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EIR Economics

Derivatives regulators set course for disaster

by Anthony K. Wikrent

Demonstrating afresh that they know nothing, and care less, about real economic processes, financial regulators in the United States and Great Britain are preparing to impose a new regime of rules that will supposedly bring financial derivatives under control. Derivatives are the paper instruments like financial futures contracts, options, interest rate and currency swaps, foreign exchange contracts, that now comprise an explosively growing world-wide market of *over $1 trillion every day*.

The latest development in the tragicomedy was reported by the London *Financial Times* on Dec. 7: A study, by the giant accounting firm Price Waterhouse, of the likely effects of the implementation within the European Union of the capital adequacy standards of the Bank for International Settlements' (BIS) Basle Committee, found that "banks will have to set aside more capital to cover securities trading and underwriting risks." The Price Waterhouse study, which is based on interviews with 35 banks, investment firms, and regulatory agencies, concluded that many banks that have not already developed the management systems needed to assure adequate supervision and control of "both risk and allocation of capital," are likely to find that the costs of adding such systems are greater than the cost of new capital.

Smaller players to be forced out

Those few firms that are already firmly entrenched in the derivatives markets will pretty much have the field to themselves. In fact, the *Financial Times* reported, "large firms which had already invested in risk pricing models for their securities and derivatives trading businesses tended to welcome the directive because they believed it would give give them an advantage." "Risk pricing models" refers to the extraordinarily complicated computer programs required to "mark to market" a bank's derivatives portfolio at the end of each day. More about this, later.

The Price Waterhouse study was led by Peter Cooke, former chairman of the Basle Committee. Cooke gloats that those banks attempting to enter the derivatives markets will find the task of establishing the required data collection and computing systems "particularly onerous." The cost, Cooke's study states in plain English, will "force some of the smaller players out of the market."

In fact, the derivatives market is already completely dominated by the "larger players." In mid-November, the New York City publication *Swaps Monitor* published the results of its survey of the swaps market. The ten largest interest rate swap dealers accounted for 49% of their market worldwide, according to the report.

But swaps are just one part of the derivatives market. In the United States, swaps account for 26.44% of notional principal amount of all derivatives, according to the figures from the Office of the Comptroller of the Currency, released to the House Committee on Banking, Finance and Urban Affairs on Oct. 28. These OCC figures show the top 25 commercial bank and trust companies in the U.S. accounting for $10.53 trillion in notional principal amount of all derivatives outstanding, out of a total $10.949 trillion. (Notional principal amount is a measure of the underlying principal on which derivatives are based, with each derivatives contract counted only once; the dollar amount of *trading* of derivatives is 30 to 50 times either notional principal amount, or the actual cost of the derivative, with each derivatives contract counted each time it changes hands.)

Only 0.32% of the nation's 77,800 banking and trust companies—three of every 1,000—controls 96.18% of the largest and fastest-growing financial market. Narrow the focus a bit more, and the picture is even worse: The largest ten banks control 91.78% of the derivatives market; the

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largest five control 75.52%. Now comes Cooke, who deigns to inform us that the latest regulations proposed by the BIS will "force some of the smaller players out of the market."

Regulators 'see no evil'

It seems past time to call in the supposedly now aggressive Anti-Trust Division of the U.S. Department of Justice, especially since U.S. regulators have repeatedly said they see no problem. U.S. Comptroller of the Currency Eugene Ludwig told the House Banking Committee on Oct. 28 that "by separating out the risk components of traditional financial instruments, derivatives can—and do—lower the risk of financial transactions for banks and others. . . . Any regulatory approach we take to derivatives should recognize and respect the important and legitimate functions that these financial instruments serve."

In an interview in the *Financial Times* on Oct. 22, U.S. Federal Reserve Board Governor Wayne Angell dismissed fears about derivatives, saying that whatever risks derivatives pose to the banking system could be ameliorated by making the global banking system better able to settle and pay within 24 hours. "I consider derivatives simply a product of the free market system," Angell stated

In an address on derivatives to Women in Housing and Finance, Inc. on Dec. 7, another Fed governor, Susan Phillips, stated, "I do not believe that supervisors should discourage banks from assuming [derivatives] risks. Rather, we should seek to ensure that the risks they assume are prudently managed."

One suspects that perhaps the regulators don't want to jeopardize their future careers when they leave "public service," perhaps hoping to follow former New York Federal Reserve Bank President E. Gerald Corrigan into "retirement" at such places as Goldman Sachs (where senior partners are being paid a bonus of $5 million this year; junior partners will have to struggle home with only $1 million). However, again, it is perhaps best to leave this issue to the U.S. Department of Justice.

Banks cut loans for productive activity

The real risk inherent in derivatives can only be seen by asking: What is the function of a banking system? It is to supply new credit for the expansion of those companies involved in the production of real wealth. In 1990, when all U.S. companies raised a total of $446 billion in new financing (not even new capital—only $24 billion was raised through equity; $291 billion was borrowed, and $131 billion was privately raised), the notional principal amount of derivatives outstanding increased from 1990 to 1991 by $1.863 trillion—over four times more than the 1990 amount of new financing raised, and almost three times the $701 billion of new financing U.S. business enterprises raised in 1991.

The OCC figures show that Morgan's total portfolio of all derivatives had grown from $1.014 trillion on June 30, 1992, to $1.537 trillion on June 30, 1993. That increase of $523 billion is just slightly smaller than the total amount of commercial and industrial loans outstanding at *all* U.S. commercial banks in April 1993—$589.7 billion. In other words, one single institution, J.P. Morgan, increased its derivatives paper in one year by just about the same amount of bank loans to all industrial and commercial firms in the entire U.S. economy.

In fact, while Morgan and the other large money center banks were expanding their derivatives portfolios by 40-50% or more, the total amount of commercial and industrial loans outstanding was *shrinking*. From April 1992 to April 1993, the amount of commercial and industrial loans out to U.S. businesses fell from $609.2 billion to $589.7 billion—a decline of 3.2%.

As bad as these comparative figures look, the situation is even worse, because most of the money center banks' profits now come from taking "speculative" positions, using the derivatives they have created. That is, banks like Morgan are no longer primarily in the business of issuing and administering loans; they are "day traders," moving in and out of equity, bond, futures, options, and currency markets several times a day, sometimes even several times an hour. David Berry, director of research at Keefe, Bruyette and Woods, Inc., presented figures to the House Banking Committee on Oct. 28, showing that in 1993, Morgan is expected to realize $1.453 billion in profits from trading for its own account; Bankers Trust, $1.182 billion; Citicorp, $1.507 billion; Chase Manhattan, $548 million. No wonder Michael G.J. Davis, deputy head of risk management for Chase, told the *New York Times* Aug. 4, "The 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. The worst thing for us is a marketplace where nothing happens."

No small part of the banks' proprietary trading is undertaken for the purpose of "dynamic hedging"—that is, adjusting the banks' risk profile by moving in and out of the various financial markets, depending on what the banks' derivatives holdings are. The largest firms, such as Morgan, now do computer evaluations continuously through out the day and night. The regulators are demanding that the banks now "mark to market" their derivatives holdings at the end of each day, so that weaknesses can be immediately identified and acted upon the next day.

Rather than forcing banks back into the business of providing loans to commerce and industry, regulators are exacerbating the problem. For the regulators to say that their new rules will keep derivatives "under control," is like saying you are still in control of a car that has plunged over a cliff, because you still have your seat belt on, and that the blame lies not on the fact that you were asleep at the wheel, but on the car's speed and steering angle at the point that the car began its plunge.