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EIR Economics

Greenspan protects the derivatives bubble

by Richard Freeman

An increasingly bitter fight has emerged between Federal Reserve Board Chairman Alan Greenspan, and the Norwalk, Connecticut-based Financial Accounting Standards Board (FASB), the national body entrusted with setting corporate accounting standards governing how to report corporate holdings of the highly speculative instruments called derivatives. Currently, corporations either do not report certain categories of derivatives, or when they do report derivatives, they report them off their balance sheet, buried in footnotes, in small type in annual reports. Information concerning the size and exposure of a corporation's derivatives holdings is not readily available, nor is the derivative usually accounted as an asset or liability.

Since 1987, derivatives have grown cancerously in the United States. Banks hold huge derivatives portfolios, but the derivatives holdings of non-financial corporations are growing rapidly, too. Derivatives are speculative side-bets which suck dry the underlying physical economy. Over the last few years, Orange County, California suffered a $1.7 billion derivatives loss; Barings Bank experienced a $1.1 billion derivatives loss, which caused the bankruptcy of the bank; corporations such as Procter & Gamble and Gibson Greetings Cards bought exotic derivatives contracts and suffered multimillion-dollar losses.

Yet, there is no way of knowing from what a company lists on its balance sheet, what derivatives it holds.

During the past 18 months, the FASB has formulated certain accounting rule changes, which would require that 15,000 publicly traded U.S. corporations *report their holdings of derivatives openly, and "at fair market value," on their balance sheets*. The new rules would go into effect on Jan. 1, 1999.

On July 31, Fed Chairman Greenspan wrote the third in a series of letters to FASB Chairman Edmund Jenkins. Greenspan demanded that Jenkins drop the proposed new reporting rules. Curiously, on the same day, a group of leading bankers wrote to Jenkins, making the same demand. Republicans loyal to the New York banks have threatened to hold Congressional hearings on the matter. The Aug. 24 *Washington Post* reported that an aide to one Republican senator said, "Why is the FASB so immune to all this criticism . . . ? It seems as if they're pushing generally rejected accounting practices." The hearings are a highly unusual step, as this accounting procedure does not normally fall within Congress's purview; it is simply a pressure tactic to try to make the FASB back down.

Why all this concern over an accounting rule? First, it would force corporations that have lost on derivatives not to hide the loss, but put it on the books. Second, and of paramount importance, just reporting the derivatives on the books would show that the notional value of derivatives in the United States alone is over $30 trillion, indicating both the scope of the speculation and the depth of the bankruptcy of the U.S. banking and financial system. Indeed, this situation obtains for all the major Western nations' banking systems.

Greenspan fears that reported news of this could pop the derivatives bubble, with dire consequences.

Origins of the FASB

The 1933 and 1934 acts which created the Securities and Exchange Commission gave the SEC the responsibility to promulgate and enforce accounting standards for the companies that have publicly listed stock, and trade on a stock exchange regulated by the SEC. Today, there are 15,000 compa-

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nies that are so regulated by the SEC. In the 1930s, it was decided that instead of having a public institution—the SEC—set the accounting standards, a private institution would do that. That function was originally performed by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants. In 1973, the FASB was created to perform that function. In addition to derivatives, the FASB defines the accounting procedure for reporting retained earnings, depreciation, and so forth. The FASB is independently funded by the Big Six and other accounting firms, and by many U.S. corporations. It is governed by a seven-member board.

The FASB's proposal

In his July 31 letter to FASB Chairman Jenkins, which attacks the FASB standards, Greenspan wrote, "We understand that the [FASB] Board intends to adopt a new [accounting] approach as a final standard without exposing it for public comment and debate." Just the opposite is the case. The FASB started looking at ways to have derivatives reported on the balance sheet ten years ago. On June 20, 1996, the FASB issued a proposal for improved standards for accounting for derivative financial instruments and hedging transactions. It requested and received hundreds of comments from corporations on the proposal through Oct. 11, 1996. The FASB then held public hearings on the proposal during mid-November of that year.

