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The FDIC whistles past the graveyard

by John Hoefle

The Federal Deposit Insurance Corp.'s *Quarterly Banking Profile* for the fourth quarter of 1993, released March 15, claimed that FDIC-insured U.S. commercial banks made a record profit of $43.4 billion for all of 1993, and that the U.S. banking system was the most profitable it has been since the FDIC was created and began keeping statistics in 1934, in the wake of the Great Depression.

These statistics bring to mind the old joke about the man whose upper half was on fire and whose lower half was frozen. "On average, you're doing just fine," said his statistician.

With the U.S. economy locked in a deepening depression, in which real economic activity is rapidly collapsing, and with the gigantic speculative bubble known as the derivatives market suffering an increasing density of ruptures, the FDIC's claims of record-setting profits for the U.S. banking system are nonsense.

"The impressive fourth quarter results capped a year in which commercial bank earnings soared to unprecedented levels," the FDIC said. According to the FDIC, the banks earned $11.1 billion in profits for the fourth quarter of 1993, the second highest quarterly profit ever recorded, after the $11.5 billion for the third quarter of the same year. With $10.8 billion in reported profits in the first quarter of 1993, and $10.4 billion in the second quarter, the four quarters of 1993 are the four most profitable quarters in U.S. banking history.

By comparison, the banks' reported profits of $32.2 billion in 1992. That figure was also a record, topping the $25.2 billion in profits reported in 1988. It easily surpassed the $18.3 billion reported in 1991 and roughly doubled the $15.6 billion and $16.9 billion reported in 1989 and 1990, respectively. The banks reported an average return on assets (ROA) of 1.21% for 1993, the FDIC said, "marking the first time since the creation of the FDIC that full-year ROA exceeded 1%." By comparison, the banks reported an ROA of 0.93% in 1992, and 0.53% in 1991.

Lower loan-loss provisioning

According to the FDIC, "The largest contribution to banks' increased earnings [in the fourth quarter] came from lower loan-loss provisioning, reflecting improved asset quality." Because of the alleged improvement in the U.S. economy, the level of non-performing assets held by the banks has decreased, thereby reducing the amount of money the banks must set aside as reserves against future loan losses. The banks set aside just $3.8 billion in the fourth quarter, more than 40% less than the $6.4 billion they set aside in the fourth quarter of 1992. For all of 1993, the banks set aside $16.6 billion in reserves for possible loan losses, a decline of $9.5 billion from the $26.1 billion set aside in 1992, and the lowest annual total since 1984. The banks charged off a net $17.5 billion in bad loans in 1993, down 32% from the $25.6 billion charged off in 1992.

Overall, the level of reserves against possible loan losses in the U.S. banking system actually dropped $1.8 billion, or 3.4%, to $52.6 billion at the end of 1993 from $54.5 billion at the end of 1992. "The improvement in asset quality that began two and one-half years ago remained strong through the end of the year," the FDIC said. "Both noncurrent loans and other real estate owned registered their largest quarterly declines ever in the fourth quarter, falling by a combined $11.1 billion." These bad assets, which peaked at 3.19% of total assets during the second quarter of 1991, dropped to only 1.61% of assets at the end of 1993, according to the FDIC's statisticians. "In dollar terms, troubled assets are at their lowest level since 1986," the agency said.

The idea that asset values are rising, in an economy

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caught in the midst of a deflationary spiral, is patently absurd. Asset value statistics may be rising, but the actual values of the assets are not.

Another "source of earnings improvement" cited by the FDIC was "increased net interest income." The banks reported $36 billion in net interest income for the fourth quarter, up $947 million from the fourth quarter of 1992. For the year, the banks reported $139 billion in net interest income, up $6 billion (2.7%) from the $133 billion reported in 1992.

The increases in interest income reported by the banks over the last several years is a direct result of the Federal Reserve's policy of manipulating interest rates and U.S. monetary policy to boost banks' income. That covert bank bailout, which Fed Chairman Alan Greenspan discreetly called "rebuilding balance sheets," represents market manipulation and insider trading on a scale that would turn Michael Milken and Ivan Boesky green with envy.

So far, then, the two biggest sources of the banks' record profits are a nonexistent increase in asset quality, and a covert bailout from the Fed, paid for by looting the economy.

