

Greenspan backs hedge funds; Congress gags

by Marcia Merry Baker

On Oct. 1, Federal Reserve Board Chairman Alan Greenspan testified for three hours before the U.S. House of Representatives Banking Committee, on why the Fed took action to rescue creditors and principals of the Long-Term Capital Management (LTCM) hedge fund, which failed in September, but he still demands that derivatives remain unregulated.

On Sept. 23, the New York Federal Reserve intervened to host a rescue meeting, and \$3.5 billion was put up as a bailout fund. This follows years of repeated avowals by Greenspan that there is no public interest in regulating, or even studying, the risks and menace of private hedge funds and the growth of derivatives trading. LTCM's own founding partners, in 1994, included the two mathematicians who won the 1997 Nobel Prize for Economics for their formula for how to succeed in "options," or derivatives bets. Their formula crashed within a year.

Unusual for such a hearing, the Oct. 1 occasion saw Banking Committee members drop their customary cloying deference to Greenspan, and confront him. There was real shock in the chamber that Greenspan could so arrogantly continue to defend the rights and privileges of hedge funds and derivatives traders, after the LTCM failure, and amid the many subsequent reports of other derivatives losses and crises.

Nevertheless, on Oct. 2, the House dutifully passed a bill (as has the Senate) proscribing for another six months, any study or attention to derivatives trading by the Commodity Futures Trading Commission, whose chairman, Brooksly Born, has attempted for many months, to launch an investigation on the scope and dangers of derivatives.

In 1993-94, before the cowardly "Conservative Revolution" Republican leadership gained the majority in both the House and Senate in 1996, then-House Banking Committee Chairman Henry Gonzalez (D-Tex.) had not only held hearings on the dangers of derivatives, but, in spring 1995, proposed Federal legislation (the "Derivatives Safety and Soundness Supervision Act of 1995") to tax and control derivatives betting. Pennsylvania and other states also introduced "financial betting" transaction tax bills. As of 1996, this thrust was squashed by the ascendant Gingrichite Republicans. Now, their own incompetence and subservience to Wall Street and the City of London is exposed, along with Greenspan's. Nevertheless, on Oct. 1, Greenspan was too much for even their stomachs to take.

Greenspan said, "Since its founding in 1994, LTCM has

had a prominent position in the community of hedge funds, in part because of its assemblage of talent in pricing and trading financial instruments, as well as its large initial capital stake. In its first few years of business, it earned an enviable reputation by racking up a string of above-normal returns for its investors." However, Greenspan said that LTCM maybe took a little too much risk: "In that [volatile] environment—so at variance with the experience built into its models—LTCM's embrace of risk on a large scale produced stunning losses." Therefore, he said, the Federal Reserve stepped in, to "avoid fire-sale conditions."

A danger of global meltdown

Moreover, he warned Congress, "Had the failure of LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own."

But, Greenspan abjured any regulations. He asked, "Does the fact that investors have lost most of their capital, and [that] creditors may take some losses on their exposure to LTCM, call for direct regulation of hedge funds? . . . Any direct U.S. regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction. The best we can do, in my judgment, is what we do today: Regulate them indirectly through the regulation of the sources of their funds," i.e., regulation of the banks that lend them money.

Greenspan then apotheosized hedge funds as essential to the functioning of the economy: "Commercial and investment banks especially have the analytic skills to judge the degree of risk to which the funds are exposed. . . . If, somehow, hedge funds were barred worldwide, the American financial system would lose the benefits conveyed by their efforts, including arbitraging price differentials away. The resulting loss in efficiency and contributions to financial value added and the nation's standard of living would be a high price to pay—to my mind, too high a price."

Rep. Michael Castle (R-Del.), in his opening remarks at the hearing, said, "What I hope we avoid today is obfuscation and deflection, as if there is no problem whatsoever." At the close of Greenspan's testimony, Castle said that there is a "disconnect" here, when we are told the Fed must intervene on a private company to prevent global meltdown, yet, "I don't hear any recommendations about what to do, or how to regulate."

Rep. Barney Frank (D-Mass.) told Greenspan, "The extent you underestimated this [hedge fund derivatives crisis] is impressive. . . . And, Mr. Greenspan has said that this may happen again. So then, the question is, if it was so important as to justify this intervention now, how do you persuade us to do absolutely nothing except wait again and trust entirely in your discretion to deal with it if it happens again?"