Wave of bank mergers reflects a grave danger to the economy

by John Hoefle

The following is testimony submitted by the author before the hearing on bank mergers held on April 29 by the House Committee on Banking and Financial Services. Subheads have been added.

It's a lot more difficult to solve a problem, when one is unable or unwilling to admit what the nature of the problem really is. That is the situation facing this committee, and the nation, on the question of the current wave of bank mergers. The issue is not, as the proponents of "financial modernization" would have us believe, that the U.S. financial system is laboring under "outmoded" and "antiquated" laws which unfairly restrict banks. The claims by the banks that they are saddled with unfair "regulatory burdens" are absurd, and should not be taken seriously by any thinking individual. The issue is, whether the United States' and the world's economies will survive the looming financial disintegration.

For proof that the banks are not suffering unfair burdens, one need look no further than the level of what the Federal Deposit Insurance Corp. terms "off-balance-sheet derivatives." The U.S. commercial banks, as a group, had $25.4 trillion in these derivatives at the end of 1997, compared to $5.0 trillion in assets, $418 billion in equity capital, and $55 billion in reserves against losses. With off-balance-sheet items of more than five times assets, more than 60 times equity, and more than 463 times loan loss reserves, the banks can hardly claim to be suffering from excess regulation. Worldwide, we estimate that there are some $130-150 trillion in derivatives outstanding. If this is *over*-regulation, one would hate to see the effects of *under*-regulation! The banks are already out of control. We don't need further deregulation, we need *re*-regulation, and quickly.

The banking picture is even worse, when you consider that 93% of the derivatives were held by just seven banks at the end of 1997, and that four of these seven banks are involved in the mergers announced in April, increasing an already dangerous level of concentration. The following table shows the big banks' derivatives exposures as of Dec. 31, 1997:

Consider the derivatives exposures of these banks, relative to their assets, equity, and reserves. What do balance sheets mean, when the banks have "off-balance-sheet" items more than 20 times the size of their balance sheets? If the derivatives are used to manage risks, as they claim, what in the world are they doing, that they need so much risk management? If they are taking so much risk, that they need 20 times their assets to protect themselves, then they are already out of control. And if they don't, then why the staggering level of derivatives? What is going on? The answer is that they are no longer banks, but have become speculators, players in a global casino. They are not managing risk, they are spreading it, at a breakneck pace.

Now consider the effect, on this already dangerous situation, of the mergers announced this month:

Citicorp-Travelers: Citicorp's $3.1 trillion in derivatives will be combined with Travelers' extensive holdings, mostly through its Salomon Smith Barney subsidiary. We estimate the new Citigroup would have $5 trillion to $6 trillion in derivatives, giving the U.S. three banks with $5 trillion or more in derivatives (these three banks alone—Citigroup, Chase, and Morgan—will have derivatives with a notional principal value of more than twice the U.S. GDP).

NationsBank-BankAmerica: This merger would combine the fifth- and sixth-largest derivatives-holding banks in the country, yielding a bank with some $3.3 trillion in off-balance-sheet derivatives. The two banks combined, would be even worse off than they are separately.

Banc One-First Chicago NBD: Banc One had, up until now, avoided getting on the derivatives disaster train, having just $33.6 billion in derivatives at the end of 1997, compared to $116 billion in assets. However, with the acquisition of First Chicago NBD and its $1.3 trillion in derivatives, Banc One will vault into the trillion-dollar club, sealing its demise when the derivatives bubble pops.

Playing with fire

The result of these mergers, would be to further increase the concentration of derivatives in the U.S. banking system, thereby making the effects of any derivatives crisis even worse. Imagine the effect on the U.S. economy, were the new Citigroup, the new BankAmerica, Chase Manhattan, J.P. Morgan, Bankers Trust, and Banc One, all to suffer significant losses in their derivatives portfolio. At Morgan, a loss equivalent to just 0.18% of its derivatives portfolio would be enough to wipe out the bank's entire equity capital; similarly, a loss of just 0.27% would bankrupt Bankers Trust, 0.28% would take down Chase, 0.63% would bankrupt First Chicago NBD,

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0.68% would wipe out Citicorp, and 1.24% would be enough to take out both NationsBank and BankAmerica.

Allowing any of these banks to combine, is playing with fire—and the fire has already begun to spread.

Then there is the matter of national sovereignty. The Citicorp-Travelers merger, by any reading of U.S. law, is illegal. In fact, the mere holding by Citicorp's John Reed and Travelers' Sandy Weill, of a press conference to announce their planned merger, was a violation of Federal conspiracy laws.

