EIR Economics

# Bankers' 'safety net' won't avert derivatives blowout

by Anthony K. Wikrent

Seeking to allay rapidly growing public and government alarm over losses running into the billions of dollars, regulators in the United States, at the Bank for International Settlements (BIS) in Switzerland, and elsewhere are furiously racing to put in place some semblance of a regulatory structure for the speculators' casino called the financial derivatives market. At the same time, the banks and derivatives dealers themselves are moving to establish what they describe as a "safety net" for the largest segment of the derivatives market. In both cases, the public is about to be stuck with a situation far worse than "too little, too late."

Derivatives are financial contracts that have their market values based on another, underlying security, or even an index of securities. Examples would be a futures contract to buy Japanese yen, a stock option, or a futures contract on the Standard and Poor's 500 Index of the U.S. stock market. But over the past few years, derivatives trading volumes have become many times larger than trading in the securities that underlie them. The largest part of the derivatives market is in foreign exchange, where an estimated $1 trillion *a day* changes hands, according to a December 1992 estimate by the BIS. Earlier this year, it was reported that derivatives now account for a greater percentage of this currency trading than spot transactions. Ever since the market meltdown of October 1987, derivatives have been growing at the explosive rate of 40-50% per annum, up until the end of last year, when losses in derivatives at the Italian conglomerate Ferruzzi began to unravel the market. Three successive interest rate increases by the U.S. Federal Reserve earlier this year accelerated the unraveling.

The long-awaited guidelines for "managing risk" in derivatives activities were finally released by a committee composed of central bankers and other financial regulators, operating under the auspices of the BIS, on July 26. The guidelines merely rehashed the recommendations made by the private Group of 30 in its report *Derivatives: Practices and Principles,* in July 1993. The Group of 30 is composed of top executives from the money center banks (Dennis Weatherstone, chairman of J.P. Morgan, Inc., heads the group) and retired regulators (such as former chairman of the U.S. Federal Reserve Paul Volcker). Not surprisingly, their report concluded that there's really not much to worry about.

According to the London *Financial Times,* the BIS guidelines urge banks to minimize credit risk by carefully scrutinizing the creditworthiness of the companies and institutions they sell derivatives to. Banks dealing in foreign exchange derivatives should be able to figure the value of their portfolios every day, and the largest institutions should be able to do so at any moment during the day. Finally, because the creation, marketing, and valuation of derivatives are so dependent on complex statistical modeling that can be done only with sophisticated computers, dealers should have contingency plans in place to deal with computer breakdowns.

The BIS guidelines also suggest that banks carefully review the laws governing derivatives in the countries in which the dealers intend to operate, to be sure that the customer's obligations under the derivatives contracts can be legally enforced.

## Coordinated moves

The same day that the BIS released its guidelines, the technical committee of the International Organization of Securities Commissions (IOSCO) also issued guidelines. The virtual convergence between the two sets of guidelines demonstrates the total lock the derivatives dealers have on so-called regulatory agencies.



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The following day, eight of the largest banks in the United States and Canada joined with the Options Clearing Corp. to announce that they were applying for regulatory approval to expand their Multinet International Bank (MIB)—a bilateral clearing house for foreign exchange transactions which was set up in 1992—to do multilateral clearing. Apparently the banks, which include First National Bank of Chicago, Chase Manhattan Bank, the Bank of Montreal, the Royal Bank of Canada, the Toronto-Dominion Bank, and the other three large banks that monopolize the Canadian banking system, want to be able to move beyond clearing currency trades bank-to-bank, to a system similar to that found in the regulated exchanges, such as the Chicago Board of Trade, or the Chicago Mercantile Exchange. These serve as clearinghouses by acting as the buyer to every seller of a futures contract, and the seller to every buyer. Such clearinghouses exist for standardized contracts such as futures and options, but not for over-the-counter derivatives, such as forwards and swaps.

