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Banking by John Hoefle

Greenspan calls for a bank bailout

Let the banks do what they want, and let the taxpayers pick up the tab, says the Federal Reserve.

Federal Reserve Chairman Alan Greenspan issued a clear call for a U.S. government bailout of the big derivatives banks on May 25, in testimony to the Telecommunications and Finance subcommittee of the House Energy and Commerce Committee.

"Regulators are going to have to judge the magnitude of the market losses that bank capital should be expected to absorb," Greenspan said. "In making this adjustment, regulators must recognize that there are some highly unlikely events—say, those that tend to occur only once in a half-century—that may call for government actions to backstop bank capital so as to avoid systemic problems."

While demanding that the government bail out the big banks by covering their derivatives losses, Greenspan arrogantly denied the duty of the government to regulate the derivatives markets. "Where we see opportunities for federal regulation to enhance private regulation, we should implement it," he said. "Where we perceive private regulatory failure, we should step in immediately. But we must keep in mind that federal regulatory intrusion in an inappropriate time or place can weaken incentives for private efforts and expose the overall system to greater risk."

What Greenspan is saying is that the government should take no action to dry up the largest speculative bubble in world history, but should instead keep the bubble going by guaranteeing it with the taxpayers' money. The "private regulation" of which Greenspan speaks, is nothing more than letting the banks do whatever they want, the very policy which created this disaster.

Greenspan's statements came during the last of three Telecommunications and Finance subcommittee hearings on the question of increasing government regulation of the over-the-counter derivatives markets.

The case for such regulation was made by the General Accounting Office, which issued a report on the subject on May 18. The 196-page report, entitled "Financial Derivatives: Actions Needed to Protect the Financial System," noted "significant gaps and weaknesses" in the regulation of derivatives activities, and warned that the derivatives activities of the big banks and other financial firms could ultimately lead to a taxpayer bailout.

The GAO study examined the derivatives activities of 15 major dealers in the over-the-counter derivatives market, through the end of 1992. The dealers studied included seven bank holding companies (Chemical Banking, Citicorp, J.P. Morgan, Bankers Trust New York, Chase Manhattan, BankAmerica, and First Chicago); five securities firms (Goldman Sachs, Salomon Brothers, Merrill Lynch, Morgan Stanley, and Shearson Lehman Brothers); and three insurance companies (American International Group, Prudential, and General Re).

Together, these firms accounted for $11 trillion of the $12 trillion notional value of derivatives outstanding at the end of 1992, according to the GAO report. The banks dominated the list, taking the top six spots in terms of exposure, and accounting as a group for 63% of the total derivatives market worldwide.

"This combination of global involvement, concentration and linkages means the sudden failure or abrupt withdrawal from trading of any of these large dealers could cause liquidity problems in the markets and could also pose risks to others," the GAO said.

The first subcommittee hearing, on May 10, featured testimony from former Securities and Exchange Commission chairman Richard Breeden, former president of the Federal Reserve Bank of New York Gerald Corrigan, and J.P. Morgan chairman Dennis Weatherstone. All three agreed that the derivatives market is under control, and that no additional regulations are needed. "Whatever else is true . . . the sky is not falling," insisted Breeden.

The second hearing, on May 19, featured Comptroller General Charles Bowsher, the head of the GAO.

In his opening statement at the second hearing, subcommittee chairman Edward Markey (D-Mass.) said that "both regulatory and legislative reforms" were necessary to "curb excessive speculation, abusive or fraudulent activities" in the derivatives markets. "In light of GAO's findings, I cannot agree with those who would argue that the 1,000 points of light of industry volunteerism and a few incremental changes by regulators can effectively address the risk posed by exotic derivatives," Markey stated.

Bowsher cited, as examples of the dangers, the huge losses recently reported by some U.S. companies, including losses by a U.S. subsidiary of the German Metallgesellschaft "that involved assistance of more than $2 billion from 120 banks. . . . I might point out that that's larger than the Lockheed, Chrysler, or New York City bailouts, just to put that in perspective."

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