The restrictions on banking in the Glass-Steagall Act and the Bank Holding Company Act, were designed to contain the power of the banks, to induce them to serve the interests of their communities, rather than themselves. The purpose for which banks are chartered, is to serve the needs of the regions in which they operate. Banks are supposed to serve the economy, not dictate to it. Seeking "global competitiveness," while the productive sector of the U.S. economy collapses, is a fool's dream.

One regulator, responding to the Citicorp-Travelers announcement, said that "the marketplace will do what it has to do," whether the law permits it or not. The "marketplace," in the view of the bankers and of many regulators, would therefore seem to be above the law.

The idea that the banks can be allowed to operate outside the law, and that the law either must be made to conform to the demands of the bankers, or it will be ignored, is both obscene and illegal. The banks, whatever they may think, are subject to the laws of the sovereign nations which charter them—nations without whose authority the banks would not exist. If the U.S. government does not have the courage to enforce the law, the United States will cease to be a sovereign nation.

Grim picture of the world economy

What is driving this merger frenzy, and the capitulation of regulators, is the reality of a systemic, global financial crisis. The so-called "Asian" contagion—which is far from solved, despite the International Monetary Fund (IMF) bailouts and the Japanese "stimulus" program—is not an Asian crisis at all, but a crisis of the global system. Only the banks know, at this point, what derivatives losses have been encountered, but not reported, over the recent months, but the sudden rush to merge, suggests that the picture is much worse than has been publicly revealed.

Deregulation has been a disaster. The "magic of the marketplace" has proved to be a cruel illusion, creating a society in which the poor clearly get poorer, and the rich seemingly get richer. But the rich are in for a great surprise, because their perceived wealth is based on pieces of a speculative bubble, a system of IOUs whose value will evaporate as quickly as the Emperor's new clothes, once reality asserts itself. The bigger the banks get, the harder they will fall. Mergers will not help, but merely make the situation worse.

We are heading into the worst financial and monetary crisis since the collapse of the Lombard banking system triggered the Dark Age. Since the events of last October-November, the IMF, the Federal Reserve, and to a lesser degree the U.S. government, have headed down the path toward a Weimar-style hyperinflation, in a vain attempt to bail out the financial system by rolling over trillions of dollars of unpayable financial claims. Massive amounts of liquidity have been pumped into the system, with more promised, to keep the financial markets from collapsing. But this liquidity, while appearing in the short-term to stabilize the system, actually increases the instability in geometric proportion. The more money you pump in, the worse the situation gets, and the bigger the inevitable explosion.

One of these days, perhaps very soon, there won't be enough cash to fill the whole, and the bubble will begin to disintegrate. A reverse-leverage chain reaction of the derivatives markets will begin, an implosion of the financial system in which one bank after another, unable to meet its short-term obligations, will fail, triggering the domino-like collapse of one bank after another, until, in a matter of days, virtually nothing is left standing.

The demands to deregulate the financial system, are actually demands to bail it out, to create banks which are too big to fail, and too powerful to regulate. The banks are demanding the right to do whatever they feel necessary to ensure their survival, no matter what the cost to the economy, the nation, or the population. The fight among the banks, the securities firms, and the insurers, is a fight over who gets to eat whom, when there is not enough food to go around.

Rather than giving the nation another dose of the medicine—deregulation—which has made us sick, it is time to abandon this failed policy, and begin to re-regulate the banks, to force them to act like banks again, instead of drunken gamblers in a bankrupt casino.

As *EIR* Founding Editor Lyndon LaRouche has observed, this *Titanic* is heading straight for the iceberg. This hearing presents Congress with the opportunity to change course, and steer us out of danger.

Derivatives exposure of the top seven banks

	$ billions			Derivatives as a multiple of:			
Holding co.	LLR	Equity	Assets	Derivatives	LLR	Equity	Assets
Chase	3.6	21.7	365.5	7738.2	2135	356	21.2
Morgan	1.1	11.4	262.2	6216.1	5750	545	23.7
Citicorp	5.8	21.2	311.9	3105.9	534	157	10.0
Bankers Trust	1.0	5.7	140.1	2146.5	2153	276	15.3
NationsBank	2.8	21.3	264.6	1720.5	618	81	6.5
BankAmerica	3.5	19.8	260.2	1593.5	455	80	6.1
First Chicago	1.4	8.0	114.1	1266.7	900	159	11.1
Top 7	19.2	109.2	1717.5	23787.5	1238	218	13.9
All banks	**54.7**	**417.9**	**5015.0**	**25380.3**	**464**	**61**	**5.1**

Sources: Comptroller of the Currency, company reports, EIR.