Banking by John Hoefle

HBPA or Bust

With each passing week, the breakdown of the U.S. banking system is becoming more visible.

The FDIC released its Quarterly Banking Profile for the third quarter the last week of November, and its tone was uncharacteristically gloomy, the normally perky assessments of financial health replaced by a slew of statistics which show that the situation is rapidly deteriorating. The report still reflects a fantasy-world, but reality is creeping in around the edges.

The big banking deal of the week was the $7.5 billion injection of cash into bankrupt Citigroup by the Abu Dhabi Investment Authority, which itself is awash in petrodollars, thanks to the high price of oil. This is a replay of the way the Saudis came to the rescue of what was then Citicorp in 1990, after the bankrupt bank had been taken over by the Fed; as today, the bank badly needed capital.

To be fair to Citigroup, it is far from alone in the bankrupt category—the names J.P. Morgan Chase and Bank of America spring immediately to mind. But to understand the nature of the crisis, one has to switch focus from the trees to the forest, from individual institutions to the system as a whole.

Trillions of dollars of nominal value of financial assets have vaporized in recent months, with more disappearing every day, a deflation of historic proportions which is eating through the balance sheets of financial institutions and speculators all over the world. The values themselves may never have been real, but they did exist as accounting entries, as assets and liabilities and off-balance-sheet items, where they were treated as if they were real. It is that *perception* of value which is now vaporizing, at an accelerated rate.

This wave of losses is headed inexorably toward the balance sheets of the world's banks, and the bankers know it. The turmoil we've seen so far, the firing of chief executives and other top officers at some of the biggest banks, the losses which grow by billions between the time they are projected and the time they are admitted, the losses on financial instruments which were once considered safe, are all signs of the shock waves of collapse that are circling the globe.

The Bank for International Settlements, in its latest derivatives survey, reported a record $613 trillion in notional value of derivatives outstanding in the over-the-counter markets and derivatives exchanges as of June 30, 2007, an increase of $159 trillion, or 35%, in 12 months. Of particular interest was the $51 trillion in credit derivatives, which have increased more than tenfold since 2004. These numbers, while understated from the likely quadrillions, are so astronomical already, that further quantification is irrelevant. Once you're gone, you're gone.

This growth in derivatives continued in the third quarter. The FDIC reported a staggering $173 trillion in derivatives at U.S. commercial banks as of Sept. 30, a figure which is 16 times the $10.8 trillion in total assets of the commercial banks, 27 times their $6 trillion in loans outstanding, and 157 times their $1 trillion in equity capital. A loss equivalent to just 0.63% of that derivatives total would be enough to wipe out all the equity in these banks.

For the Big Three banks, the situation is even more precarious. As of Sept. 30, J.P. Morgan Chase had $84 trillion in derivatives, Citigroup $38 trillion, and Bank of America $34 trillion. These numbers make their CDO, SIV, and subprime exposures look tiny by comparison, even though those "little" numbers are big enough to blow the banks out of the water. A loss equivalent to just 0.14% of its derivatives portfolio would be sufficient to wipe out every last dollar of Morgan Chase's equity, while at Citigroup it would take 0.33%, and at Bank of America 0.40%.

The point is that losses of this magnitude, and much greater, have already occurred. We cannot accurately quantify these losses, as the statistical reports tend to follow well after the fact, and are usually sanitized when they are released. We can say with certainty that the losses are in the trillions of dollars, more than enough to wipe out the reported equity in the system, and that they are growing at an accelerating pace. The system has already blown, and the bookkeeping admissions are now under way.

The central banks and the plunge protection apparatus are working overtime to try to minimize the damage, but are only pouring money down a rathole. The big banks are virtual zombies at this point, and will all have to be reorganized, and the casino closed.

What is required now, immediately, is to put up the firewalls against further damage, to stop foreclosures and preserve essential banking functions. It is past time for the Homeowners and Bank Protection Act.