House Banking Committee hears derivatives victims

by Anthony K. Wikrent

The House Committee on Banking, Finance, and Urban Affairs, chaired by Rep. Henry B. Gonzalez (D-Tex.), held hearings on Oct. 5, which were devoted entirely to listening to the stories of institutions which have lost money in financial derivatives. Derivatives are the explosively growing financial instruments—there is now over $1 trillion a day traded around the world—the market price or value of which are based on underlying assets, such as stocks, bonds, or commodities. Ever since the derivatives-related failures of three large companies in Europe (Metallgesellschaft of Germany, Ferruzzi of Italy, and Banesto of Spain) last year, the world's financial markets have become increasingly volatile and unstable because of the way in which derivatives have tied together these markets in a hyperactive web of speculation.

The witnesses were:

- Lewis Teel, Director of Risk Managment for **Bank of America,** the parent company of which, BankAmerica Corp., in May pumped $17.4 million into two money market mutual funds run by a Bank of America subsidiary to make up for losses suffered on structured notes.
- Roger Lee Fink, County Attorney for **Charles County, Maryland,** which temporarily lost its entire operating budget of $24 million in July when $1.3 million in losses on derivatives investments was discovered.
- Vernon Hill, member of the Business Council of the **Eastern Shoshone Tribe** of Wyoming, which has seen $4.977 million it had invested in mortgage-backed securities fall in value by at least 15%.
- Dr. Philip Speegle, President of **Odessa Community College** in Odessa, Texas. The college discovered early this year, when it attempted to sell some of its portfolio of collateralized mortage obligations (CMOs) to pay for operating expenses, that the instruments had collapsed in value almost 50%. The college took a loss of $2.7 million in order to meet its March payroll, and has since obtained emergency loans from local banks and slashed its budget to keep its doors open.
- Lawrence F. Alwin, State Auditor of **Texas,** who testified about the initial findings of an investigation which his office began statewide, following the news of the losses at Odessa College.

In addition, Alan McDougle, Director of Finance and Purchasing for Lima, Ohio, who testified on behalf of the Government Finance Officers Association about GFAO's policy regarding investing in derivatives by local governments.

Gonzalez slams 'intense pressure'

Representative Gonzalez, who has been derided in the U.S. business press as a "populist," began calling attention to the problem of derivatives over two years ago. In the autumn of 1993, he chaired two extraordinary series of hearings: one on the accountability of the U.S. Federal Reserve System in general, and another on derivatives specifically. This spring, Gonzalez, and also Rep. Jim Leach of Iowa, the ranking Republican on the Banking Committee, each introduced legislation aimed at strengthening federal oversight and regulation of derivatives. Gonzalez's proposed legislation included the imposition of a small tax, of less than 1%, on all transactions of financial derivatives, something which had been proposed by Lyndon LaRouche in March 1993. Subsequently, the Gonzalez and Leach bills were combined into one, but without the tax.

Nonetheless, derivatives dealers who testified before the committee in July were vociferous in their opposition, and in fact stretched the truth so far that Rep. Leach at one point told J.P. Morgan and Co. Vice President Marck Brickell, testifying as vice chairman of the International Swaps and Derivatives Association to his face that Brickell was making "a statement that is false."

Further helping to make the July hearings a spectacle were the various federal regulators who, despite their having practically written the legislation in close cooperation with the staffs of Representatives Gonzalez and Leach, now came out saying they opposed the legislation. Congressmen who were visibly very disturbed by this sudden change of heart by the regulators, put the regulators on the spot by asking them point-blank whether they could prevent or control a panic in the world's financial markets initiated by a derivatives disaster (which was warned about in the May 1994 report on derivatives by the congressional General Accounting Office). The silence of the regulators in response to these questions was truly deafening.

In opening, Gonzalez departed from his prepared remarks to note the "very intense" pressure that has been brought to bear to prevent the enactment of new legislation and regulation that would curb derivatives trading. "I said on the House floor two years ago that the 15 largest banks had exposures of from 550% to 1,750% in their off-balance sheet activities, against which they don't have to have reserves. It was an alarm bell at night, but nobody much cared. It seems that people aren't going to care until the system is crumbling about our ears." Gonzalez expressed his hope that the hear-

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ings on Oct. 5 would help show that the type of derivatives legislation he has proposed in the past is badly needed.

