IOUs—derivatives, overblown assets, and unpayable debts—on their books at face value, in order to appear solvent. In the late 1980s, the term "zombie" was used to refer to banks which manifested some mechanical signs of life but were in fact dead.

Today, the zombies have taken over the asylum.

Banks Become Casinos

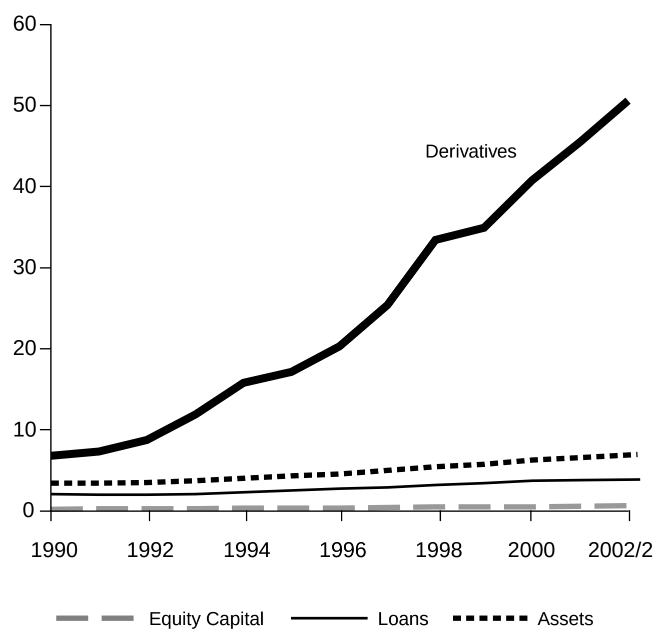
A little history is in order to back up these statements. The U.S. banking system actually went bankrupt in the late 1980s, with the collapse of the real estate bubble and the junk-bond market. The most obvious manifestations of the collapse were the failures of nearly every large Texas bank, and the Texas-centered blowout of the savings and loan sector, but Texas was just the leading edge of a systemic banking crisis. Citicorp was secretly taken over by the Federal Reserve in 1989, shotgun mergers were arranged for other giant banks, backdoor bailouts were given through the Fed's lending mechanisms, and bank examiners were ordered to ignore bad loans. These measures, coupled with a headlong rush into derivatives and other forms of speculation, gave the banks a veneer of solvency while actually destroying what was left of the U.S. banking system.

That the banks have become casinos can be seen by comparing the growth of their off-balance-sheet derivatives holdings to the assets, loans, and equity capital they report on their books (**Figure 1**). As a whole, U.S. banks have notional

FIGURE 1

Derivatives Cancer Takes Over U.S. Banking System

($ Trillions)

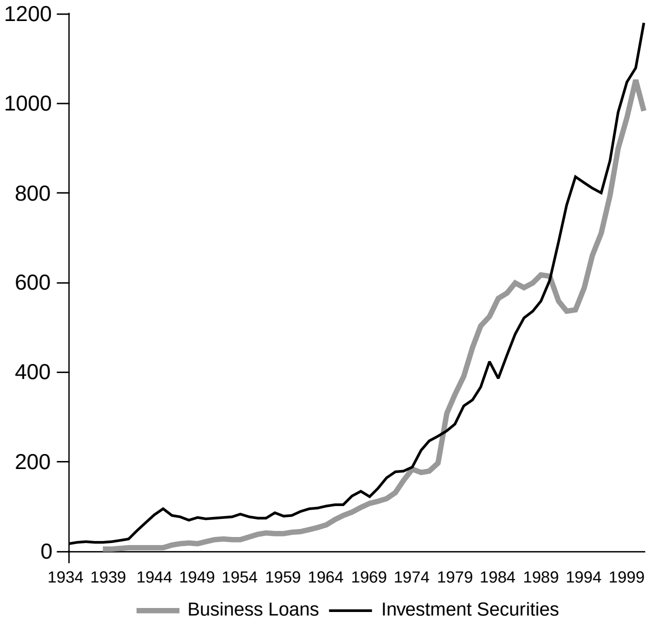


Source: FDIC.

