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Regulators panicking, call for scrutiny of derivatives

by John Hoefle

The United States government has, in recent years, shown extreme reluctance to put any brakes on the speculative bubble known as the international derivatives market. But now, with that bubble visibly blowing out and threatening to set off a chain-reaction collapse, some government regulators are taking tentative steps to deal with at least some of the symptoms of the crisis.

In the wake of the April 13 hearings on the dangers of hedge funds held by House Banking Committee Chairman Henry B. Gonzalez (D-Tex.), both Securities and Exchange Commission (SEC) Chairman Arthur Levitt, Jr. and Comptroller of the Currency Eugene Ludwig expressed concern about derivatives, and suggested further regulatory scrutiny.

The SEC "is taking further steps toward the development of appropriate capital standards for derivatives products," and is working to increase regulatory oversight of the over-the-counter derivatives markets and the activities of large traders, Levitt told the Banking Committee. "I don't think we have enough information about hedge fund activities," Levitt said.

Levitt promised to take his concerns to other regulators around the world and, according to European reports, did insist that action against derivatives be made a top item on the agenda of the April 24 Group of Seven (G-7) meeting in Washington.

Comptroller Ludwig, whose office regulates federally chartered banks, issued similar warnings April 20, in a speech to the Exchequer Club, a Washington, D.C.-based group of economic policymakers, financial lobbyists, and wealthy investors. "We are looking at whether they [derivatives activities] are appropriate for national banks and, if so, to what extent they are appropriate, and whether we need to take further regulatory action on these instruments," Ludwig told the group.

Ludwig's speech emphasized three main worries over the derivatives activities of national banks. First, he said, the banks' boards and senior managers often do not understand what their traders are actually doing. Second, Ludwig said, banks might not belong in the derivatives market at all. (U.S. banks dominate the international derivatives market, accounting for $12 trillion of the $14 trillion market for derivatives in the United States, he noted.) Third, he expressed concern over the level of proprietary trading by banks (banks trading on their own behalf rather than for customers), comparing their activities to those of the highly speculative, and effectively bankrupt, hedge funds.

Noting that derivatives "can be misused and abused," Ludwig said his office was developing "comprehensive procedures" for examining the derivatives activities of national banks, and was considering whether to place restrictions on derivatives trading, "or whether some other type of regulatory response is appropriate." He said his office has identified more than 1,200 different derivatives products offered by banks, adding that hundreds of national banks engage in some degree of derivatives trading, and that six national banks have set up proprietary trading desks.

Several bridges are missing

"Since October, a lot of water has gone under the bridge . . . and some over the bridge—and there are several bridges missing," he concluded.

U.S. regulators are not the only ones sounding the alarm, either. Bank of Italy Governor Mario Fazio warned the G-7 meeting of "the existence of a speculative bubble which has been formed in financial circles" which could lead to a financial shock similar to the stock market crash of October 1987. "In the last months," he said, "operators have bet everything on a decrease of interest rates that now seems put into ques-

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tion, after the Federal Reserve inverted its monetary course. If the bubble blows up, it would be a crash similar to the 1987 one. With the difference that today it would concern the bond market."

Such warnings from official circles are rare, and reflect the panic which is dominating the international financial markets. When regulators start talking like that, the situation is already out of control.

Official denial

The G-7 finance ministers, however, continued to keep their heads buried in the sand, exposing their public faces.

"Financial markets [have] functioned well, coping with the increased volume of transactions without creating tensions," the finance ministers said in a statement issued at the semi-annual meeting of the International Monetary Fund and World Bank following the G-7 meeting. Nevertheless, the IMF's Interim Committee did agree to study the possibility of systemic risks to the financial system, including, in the words of Interim Committee chairman and Belgian Finance Minister Philippe Maystadt, "possible ways to introduce a higher degree of discipline in the present exchange rate system."

Meanwhile, the finance ministers continued their insane blathering about the supposed recoveries in their own countries, all of which are sinking ever deeper into depression.

