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Is U.S. Congress waking up to derivatives danger?

by Anthony K. Wikrent

A marked shift in approach toward financial derivatives was evident in hearings July 12 on H.R. 4503, "The Derivatives Safety and Soundness Act of 1994," held before the Subcommittee on Financial Institutions of the U.S. House of Representatives Committee on Banking and Urban Affairs. Federal regulators and private bankers were told that Congress is not about to play along with the derivatives game, after having been so terribly burnt by the savings and loan crises in the 1980s. Regulators were asked bluntly whether they could prevent the world systemic crisis warned about in the May report on derivatives by the General Accounting Office (GAO). And J.P. Morgan's Mark Brickell, who appeared in his capacity as vice chairman of the International Swaps and Derivatives Association, was told to his face that he is a liar. The confrontational stance taken by the congressmen contrasted sharply with the approach they took last year, when Banking Committee Chairman Henry B. Gonzalez (D-Tex.) first placed the issue of derivatives before his colleagues.

A derivative is a financial instrument whose value is based on the price of stocks, bonds, bills, currencies, or even indexes of these, such as the Dow Jones Industrial Average. These derivatives are traded, in turn, in an endless round of speculation. While it is impossible to determine the true volume of U.S. derivatives trading, it has grown at a breathtaking rate in recent years, to somewhere around $14-16 trillion per year. This speculative bubble is looting the physical economy to the point that a financial blowout is now imminent. On March 9, 1993, Lyndon LaRouche issued a proposal for a 0.1% sales tax on these transactions. That proposal was later endorsed by Chairman Gonzalez.

H.R. 4503 is the merger of legislation introduced earlier this year by Gonzalez, with another bill introduced by Rep. Jim Leach (R-Iowa), the ranking Republican on the Banking Committee. The major change is that the tax on derivatives transactions contained in the Gonzalez bill has been deleted. Drawn largely from the July 1993 report on derivatives by the Group of 30, a private group of central bankers and derivatives dealers, and headed by former U.S. Federal Reserve Chairman Paul Volcker, H.R. 4503 basically codifies the approach to derivatives now being taken by such U.S. regulatory agencies as the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Federal Deposit Insurance Corp. (FDIC), and the Office of Thrift Supervision (OTS). H.R. 4503 is thus not hostile to derivatives by any stretch of the imagination.

The subcommittee hearing was chaired by Rep. Stephen Neal (D-N.C.), who in his opening remarks assured the witnesses that Congress has no intention of outlawing or even constraining derivatives. "It is not our intention . . . to stifle the growth of derivatives . . . [which, when] used properly, can lower costs," Neal declared.

On the hot seat

This cordial atmosphere ended abruptly once the question and answer sessions began, when the congressmen wasted no time putting the regulators and bankers on the hot seat. The fun began with the third question Representative Neal asked the regulators: "The GAO report says that derivatives could turn panic in one market into a global crisis that would be beyond the ability of regulators to control. Do you agree or disagree?"

The crowded room was hushed with expectation. Seconds passed as the three regulators in the first panel—Comptroller of the Currency Eugene Ludwig, acting FDIC Chairman Andrew C. Hove, Jr., and acting OTS Director Jonathon

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Fiechter—nervously looked at each other. Finally, Ludwig stammered, "Well, in the 136 years of its operation, the Office of the Comptroller of the Currency has seen issues come and go." Chuckles from the press and vistors' galleries. Hove jumped in, saying, "The problem we have is a fast-changing environment. The banks we regulate are being asked to make decisions that are different than management decisions banks have made in the past."

Representative Neal interrupted Hove, to ask his question again.

Silence.

Neal continued, "Do you agree, or do you just say, well, we're on top of it?"

Hove replied, "I would hesitate to say it couldn't happen, but I would say it is extremely unlikely to happen."

Fiechter said that derivatives link markets together, so such a crisis "could affect a large number of institutions. I don't think any of us could stand up here and say that there would never be a global collapse."

