Record Derivatives Growth Ups System Risk

by Richard Freeman and John Hoefle

The Office of Comptroller of the Currency (OCC) of the U.S. Treasury Department disclosed in a report June 18 that U.S. commercial banks' derivatives holdings outstanding had leapt to $76.5 trillion by the end of first-quarter 2004, a level 24% greater than that of the first quarter of 2003. Never has the American banking system been so vulnerable to a systemic meltdown triggered by a chain-reaction derivatives failure. Also on June 18, a senior official of the Federal Reserve Bank of San Francisco warned of heightened "systemic risk concerns" due to stepped-up bank mega-mergers, by which a handful of giants have consolidated in their hands, a large amount of U.S. bank assets. Unsaid, but obvious: The same process has consolidated in the giant banks' hands an immense volume of highly leveraged derivatives.

In a world financial crisis characterized by hyperinflation in oil and commodity prices, rising interest rates, and so forth, any instability could puncture the world derivatives market, valued at $300-400 trillion. Since derivatives "bets" are electronic book-keeping entries, this instability would spread around the world at the speed of light. When such a destabilization hit in September 1998, with the LTCM hedge fund crisis, the system came within a hair's breadth of a global crash.

Not only have U.S. commercial bank derivatives holdings grown by 24% in the past year. Consider this comparison: In first-quarter of 1995, U.S. commercial banks held $17.5 trillion in derivatives; today, they hold $75.6 trillion, a 4.5-fold increase in less than a decade. Once upon a time, the American banking system extended loans to productive agriculture and industry. Now, it is a vast betting machine, gaming interest rates, stocks, currencies, etc. Of bank-held derivatives, 91% are Over-The-Counter (specially tailored to financial institutions, often having exotic and complex features, and not traded on standard exchanges).

The walking-dead JP Morgan Chase Bank (JPMC) dominates the U.S. derivatives market, having $39.6 trillion in derivatives outstanding in the first quarter, up from $36.8 trillion at the end of 2003. JPMC Bank alone has derivatives approaching four times the U.S. Gross Domestic Product of $11.5 trillion. Next come Bank of America and Citibank, with $14.9 trillion and $14.4 trillion in derivatives, respectively. The OCC reports that the top seven American derivatives banks hold 96% of the U.S. banking system's notional derivatives holdings. If these banks suffer serious impairment of their derivatives holdings, kiss the banking system goodbye.

Overall, according to OCC data, one can see the perilous inverted pyramid that characterizes U.S. banks' derivatives holdings: The banks hold $76.5 trillion in derivatives, against $7.8 trillion in bank assets, and $715 billion in bank equity. Bank equity equals—and covers—only 0.9% of derivatives holdings.

However, there are also derivatives held by U.S. investment banks and corporations not accounted for by the OCC. *EIR* estimates that total derivatives holdings held by all U.S. institutions exceed $85 trillion.

Derivatives are growing globally: The Bank for International Settlements (BIS), in its recent Quarterly Review, placed such holdings by financial institutions worldwide at $233.9 trillion, at the end of the first quarter of 2004. Of these, $197.2 trillion (84%) are Over-The-Counter, and the rest exchange-traded.

However, the BIS significantly understates the size of derivatives outstanding, through such techniques as "netting," to disguise the true dimension of the danger. *EIR* estimates that financial institutions of the world's leading nations hold between $300 and $350 trillion in derivatives outstanding.

San Fran Fed: 'Systemic Risk'

The scale of U.S. bank mega-mergers now taking place, makes it all more worrisome. Until this year, Citigroup was the only trillion-dollar-asset banking organization in the United States. Now there are two more: Bank of America, which merged with FleetBoston; and JP Morgan Chase, which will finalize its merger with Ohio-based Bank One in July. On June 18, Simon Kwan of the San Francisco Federal Reserve Bank asserted, in a highly unusual warning in the Bank's *Economic Letter,* "The ever-growing scale of bank mergers raises challenging policy questions, including banking concentration at the national level and systemic risk concerns." He wrote, "When banking activities are concentrated in a very few large banking companies, shocks to these individual companies could have repercussions to the financial system and the real economy."

The share of commercial banking assets held by the top ten U.S. commercial banks has risen from about 30% in 1995, to about 45% today. The U.S. is moving towards the dangerous British model, where six banks dominate the commercial banking system top-down. The even more concentrated derivatives, basically held by seven banks, could act as a detonator charge for explosion.

On June 17, the *Financial Times* of London quoted Bill Gross, head of Pimco, the largest bond-trading fund in the world: "Too much debt, geopolitical risk, and several bubbles have created a very unstable environment which can turn any minute. More than any point in the past 20 or 30 years, there's potential for a reversal."