Oil Prices, Derivatives Light Fuse on Wall Street Time Bomb

by Paul Gallagher

Dec. 30—It is becoming clear to more experts on debt in the trans-Atlantic banking system, that the outrageous mid-December power play by which Wall Street banks forced Congress to grant FDIC insurance to their commodity and credit derivatives, was directly linked to the oil and gas price collapse. This outrage in Congress may lead to the government bailing out Wall Street banks in crisis, sooner than any of the suborned members of Congress thought when they went along with urgent telephone calls from JPMorgan Chase CEO Jamie Dimon and from the Obama White House. The impact of the oil price collapse in the derivatives markets is a time-bomb for an already bankrupt Wall Street.

That mid-December bribery-and-corruption orgy was led by Citigroup, JPMorgan Chase, and Morgan Stanley banks (along with their stickman, Barack Obama). Those three banks, along with Goldman Sachs, are the most exposed to oil/gas sector debt—which has been ballooning by an average $100 billion in net new debt per year for a decade—and to $20 trillion in risky commodity derivatives exposure which has now put them in trouble. Citibank has the largest oil debt exposure, approximately 7% of its total asset book, and Citi was at the center of the "budget bill" wing-ding which put the Federal government back on the hook for the coming commodity derivatives losses by these banks. Citigroup is now the target of a "break up Citigroup" campaign proposed by MIT economist Simon Johnson and which will have some bipartisan support in the Senate of the new Congress.

The oil price collapse began in late October as the collusion by U.S. officials with Saudi Arabia's monarchy to hit Russia with an "oil sanction"; but it has gone out of their control. Notably, on Dec. 20, it was not Russia whose credit was downgraded, but the European oil majors BP, Total, and Shell, all placed on negative credit watch by Standard and Poor's. The oil majors have been loading up with debt for a decade, with an emphasis on paying dividends and buying back their own stock. That debt was piled up despite the fact that demand for oil and gas, throughout the trans-Atlantic economies, has become more and more depressed since the 2007-08 financial collapse. The sector now has roughly $1.6 trillion in debt with—*if oil prices remain in the $50 per barrel range*—not much more than $300 billion in revenues, a highly leveraged situation. Keep in mind that during December, the natural gas price has also plunged by a third, down to the range of $3/cubic foot.

Junk Debt Markets Shake

The "front end" of this debt bubble problem is in the North American shale sector, whose production of oil and gas is less efficient, more expensive, and more environmentally damaging than the industry as a whole. Here bankruptcies of drilling and rig companies are already occurring and the debt in trouble is highly leveraged and high-interest (junk bonds and leveraged loans). It is, along with long-term, high-interest auto loans, essentially the banks' subprime debt bubble of this decade. These two subprime sectors have been dominating new capital investment and employment creation in the U.S. economy. The *Wall Street Journal* on Dec. 17, in "Junk Bond Worries Spread Beyond Oil," reported that these sectors of debt, totalling about $2.4 trillion, have actually started to contract, after rising sharply from 2011 through mid-2014.

London *Telegraph* financial analyst Andrew Critchlow warned already on Nov. 14 that oil shale drillers had come to be nearly one-third of all "high-yield, sub-investment grade" (subprime) borrowers in the United States. He estimated that if the oil price stayed in the $60s (it has been in the $50s for more than a month), 30% of high-yield B- and CCC-grade (energy) borrowers would default. "A shock of that magnitude could be sufficient to trigger a broader high-yield market default cycle," Critchlow warned.

That the Wall Street banks are being hit by this, was shown by the end-of-November report—ironically, put out by Citibank's research team—that the U.S. banking sector's revenue had dropped by 17% in the third quarter, and its loan revenue, the area which has been dominated by high-interest lending to the energy sector, had dropped by 60%. At the same time, the banking sector's exposure to foreign exchange derivatives rose by 90%, and to commodity derivatives by 40%.

This highly dangerous situation for the banks goes back to the Federal Reserve's allowing the big Wall Street banks to own commodities and commodities infrastructure (warehouses, tankers, electric utility plants, etc.), by giving them waivers of the Bank Holding Company Act in the 2002-05 period.

This ownership of commodities by banks—which are also controlling the debt, futures, and derivatives markets for the same commodities at the same time—was the subject of highly condemnatory hearings in Sen. Carl Levin's (D-Mich.) Permanent Investigations Subcommittee in the waning days of the 113th Congress.

These Wall Street practices, which the Glass-Steagall Act also prohibited to commercial banks, allowed the big banks to run up key commodity prices and, at the same time, collect large secondary profits (from derivatives markets) on the commodity prices they were manipulating.

They also put the banks in danger of being hit by huge losses in case of certain "commodity catastrophes," like the breakup of a large oil tanker with a massive oil leak, for example.

Wearing Heavy 'Collars'

But a very large price shock for which the banks' trading programs are not prepared, is the biggest danger to them.

In 2012 the Federal Reserve began publicly "debating" the possibility of forcing the banks out of commodities and infrastructure holdings, but did nothing about it. The Fed "advised" the Wall Street banks to get out of commodity holdings; the banks ignored this. While JPMorgan Chase exited some commodity holdings which had just cost it large fines for market manipulation, Goldman, Citi, and Morgan Stanley went deeper into commodity holdings.

In 2013, the Fed started jawboning Wall Street to stop making massive amounts of "leveraged loans," which were going most heavily to energy firms related to the "shale boom" or to similarly inefficient wind power and solar power schemes. The Fed has admitted publicly that the banks ignored this "advice" as well.

With the collapse of the oil price by 50% in the second half of 2014, the banks have found that a widespread type of commodity derivative known as a "three-way collar" has become very dangerous to them. As the price has declined, from $110/barrel for West Texas Intermediate Crude all the way down to below $55/barrel now, these derivatives have compelled the banks not only to buy more leveraged debt paper, but to buy more oil and gas futures as well.

According to financial experts, the immediate prospect of losses from defaulting debt in the leverage loan and junk bond markets, together with the only slightly longer-term prospect of huge losses in the derivatives markets, have put the Wall Street banks in trouble. The latter's losses could be in the hundreds of billions in total, given that this derivatives exposure of Wall Street is in the trillions.

The biggest U.S. banks, which now reportedly have some $240 trillion in derivatives exposure, have been allowed to pile up almost all of it on their FDIC-insured commercial banking units since Glass-Steagall was eliminated in the 1990s. But due to their extreme risk, these *commodity* derivatives were among the few types that could not be in those depository units—until the banks ran roughshod over Congress in mid-December. Now, with potentially huge losses looming, those trillions in derivatives are subject to a crisis Federal bailout.