FIGURE 2

Banks Prefer Securities Over Business Loans

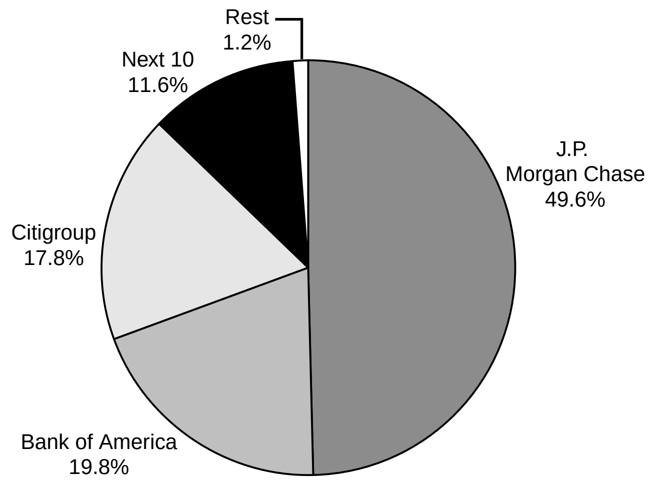
($ Billions)



Source: Federal Reserve.

FIGURE 3

Derivatives Concentrated in Handful of Banks

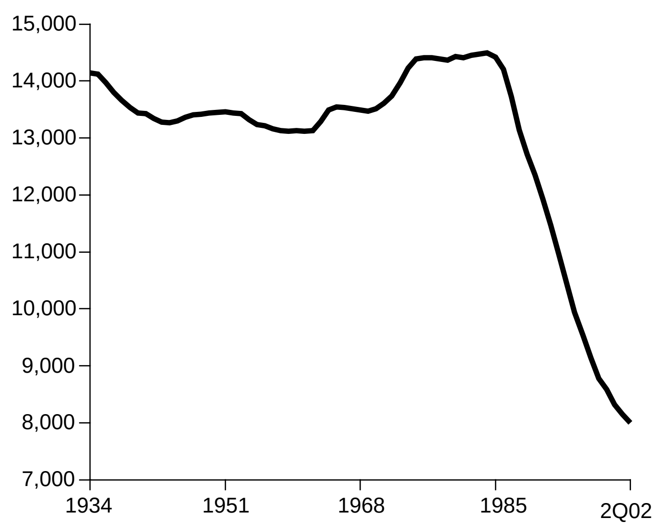


Source: Comptroller of the Currency, *EIR.*

FIGURE 4

Rapid Consolidation of U.S. Banking System

(Number of Banks)



Source: FDIC.

derivatives holdings 81 times their equity capital, 13 times their loan portfolios, and over seven times their asset base. Another reflection of the way in which banks have abandoned traditional banking for the casino is the way in which their holdings of investment securities now surpass their level of business loans (**Figure 2**). They would rather buy and hold corporate bonds, mortgage-backed securities and other instruments, than put their money to use the traditional way, making loans.

However, while the banking system is dominated by this derivatives bubble, the vast majority of these derivatives are concentrated in just a handful of banks (**Figure 3**). J.P. Morgan Chase alone had $26 trillion in derivatives as of June 30, 2002, some 50% of all the derivatives held by U.S. bank holding companies. Bank of America held over $10 trillion, or 20%, while Citigroup held $9 trillion, or 18%, giving these three institutions together 87% of the total. The ten next-largest derivatives banks (Wachovia, Bank One, Wells Fargo, Bank of New York, HSBC, FleetBoston, Taunus, Countrywide Credit, State Street, and ABN Amro) held another $6 trillion, or 12%, with all other U.S. banks combined accounting for the remaining 1%.

Rapid Consolidation

With the shift from real banking into speculation has come a rapid consolidation in the banking sector. At the end of 1984, there were 14,496 U.S. banks, but in the intervening years, 6,473 have disappeared, a decline of 45% and the equivalent of one bank a day. As of June 30, there were 7,996 U.S. banks left, the smallest number since the FDIC began keeping statistics in 1934 (**Figure 4**).