Tax the derivatives 'Ponzi scheme'

"But the most worrisome aspect of the derivatives market," Gonzalez declared, "is the fact that much of the underpinnings of the trillion-dollar-a-day global derivatives market is rampant speculation and gambling. . . . It is a monstrously, global-sized, electronic Ponzi scheme. It is an inverted pyramid, and how long can you hold the pyramid on its apex? . . .

"In the past I have proposed a tax to help dampen derivative speculation. Taxing speculative derivative transactions was supported recently by the former British Chancellor of the Exchequer Denis Healey, who stated that 98% of all foreign exchange transactions were purely speculative and that they needed to be curbed.

"While the alarm bells are sounding, it appears that the financial regulators are content to let the speculative fires burn out of control while they keep the fire trucks parked at the station."

In his opening remarks, Leach distanced himself from the approach shared by the derivatives dealers, and federal regulators, especially Federal Reserve Chairman Alan Greenspan, who have all insisted that the markets be left to their own devices. "As an elected representative of the public," Leach declared, "I am obligated to express reservations about a total laissez faire approach to the fastest growing financial market in the history of the world. For, if a financial meltdown occurs, it is inevitable that, as in the S&L debacle, there will be an immediate tendency to privatize profits and socialize losses."

Wall Street cannot ignore mainstream values

Leach noted the irony that as derivatives "losses have continued to accumulate, the industry and regulators' position of no legislation has continued to gain strength. . . . While no major catastrophe has yet occurred, many would argue that these losses may be an early warning sign much like losses in the S&L industry in the late '70s and early '80s were a precursor to the $120 billion taxpayer bailout. Wall Street must learn that it cannot ignore mainstream concerns and values. . . . Protections should be developed in today's circumstances, when we have modest warning signs evident in the marketplace, rather than in a crisis atmosphere."

Noting the tendency of dealers to develop derivatives in areas where regulatory authority is unclear, or even absent, Leach slammed the "phenomenon of 'regulatory arbitrage' [that] is being played in three different areas of the derivatives markets, namely: banks vs. unregulated entities; OTC vs. exchange-traded derivatives; and U. S. vs. other countries."

"The sheer magnitude of the market and the extraordinary growth in product trading present worrying concerns," Leach declared. "Despite the apparent benefits of wider use of derivatives products, a persuasive argument can be made that only sophisticated users with comprehensive risk management strategies, qualified personnel, and deep financial reserves should participate actively in this exploding market."

'Aggressively marketed'

Though most of the witnesses were compelled, because of ongoing litigation, to limit their remarks concerning whether they felt that derivatives dealers had made misrepresentations to them, or had defrauded them, it was clear that most felt that it would have saved them much anguish if there had been laws requiring much greater disclosure by the dealers about the risks of investing in derivatives. "We are not asking for a handout" or a bailout, Dr. Speegle told the committee. "However, we feel small political institutions, such as Odessa College, need clearer signposts as to what is advisable or inappropriate. We now know about derivatives. However what is next? . . . Enterprising and energetic marketing of new products are likely to continue."

McDougle of the GFOA told the committee, "Finance Officers [around the United States] report that these instruments are being aggressively marketed to governments that are assured of their safety while not being fully informed of many of the risks. Many finance officers believe thay have been misled by dealers regarding these instruments. There is a lack of unbiased information available to finance officers regarding specific instruments, even from outside investment advisers or bond counsel who are not familiar with these instruments."

In response to questions, Fink stressed that when the county attempted to learn how deeply its portfolio had fallen in value, it found that the derivatives were so complicated that even long-established and sophisticated investment firms could not supply price quotes, until after they had studied the derivatives for hours, at the very least. "And we had not even addressed the question of if buyers could be found," Mr. Fink added.

Hill described how the derivatives sold to the Eastern Shoshone Tribe were represented as "the absolute most secure investment you can go into," and as "government issued or government guaranteed bonds." "We urge Congress," Hill said, to inquire why the Federal National Mortgage Association and the Federal Home Loan Mortgage Association, federally chartered corporations, are involved in developing such volatile securities."

During a recess, Speegle, who decided to continue working for one dollar a year, but whose health has been adversely affected by the derivatives crisis at Odessa—the college has had to eliminate dozens of employees through "early retirements" while maintaining a freeze on hiring—said that the most wonderful thing he could hope for would be that his successor will "never hear the word 'derivative.' "