If the MIB is granted regulatory approval, then the banks will begin settling spot and forward currency trades through the MIB, rather than among themselves, and would later expand the MIB to include swaps and other, more exotic derivatives. According to the bankers, this would facilitate the ability to "net out" their market risks. Chase Manhattan, for example, would be able to say that its risk from contracts sold to Company A in yen, is offset by a yen contract Company A had with Toronto-Dominion Bank. In the event Company A defaulted, the MIB would calculate the difference between the two contracts, and credit to either Chase Manhattan or Toronto Dominion the balance in its favor, thus closing out both contracts.

Doing this, the bankers maintain, reduces "counterparty credit risks," the euphemism for default by their customers. "We're building a safety net under today's $1,000 billion daily currency market," claimed Garrett Glass, senior vice president of First National Bank of Chicago.

## More loot

The key to what is really going on here is provided by a footnote in the May 1994 report by the U.S. General Accounting Office (GAO), "Financial Derivatives: Actions Needed to Protect the Financial System," which states, "Multilateral netting reduces the amount of money subject to settlement risk (the risk that funds and/or financial instruments will not be exchanged as anticipated) *by releasing capital currently used to support derivatives transactions*" (emphasis added).

As usual, the bankers are speaking with forked tongues. They're not as interested in erecting a safety net as they are in squeezing out more money to keep their bankrupt system going a little longer. Not only will multilateral netting give the banks more money to play with; the GAO also suggested that multilateral netting actually *increases* risks in the derivatives markets. The same footnote in the GAO report goes on to argue that such a scheme "has the potential to increase systemic risk by concentrating risk in a central counterparty and *increased incentives to expand derivatives activities to lower credit counterparties*" (emphasis added).

## LaRouche: 'It's a dog-and-pony show'

The question that should present itself to any thoughtful observer of this insanity, is why the bankers are attempting to portray this as a means of increasing the "safety" of the derivatives bubble. Addressing the question of the new BIS and IOSCO guidelines, U.S. physical economist Lyndon LaRouche said in an interview on July 28: "The problem is, these guys don't want to stop derivatives. They would like to regulate them privately, but they don't want to step on anybody's toes, among their crowd, in doing so. They're not that stupid, to imagine that they're actually trying to control derivatives. What they're trying to do, essentially, is to *pretend* that they're going to control derivatives.

"The reason for pretending, is to . . . enable [U.S. Federal Reserve Chairman Alan] Greenspan to say to the government of the United States: Look, don't meddle in the market. You mustn't meddle in the market. If there's any regulation to be done, of the private banking sector, let the private banking sector and us do it, and don't let the U.S. government, or other governments, get involved.

"So essentially, the BIS put on some token measures of regulation, and told some of the boys, 'Don't be quite so crazy as you're being, because you're getting us into trouble.' What they're trying to do, is simply put on a dog-and-pony show, to keep the U.S. government and others from moving in, to regulate this market."

Even if the bankers succeed in finding more money to pump into their derivatives madness, their system is ultimately doomed, LaRouche stressed. "In a world economy which is less, in terms of total output, than $20 trillion, we are turning over, probably, $300 or more trillion a year in these kinds of derivatives market. And, the total value outstanding of the derivatives, which is certainly over $16 trillion, may be running, on the secondary and tertiary markets, even double that, or more.

"So, these derivatives can only be sustained by an increase in fictitious capital gain, through leverage, which means that to maintain the fictitious derivatives market, you have to squeeze more blood out of the real economy, income-to-leverage; and that means that your pensions are gone, that means that your governments are being looted, through indebtedness, to help fund this thing. It's really a mess, and this whole system is going to blow. It is now in the process of blowing. You see the events in Venezuela, you see it in other parts of the world. *This thing is going to blow, and soon*. Nobody knows exactly when, because there are political factors involved. But, what is certain, is that *this bubble is going to pop*. And, if we don't regulate it out of popping first, it's going to pop on us, and blow the whole system out."