Failures account for about 20% of the drop in the number

TABLE 1

Top Banks in 1985, Then and Now: Only Chemical Remains

1985 Rank	1985 Bank	Assets	Bought By:	Now a Part of:
1	Citicorp	173.6	Travelers, 1998	Citigroup
2	BankAmerica	118.5	NationsBank, 1998	Bank of America
3	Chase	87.7	Chemical, 1995	J.P. Morgan Chase
4	Manufacturers Hanover	76.5	Chemical, 1991	J.P. Morgan Chase
5	J.P. Morgan	69.4	Chemical, 2000	J.P. Morgan Chase
6	Chemical N.Y. Corp	57.0	—	J.P. Morgan Chase
7	Security Pacific	53.5	BankAmerica, 1991	Bank of America
8	Bankers Trust N.Y.	50.9	Deutsche Bank, 1999	Taunus Corp.
9	First Interstate	49.0	Wells Fargo, 1996	Wells Fargo
10	First Chicago	38.9	Bank One, 1998	Bank One

Notes: Travelers bought Citicorp, and changed its name to Citigroup
NationsBank bought BankAmerica, then renamed itself Bank of America
Chemical adopted the Chase name, then became Morgan Chase when it bought Morgan
Wells Fargo was taken over by Norwest in 1995, which kept the Wells Fargo name
First Chicago was taken over by NBD of Detroit in 1995, then Bank One bought First Chicago NBD

of banks, with 1,322 banks failing during the 1995-2001 period. During that same period, 8,092 banks were acquired by other banks, while another 3,300 were created through the issuance of new charters or conversions.

The sharp decline in the number of U.S. banks reflects the adoption by the U.S. financial system of the British banking model, in which a handful of big banks predominate, exercising unhealthy control over the issuance of credit.

That process is shown even more clearly in changes among the bigger U.S. banks. **Table 1** shows how, among the ten largest U.S. banks in 1985, *only one,* Chemical Bank, remains. Starting with the acquisition of Manufacturers Hanover in 1991, Chemical has acquired three banks on the 1985 list, buying Chase Manhattan in 1995 and J.P. Morgan in 2000, changing its name twice along the way, adopting the more prominent Chase and Morgan names. All together, four of the top ten banks—all based in New York—in 1985 have been rolled into the zombie known today as J.P. Morgan Chase. Bankers Trust New York, which suffered a derivatives blowup in 1994, was rehabilitated and eventually sold to Germany's Deutsche Bank. The remaining New York bank on the list, Citicorp, was taken over by Travelers in 1998, in a deal which was illegal at the time. Travelers bought itself a bank charter, renamed itself Citigroup, and became the biggest bank in the United States.

The West Coast banks were also wiped out. In 1991, San Francisco-based BankAmerica Corp. bought Los Angeles-based Security Pacific, and in 1998, Charlotte's NationsBank bought BankAmerica, and promptly renamed itself Bank of America. San Francisco-based Wells Fargo bought Los Angeles' First Interstate in 1996, but it wasn't really Wells Fargo anymore, but Norwest, the Minneapolis bank which bought Wells Fargo in 1995, adopting both the legendary Wells Fargo name and its hometown.

TABLE 2

The Largest U.S. Bank Holding Companies, by Assets, as of June 30, 2002

($ Billions)

Rank	Bank	Assets
1	Citigroup	1,083
2	J.P. Morgan Chase & Co.	741
3	Bank of America	638
4	Wachovia	325
5	Wells Fargo	315
6	Bank One	270
7	Taunus (Deutsche Bank)	231
8	FleetBoston	191
9	ABN AMRO North America	176
10	US Bancorp	173

The only Midwest bank on the list, First Chicago, was taken over by Detroit's NBD in 1995; NBD renamed itself First Chicago NBD and moved its headquarters to Chicago, where it was bought by Columbus, Ohio-based Bank One, which didn't change its name, but did move to Chicago.

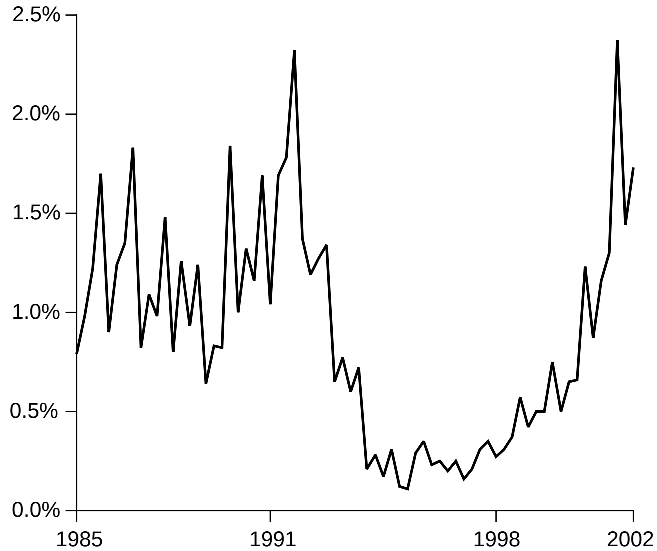
To complete the circle, Bank One is now being rumored as a buyer for the desperate J.P. Morgan Chase. The idea of the $270 billion in assets Bank One, buying the $741 billion Morgan Chase, is ludicrous, despite the fact that Bank One now has a higher stock market capitalization than Morgan. Still, letting Morgan fail, which it seems determined to do, is clearly unacceptable from the standpoint of the White House/

