Banking by John Hoefle

Going, going . . .

Reverse leverage turned the third quarter into a disaster for U.S. banks and securities firms.

Looking at the third-quarter financial reports of the big U.S. banks and securities firms, one is reminded of the cartoon character who has run off the edge of the cliff, but has not yet looked down. With reverse leverage ripping through the financial markets, many of these firms are already bankrupt in reality, and perhaps even bankrupt by the more charitable standards of modern hide-the-losses financial accounting, and those that aren't yet bankrupt, are soon to be so.

One institution after another is plunging into chaos. Lehman Brothers, in a vain attempt to head off rumors of its demise, was forced to publicly deny it is insolvent; Bankers Trust, also rumored to be mortally wounded, is said to be desperately looking for a merger partner; the chairman of UBS, the giant Swiss bank formed by the merger of Swiss Bank Corp. and Union Bank of Switzerland, was forced to resign in the wake of the collapse of Long-Term Capital Management; the president of BankAmerica resigned over losses to another hedge fund; the head of ING Barings was forced out over losses; and Citigroup, Merrill Lynch, and Donaldson, Lufkin, Jenrette have all announced layoffs and cut-backs. In the vernacular of Wall Street, there's blood in the water.

Take the case of two recent death-row marriages, the Travelers/Citicorp and the NationsBank/BankAmerica mergers.

Back in April, when Travelers Group and Citicorp announced their intention to merge to form the $700 billion in assets Citigroup, the deal was valued at $70 billion, but by the time it was closed on Oct. 8, the price Travelers paid had fallen to $37 billion, reflecting the sharp declines in both institutions' stock prices. The merger combines two of the largest derivatives dealers in the world, Citicorp, with $3.5 trillion in notional value of derivatives as of June 30, and Travelers' Salomon Smith Barney, which had $3.3 trillion at the end of 1997. The deal was originally touted as a "merger of equals," but it is clearly a takeover by Travelers of Citicorp. It is, in fact, the second takeover of Citicorp this decade, the first being the November 1990 secret seizure of the bank by the Federal Reserve, as part of a covert bailout of the U.S. banking system.

The new Citigroup is off to a bad start, with a 65% decline in third-quarter profits, including a $1.3 billion trading loss at Salomon Smith Barney, while Citicorp's corporate banking operation lost $127 million, thanks to a $384 million loss from Russia. Salomon lost $700 million trading bonds, and has closed its U.S. bond arbitrage unit.

Then there's the new $570 billion BankAmerica, formed by the Sept. 30 takeover by NationsBank of BankAmerica (NationsBank bought the bank, then adopted its name). On Oct. 1, BankAmerica chairman Hugh McColl (chairman of the old NationsBank) announced that the new bank had less than $300 million in exposure to hedge funds. However, when the bank released its third-quarter results on Oct. 14, it reported a $372 million charge-off, on a $1.4 billion loan to D.E. Shaw & Co., a New York-based hedge fund. The bank also reported a $529 million trading loss, some $400 million of which came from the old BankAmerica and the rest from the old NationsBank. As a result, BankAmerica president David Coulter, former chairman of the old BankAmerica, announced his resignation on Oct. 20.

The third quarter was a disaster for the commercial banks, with the market capitalization of the top 100 U.S. bank holding companies falling $242 billion (23%), to $795 billion, after hitting $1 trillion for the first time in the second quarter, according to *American Banker*. The damage was concentrated in the biggest banks: Chase fell 42%; Citigroup fell 38%; Bank One fell 24%; and Bank of New York fell 55%.

Bank One acquired First Chicago NBD on Oct. 2, transforming itself from a regional bank into a major derivatives player, raising its derivatives holdings from $36 billion, to $1.3 trillion (and prompting suggestions that the bank should change its name to Bank Once).

The mergers have transformed the face of American banking, giving the United States two of the five largest banks in the world (Citigroup and BankAmerica join the Bank of Tokyo-Mitsubishi, UBS, and Deutsche Bank), and increasing even further the deadly concentration of derivatives. Chase still leads the pack among U.S. commercial banks, with $8.5 trillion, followed by J.P. Morgan with $7.5 trillion, Citigroup with $7 trillion, BankAmerica with $4 trillion, and Bankers Trust and Bank One with $2.3 trillion each.

While most financial institutions are reporting reduced profits, rather than net losses, securities giant Merrill Lynch & Co. reported a net loss of $164 million for the third quarter—its first loss since 1989—and announced plans to cut its workforce by 3,400, or 5%. Merrill's trading income plunged 71% in the quarter, including a $135 million loss from emerging markets.