Neal then yielded to Rep. Charles Schumer (D-N.Y.), who told the three regulators, "You say you're doing everything that is in this legislation already. What would happen if, God forbid, we get some laissez-faire regulators a few years from now? I sat here in '81, '82, and '83, when we had a bunch of regulators come in and tell us, 'Let the S&Ls do what they want.' I thought they were crazy then. . . . We have careful regulators now, but what if we don't have them in a few years? What's wrong with taking what you're doing now, and putting it into law," to guide regulators in the future?

Again, the three regulators stumbled about for an answer. Schumer interrupted them, "Do any of you feel confident that you can predict what will happen in the derivatives market five years from now?" Silence.

The question of whether the regulators could tell the difference between hedging and speculation was then batted around, with one very long, embarrassing silence by the regulators after a very direct question from Schumer.

Rep. Maurice Hinchey (D-N.Y.) asked about the potential of systemic risk causing "sequential damage" that the regulators could not stop. Ludwig started his answer with this memorable reply, likely to become famous last words: "It's usually the lightning bolt you don't see that kills you."

All congressmen present demanded to know why the regulators were opposed to the legislation. The regulators explained that the derivatives markets were "so dynamic" and "changed so fast" that laws might hamper appropriate regulatory responses to new developments. The congressmen became increasingly frustrated and irate with this answer, pointing out that the law had been written with much input from the regulators, and would not constrain the regulators in any way.

The one major policy issue that emerged centered on "suitability," which would require a derivatives dealer to determine whether a derivative instrument was suitable for the customer to whom it would be sold. While the regulators were clearly not happy with this section of the legislation, the person who whined the loudest was J.P. Morgan's Mark Brickell. Besides the violation of the sacrosanct free-market theory of *caveat emptor* ("let the buyer beware"), Brickell is upset by the suitability requirement because it would, he claims, put derivatives dealers at a competitive disadvantage not imposed on anyone else. But in the panel of regulators which appeared before Brickell, it was noted that securities dealers face a similar requirement—the "widow and orphan" test (don't sell widows and orphans speculative investments, but "safe" investments, such as U.S. government bonds or blue chip stocks).

The other major issue discussed was whether banks should be allowed to invest in derivatives with insured money—i.e., knowing that they could take losses that the federal government would end up absorbing, because of the requirement of insuring savings deposits. It was apparent that very few people had reached any conclusions about this, with the exception of Representative Schumer.

Bankers get broiled

The scond panel consisted of J.P. Morgan's Brickell and John Ward Logan, executive vice president of First American National Bank in Nashville, Tennessee, appearing as an officer of the American Banking Association. Rep. Jim Leach (R-Iowa) was waiting in ambush for Brickell.

Leach began by referring to an article in *American Banker* which appeared the day before the hearing, which quoted Brickell as saying that derivatives can serve as a supplement to capital, and demanded that Brickell explain how this was possible. Brickell tried to explain what his concept of capital was—which did not go down very well with Leach, who constantly interrupted Brickell to force him back to the standard idea of capital as basically a cash reserve. An exasperated Brickell finally blurted out, "I got the idea from an economics professor at Harvard who said derivatives are a substitute for capital." Guffaws from around the room.

In the *American Banker* article, Leach said, "you claim that banks could become liable for every derivatives contract that loses money" under this legislation. "Now, my staff and I wrote this bill. I don't recall putting that in there."

A red-faced Brickell interrupted, "Perhaps I could reply."

"Perhaps," responded Leach, to the amusement of all present except the two bankers. Brickell got out about four or five words before Leach exploded, "You and your institution have been up here time and again, making misleading statements. 'Banks could become liable.' That's a powerful statement, and one that is false."

"The legislation requires directors to be knowledgeable about—" Brickell tried to explain.

"Oh," Leach broke in, "you want Morgan to be run by people that are not knowledgeable. Yes, that I can understand," as the room convulsed with laughter.