TABLE 3
The World's Largest Financial Institutions, by Assets, 2001
($ Billions)

Rank	Institution	Country	Assets
1	Mizuho Holdings	Japan	$1,149
2	Citigroup	U.S.	$1,051
3	Allianz	Germany	$839
4	Sumitomo Mitsui Banking	Japan	$820
5	Deutsche Bank	Germany	$814
6	Fannie Mae	U.S.	$800
7	Mitsubishi Tokyo Finl.	Japan	$755
8	UBS	Switzerland	$752
9	BNP Paribas	France	$733
10	HSBC Holdings	U.K.	$694
11	J.P. Morgan Chase	U.S.	$694
12	Bayerische Hypo Bank	Germany	$648
13	ING Group	Netherlands	$627
14	Bank of America	U.S.	$622
15	Freddie Mac	U.S.	$615

Source: *Wall Street Journal.*

FIGURE 5
Business Loan Charge-Offs Soaring
(Pct. of total business loans, by quarter)



Source: Federal Reserve.

Federal Reserve Plunge Protection Team (inevitable, yes; acceptable, no).

The result of all these mergers is a group of much larger, and far more bankrupt, giant banks (**Table 2**). Citigroup, which like Morgan Chase appears to be on Federal life support, now has assets in excess of $1 trillion, six times the size of Citicorp in 1985. While the first two banks on the list are based in New York, the next two (Bank of America and Wachovia) are based in Charlotte, N.C., and two of the banks, Taunus (the old Bankers Trust) and ABN Amro, are foreign-owned.

Table 3 shows how a similar process has played out worldwide. The three Japanese banks on the list (Mizuho, Sumitomo Mitsui, and Mitsubishi Tokyo) are all the result of mergers among Japan's top banks. Germany's Allianz, the world's largest insurance company, also owns the $500 billion Dresdner Bank, while Switzerland's UBS is the result of a merger between Swiss Bank Corp. and Union Bank of Switzerland, and BNP Paribas combines two large French banks.

The global list also includes two institutions which specialize in pumping up the U.S. real estate bubble. Both Fannie Mae and Freddie Mac specialize in converting mortgages into mortgage-backed securities, and will vaporize when the U.S. housing bubble pops.

Vaporization

The wave of mergers worldwide results in the concentration of "toxic" derivatives exposure in an ever-shrinking circle of banks, at a point when world stock markets are plunging (the current Plunge Protection Team bump notwithstanding), and the bond markets are beginning to realize that a promise to pay is not the same as the ability to pay. According to European financial sources, blacklists are beginning to circulate, naming financial institutions that can no longer be trusted as derivatives counterparties. Leading almost everyone's list is J.P. Morgan Chase, and the *Financial Times* recently identified Crédit Suisse and Commerzbank as "pariahs" in the derivatives market.

Derivatives, which supposedly reduce risk by spreading it among a larger pool of parties, actually serve to concentrate that risk in a handful of major financial institutions. Banks which specialize in selling credit derivatives to investors, for example, have to pay off when corporations such as Enron default. Since investors tend to buy credit insurance against their riskier holdings, the banks often take hits on their credit derivatives portfolios at the same time that they suffer loan losses from the same company. Morgan Chase, which has a larger credit derivatives portfolio than loan portfolio, may very well have taken a multibillion-dollar hit on credit derivatives written on Enron bonds, in addition to its acknowledged multibillion-dollar losses on loans to Enron.

In addition to the derivatives losses, the process of collapse can already be seen in record levels of business and personal bankruptcies, which have triggered soaring levels of credit card and business loan charge-offs at U.S. banks (**Figure 5**).