"We have reasons for somewhat greater optimism," said U.S. Treasury Secretary Lloyd Bentsen, whistling past the graveyard.

"The outlook for world activity and stability has improved," insisted IMF Managing Director Michel Camdessus, proving once again why no sane person would ever believe anything the IMF says.

Sophisticated liars

Unfettered by the need to maintain even the appearance of answering to the public, the banks are much more sophisticated in their lying than are the clumsy politicians. There are risks, the bankers admit, but only we bankers are qualified to assess and deal with them, they say.

The French economic daily *La Tribune* reported on April 26 that it had obtained the text of a letter written on behalf of eight top U.S. investment banks dealing in derivatives (Merrill Lynch, Goldman Sachs, Salomon Brothers, Morgan Stanley, Kidder Peabody, Crédit Suisse First Boston, Lehman Brothers, and Bear Stearns) by Lehman Brothers director Jeffrey Seltzer, in his capacity as president of the "swaps and derivatives products" committee of the Securities Industry Association.

The investment houses acknowledge that a "systemic risk" does exist, but "warn against any regulation imposed by non-professionals." What is needed, the bankers insist, is "self-regulation." After all, who better to guard the chicken coop than the fox, who knows all the predators' tricks? Besides, the banks have done a wonderful job of managing their own derivatives exposures, judging by the year-end 1993 figures.

Take Chemical Banking Corp., for example. At the end of 1993, Chemical had $2.5 trillion in off-balance-sheet derivatives, compared to $150 billion in assets. That means that for every $1 in assets, Chemical has $16.54 in derivatives. Chemical's derivatives exposure has grown rapidly, from $1.3 trillion as of June 30, 1992, to $2.1 trillion on June 30, 1993. During the second half of 1993, Chemical's derivatives exposure grew $366 billion, nearly two-and-one-half times its total assets in only six months.

Second place in the derivatives sweepstakes belongs to Citicorp, which had $2.0 trillion in derivatives, or $9.12 for every one of its $217 billion in assets. Citicorp had $1.4 trillion in derivatives in mid-1992, and $1.8 trillion in mid-1993, with a growth of $187 billion in the last six months of 1993.

Closely following is Bankers Trust, which had $1.9 trillion in derivatives at the end of 1993, for $20.67 in derivatives for every one of its $92 billion in assets.

Rounding out the top seven are Chase Manhattan, BankAmerica, and First Chicago, two of which actually posted declines in the size of their derivatives portfolios during the second half of 1993. Chase finished the year with $977 million in derivatives, or $9.57 for each of its $102 billion in assets; at mid-year, Chase had $1.0 trillion in derivatives. BankAmerica had $921 million in derivatives, or $4.93 for each of its $187 billion in assets at year's end. First Chicago had $432 billion in derivatives at year's end, or $8.21 for each of its $53 billion in assets.

Thanks to the interstate banking bills passed by the House and Senate, these greedy giants will soon be able to throw more of America's bank deposits down the derivatives rathole.

Losses growing

While the banks were able to claim profits in the first quarter, their trading revenues were down significantly. Bankers Trust, the investment bank masquerading as a commercial bank, posted trading revenues of a mere $14 million for the quarter, compared to an average of over $400 million a quarter in 1993. But while Bankers Trust managed to eke out a profit, some of its customers were not so lucky: Procter and Gamble, Gibson Greetings, and Mead Corp. all suffered multimillion-dollar losses. A shareholder has filed suit against Proctor and Gamble and nine top executives, demanding that they reimburse shareholders for the $157 million the company lost in the derivatives market in the first quarter. Proctor and Gamble and Gibson Greetings have, in turn, threatened legal action against Bankers Trust.

Whether the banks have resorted to their post-Great Depression practice of sticking their customers with bad paper in order to save themselves, remains to be seen. But one thing is for sure: If corporations take their funds down to the casino to gamble, they deserve to get burned.