The FASB's proposed new rules would require all U.S. corporations, including banks, to report their derivatives holdings on their balance sheets. Further, the FASB proposed new rules that would require that there be "fair market-value reporting" of the corporations' derivatives, which would mean that where the rule is applicable, which depends on the type of derivatives, the derivatives holding would be reported at its current market value, not at its historical purchase price or book value. This is called marking the portfolio to market.

Under the FASB rule changes, a corporation must not only report a derivative on its balance sheet, but it must report it as part of its assets or liabilities, and also report the earnings arising from the derivative. According to an FASB spokesman, the FASB would create a new accounting category, called "other comprehensive income." Certain categories of corporate derivatives and hedges would have the earnings or losses arising from the derivatives contract reported immediately in the corporation's earnings (or loss) statement. Other categories of derivatives, in which the derivatives contract is to be completed at some future, indefinite date, would report the earnings or loss from the derivative contract in the category "other comprehensive income." At the point that the derivatives contract is completed, the earnings or loss would no longer be reported in the corporation's "other comprehensive income" column, but rather in the final earnings and loss column. Either way, the earning or loss is reported. In parallel, the recording of the derivatives contract as either an asset or liability, would also be reported.

One practice that would be ended, would be one in which a corporation incurs a derivatives loss, but skillfully hides it. For example, under the new rules, were a corporation to sustain a large derivatives loss, it could not continue to list the size of its derivatives portfolio at the old book value, which it paid for the derivatives originally, as if nothing had happened. This is the procedure that many corporations now follow. Rather, the corporation would have to mark down the size of the derivatives portfolio by the size of the loss. Further, it would have to report the loss rather quickly in its earnings-loss account.

On Aug. 29, *EIR* asked an FASB spokesman why some corporations are resisting the proposed FASB rule changes. He said, "They don't want the derivatives showing up on their books. They don't want people knowing how it is affecting the company." The FASB spokesman also commented on the case of Procter & Gamble, which lost tens of millions of dollars in derivatives contracts. "Some corporations hope they can work the derivative out, and reverse the loss. They keep trying, and don't want this on the books," he said.

Further, there are some types of derivatives contracts which many corporations refuse to report at all. An FASB spokesman reported on Aug. 29 that derivatives contracts which are interest rate swaps usually are not reported by corporations. He stated, "In an interest rate swap, a corporation swaps a fixed interest rate stream for a variable interest rate stream, or vice versa [these are heavily used derivatives]. The corporation that makes the interest rate swap will show on its books the management fee that it paid to some broker [usually a bank] to make the swap, but not record the value of the swap." These swaps can be several tens of millions of dollars, and in some cases, above $100 million, apiece.

Pushing the strategy forward

On Sept. 2, the FASB released a 134-page document, "Accounting for Derivative Instruments and Hedging Activities," which it hopes will be the final version of its proposal, except perhaps for some minor adjustments. Four days before the report's release, the FASB spokesman said, "We are issuing a report . . . that will go to the Financial Instruments Task Force, a task force made up of accountants from the Big Six accounting firms and other industry experts, which has more than two dozen people in all. The Task Force will see if the proposed new FASB standards for derivatives and hedging instruments are operational, that is, will they function or are there some things to be worked out? There will be a public comment period through the middle of October. . . . Then we

will go forward with the new standards. We set the date of Jan. 1, 1999 to put the new standards into operation in order to give the companies one year's time to make the accounting changes needed to comply."

SEC Chairman Arthur Levitt is publicly supporting the FASB proposal.

Greenspan and the banks attack

But, Ayn Rand worshipper Greenspan is hell bent to derail this.