Derivatives boost non-interest income

The third major source of earnings improvement for the banks, the FDIC said, was non-interest income. Non-interest income rose more than $3.3 billion in the fourth quarter from the fourth quarter of 1992, and rose by $9.3 billion to $75 billion for all of 1993, from $65.6 billion in 1992. "Non-interest income contributed 23.4% of the commercial banks' total operating revenue in 1993, up from 20.5% in 1992 and 17.1% in 1991," the FDIC said.

One major component of this non-interest income is the banks' trading activities, including their derivatives trading. Trading revenues account for some 40-50% of profits at the big money center banks.

In testimony to the House Banking Committee's hearings on derivatives on Oct. 28, 1993, Keefe, Bruyette & Woods director of research David Berry reported that the combined trading revenue of the top seven U.S. derivatives banks (Citicorp, Chemical Banking, J.P. Morgan, Bankers Trust New York, Chase Manhattan, Bank America, and First Chicago) had $6.2 billion in trading revenue through the first three quarters of 1993, compared to trading revenue of $5.2 billion in all of 1992 and $5.4 billion in all of 1991.

Full-year trading revenue at those seven banks likely topped $8 billion for 1993. Morgan reported fourth quarter trading revenue of $606 million, the highest quarterly trading revenue ever reported by a U.S. bank, giving it a trading revenue of $2.1 billion in 1993, more than double 1992's $959 million. Citicorp had $427 million in trading revenue for the quarter, giving it a full-year trading revenue of $1.9 billion, compared to $1.3 billion in 1992. Chase Manhattan reported $167 million in trading revenue in the fourth quarter, giving it $715 million for the year, compared to $468 million in 1992.

According to the FDIC, the notional value of U.S. banks' "off-balance-sheet derivatives" portfolios rose $3.1 trillion (35.5%) during 1993, to $11.9 trillion from $8.8 trillion at the end of 1992. The banks had $7.3 trillion in derivatives at the end of 1991, and $6.8 trillion at the end of 1990, according to the FDIC. The seven banks named above, account for 90% of the derivatives activities of U.S. banks, according to the Fed.

As of the third quarter of 1993, Chemical Banking had a derivatives portfolio with a notional value of $2.4 trillion, an 86% growth over the previous 18 months. Bankers Trust had $2 trillion in derivatives, a 107% increase over 18 months; Citicorp had $2 trillion in derivatives, up 39% over the same period; and J.P. Morgan had $1.7 trillion, an increase of 64%.

Hooked on volatility

That derivatives have become the primary focus of these big banks, is clear. An unnamed Citicorp executive was recently quoted in *Fortune* magazine as saying that derivatives trading is "the basic banking business of the 1990s." Earlier this year, Chase Manhattan's deputy risk manager, Michael Davis, told the *New York Times* that his "bank's biggest fear would be a long period of calm and stability in the markets, which would lull companies and investors into slowing their trading activities."

But the volatility upon which the big banks have come to depend, is what will also destroy them.

That point was driven home in the first quarter of this year when the big hedge funds, among the most speculative players in the financial casino, lost a reported 25% of their $75-80 billion in assets. That means losses of as much as $20 billion. However, these hedge funds are highly leveraged, borrowing as much as $20-40 for every $1 in assets, amplifying the losses to as much as $400-800 billion.

To cover their bank loans, the hedge funds dumped massive quantities of their bond holdings, sending the world's bond markets into panic. Rumors spread that various financial institutions, including Goldman Sachs and Bankers Trust, were in serious trouble. Interventions by the Fed and other central banks prevented the total meltdown of the financial system, but the turmoil in financial markets is escalating and the power of the central banks to save the system is waning.

At a March 7 meeting of the Bank for International Settlements in Basel, Switzerland, the Group of Ten central banks agreed on a secret strategy to attempt to bring the derivatives markets under control, but such action is far too little, and far too late.

With $12 trillion in derivatives and only $3.7 trillion in "on-balance-sheet" assets, and $297 billion in reported equity capital, the U.S. banking system cannot survive the imminent collapse of the derivatives bubble. No amount of FDIC statistical hyperbole can save them from the coming tidal wave.