The FASB, through these rule changes, is not attempting to shut down the derivatives market, as well it should, but only to bring derivatives into the light of day. But this is seen as enough of a threat to the derivatives market to send Greenspan and the bankers into orbit. In his July 31 letter to FASB Chairman Jenkins, Greenspan stood reality on its head, stating, "The proposal may discourage prudent risk management activities and in some cases could present misleading financial information"! Greenspan said that the FASB must abandon the derivatives reporting requirement.

Further, Greenspan asserted in his letter, "major companies in a number of industries that use derivatives have expressed serious concerns" about the FASB's proposed rules. Greenspan's reference is to the heads of 22 corporations, who sent a letter to Jenkins, not accidentally, on the same day as Greenspan wrote his letter attacking the FASB rule changes. Who then, are these titans of industry? The signers include the heads of Bankers Trust, Chase Manhattan, J.P. Morgan, NationsBank, Wells Fargo, BankAmerica, First Chicago NBD, Goldman Sachs, and American International Group Insurance. Other signers include Sens. Alfonse D'Amato (R-N.Y.) and Phil Gramm (R-Tex.), and U.S. Reps. Tom Bliley (R-Va.) and Michael G. Oxley (R-Ohio).

Thus, the signers are those bankers whose banks are the high rollers in the derivatives market, which have created a global derivatives casino economy, which is destroying the world economy. They are joined by their pitch-men in the Congress. Along with Greenspan, this crew might be called the Derivatives Liberation Front.

Explosive growth in derivatives

Greenspan and the banks don't want the size of derivatives reported, because the derivatives market is growing so fast. The growth is occurring both in the United States and globally (see **Table 1**).

Some of the derivatives figures are affected by the change of a nation's currency relative to the dollar; in the case of one country (Japan) an additional bank's derivatives holdings were reported in 1995 that were not reported in 1994. But, the United States banking system holds one-third of the world's derivatives absolutely, and the U.S. and British banking systems hold 44% of the world's derivatives, making the U.S. and British banking systems bankrupt many, many times over.

TABLE 1

Derivatives holdings of top nations

	1994 Notional value of derivatives holdings (billions $)	1995 Notional value of derivatives holdings (billions $)	1995 Derivatives holdings per capita ($)
Belgium	508	689	68,130
Canada	2,460	3,321	112,718
France	11,695	9,374	161,674
Germany	3,117	4,258	52,187
Italy	177	483	8,446
Japan	9,867	11,532	92,186
Netherlands	1,250	1,596	102,948
Sweden	1,026	1,278	145,558
Switzerland	5,327	6,321	877,673
U.K.	6,655	7,367	126,455
U.S.A.	20,301	23,129	87,859
Total	**62,638**	**69,348**	

Source: "Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms," a joint report by the Basel Committee on Banking Supervision, and the Technical Committee of the International Organization of Securities Commissions.

EIR is trying to obtain figures on the assets of the banking systems of the respective countries listed in Table 1, to compare them to the size of the derivatives bubble. But, looking at the 1995 notional holdings of derivatives per capita, it can be seen that in most countries there are at least $50,000 of derivatives per person held by that country's financial system, and in some countries, several times that amount. Each individual banking system is bankrupt, but more important, the interconnected banking system of the Western world is bankrupt. There is not sufficient wealth produced to sustain the derivatives bubble.

Furthermore, as of the first quarter of 1997, the United States is now up to $32 trillion in notional amount of derivatives held by its commercial banks, investment banks, and insurance companies. Therefore, were the United States to continue to hold one-third of the world's derivatives—which seems likely—it can be safely estimated that the world's holding of notional amount of derivatives is now up to $100 trillion.

Thus, the fight over the FASB's derivatives accounting standards is more than just a fight over accounting rules. Full reporting of derivatives is a minimal step. But bringing to light the full derivatives picture would tell the world that the world financial system is hopelessly bankrupt, something that Greenspan does not want out in the open. The world derivatives bubble is headed toward disintegration, and Greenspan is insanely attempting to keep it afloat.