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BIS central bankers sound alarm over banking practices

by William Engdahl

The Swiss-based Bank for International Settlements (BIS), a non-governmental oversight organization of predominantly continental European central bankers, issued a report on May 12 on the topic of "derivative financial instruments and banks' involvement in selected off-balance-sheet business."

The report reflects the bankers' growing alarm at the explosion of a $3 trillion market in financial instruments which is outside anybody's control—and whose true dimensions nobody even knows—and which threatens to bring down the entire world banking system, as *EIR* has repeatedly warned.

Derivatives are securities which can be bought for usually a small fraction of the price of the actual stock. Examples are an "interest rate swap," or a three-month Eurodollar futures contract, or a Standard & Poors-500 Wall Street "stock index futures contract." It is claimed that derivatives constitute a hedge or security for a bank or other institution against unexpected sharp movement in the actual stock or currency held. If at the end of the three-month contract, the actual price of the commodity is above or below the amount specified in his contract, the banker must pay the difference. But futures speculation, because the amount needed to "buy" such a contract is usually a tiny fraction of the total or face value of the real stock, is subject to wild abuse by unscrupulous large traders. It has been documented that such stock futures manipulation was partly responsible for the severity of the October 1987 Wall Street stock crash.

While the quite technical BIS report has been all but ignored in most major financial press, it was significant enough to cause U.S. Federal Reserve chairman Alan Greenspan to have an unscheduled two-hour meeting in London with his counterpart in the Bank of England on May 12. Reportedly, Greenspan sought assurances from England's Governor Leigh-Pemberton that the BIS not make any decisive action to clamp down on the business of banks buying and selling such "financial derivatives" as "currency swaps," "interest rate swaps," and "stock index futures." U.S. banks would reportedly be hardest hit from such controls.

A $3 trillion market out of control

What is behind the increasing concern by central bankers over financial practices so exotic most people have never even heard of them? The answer is the fact that most of these transactions, which have ballooned into a $3 trillion market since their first widespread use in 1987, are so complex that not even the banks involved have an accurate assessment of their own credit risk should one or more major parties to such a "swap" agreement default.

"The expansion of trading in derivative instruments has been one of the major developments in financial markets during the past decade," notes the BIS. Pointing to the fact that trading in financial futures and options has "soared with the opening of many new exchanges and the introducton of a panoply of new contracts," the bankers warn that "these developments have had a profound impact on the manner in which banks and other market participants expose themselves to credit and price risks."

The study points out the explosive growth in such financial devices since the end of 1986, noting that traded positions in financial futures and options have soared by over 500%, while value of outstanding currency and interest rate "swaps" alone have increased 800% in that time, far outstripping growth in all normal areas of the financial markets. Clearly, at a time of record international bank failures and shocks such as the collapse of the $25 billion Olympia & York real estate conglomerate, bank regulators have reason to be alarmed at such growth, especially when no one knows how risky they are in event of a system breakdown.

U.S. banks in the spotlight

The BIS report singles out U.S. banks and financial houses as a prime force in the booming cross-border futures and options business. They note that U.S. banks alone control some 20% of total trading in stock index futures, despite the fact that by law U.S. banks are forbidden to act as dealers in actual stocks.

During the 1980s, with the demand for financial market "globalization" for free flows of money internationally, banks and financial firms, and even industrial corporations such as Volkswagen and Toyota, began to take advantage of looser international financial rules, to make "trading profits." When the City of London initiated its financial market deregulation under Margaret Thatcher, London's October 1986

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"Big Bang," a major opportunity was opened for banks and others to trade in hitherto unimagined volumes across borders for speculative gain. The onset of London's Big Bang in 1986 gave the already deregulated New York banks enormously increased possibilities during a 24-hour trading day, manipulating differences between their New York, Hong Kong and, say, London Eurodollar offices on the hourly quoted value of the U.S. dollar or of short-term dollar interest rates.

Through the push of a computer key, suddenly billions of dollars of "futures" could be traded instantaneously around the globe. Total volume of international electronic dollar payments cleared through New York's Clearing House Interbank Payments System (or CHIPS, as it is known), has climbed by 300% from a *daily* average of some $350 billion in early 1986 (pre-Big Bang) to almost $1 trillion by 1990. Most is pure currency speculation unrelated to transfer of hard commodities or flows in international trade of real goods.

Banks desperate to increase profits to offset huge losses in Third World debt and real estate, have turned to the deregulated markets in financial futures to profit by "arbitrage," making profit on seemingly tiny differences in the quoted value of, say, the dollar in London, Frankfurt, Hong Kong, and New York, through their global computerized trading links.

In April, a clerk in the New York office of Salomon Brothers was blamed for a clerical error which reportedly caused a panic selloff in the New York Stock Exchange. He reportedly misread instructions and executed a computer stock index futures "sell" order for 11 million shares of stock, rather than $11 million. The sell order was so large that it triggered an automatic computerized "sell" from other stockbrokers, and resulted in a huge fall in the Dow Jones Industrial Average that day, wiping out billions of share dollar values. What insurance is there that far larger such accidents of "clerical error" will not trigger global financial chaos?

Will Germany follow?

The Frankfurt Stock Exchange is currently considering adopting such a Wall Street or London model of computerized stock trading, the Elektronisches Handelssystem. The proposal was developed by the American consulting firm McKinsey and Co., which has been accused of being a "political" firm by more than one source. One reason that the German stock market has not been hit with the severe shocks of New York or Tokyo in recent years, is the absence of such computerized "stock index arbitrage" possibilities. McKinsey and certain large banks argue this is "old-fashioned," and hinders development of Frankfurt as a "global finance center."

The latest BIS study cites indications that many large U.S. banks, reportedly the worst abusers of such international currency and interest rate swaps or stock index futures, have let the problem get way out of control. The BIS notes that many U.S. banks hold such contract obligations—termed off-balance-sheet, because they are not reported on the books of the bank—in ratios above their on-balance-sheet assets, "exceeding 700%." That is, a bank's nominal holdings of such swaps is seven times larger than its reported normal banking liabilities. But, because it is off-balance-sheet, regulators and the general public have no real indication of the risk, should that bank "guess wrong" on any of thousands of daily futures trades it makes.

Extent of risk 'unknown'

This problem was behind an extraordinary speech delivered at the London City University March 5 by BIS General Manager Aléxandre Lamfalussy. Lamfalussy warned: "The proliferation of financial instruments and of off-balance-sheet operations has made our [international banking] system less, rather than more transparent, at a time when growth of the financial 'superstructure' has far outpaced that of the non-financial part of the economy, and when international financial integration has reached an unprecedented degree."

Lamfalussy cautioned that "spectacular technological advances in communications and information systems have provided means to enable market participants to make liberal use of the innovative opportunities offered by this greater freedom."

Lamfalussy warned of the unknown systemic risk factor in the mushrooming volumes of interest rate and currency swaps and such: "Off-balance-sheet business has created strong linkages between the various sectors of the financial industry. We simply do not know the size of the indirect risks for the individual institution generated by this interdependence."

He concluded his remarks with the somber warning: "Is there not something about the financial system which would imply that destructive shocks carry a greater systemic risk than in other industries? In particular: Do not globalization and the speed with which shocks are transmitted create fertile ground for full-blown crises?"

He takes up the argument of deregulation advocates. "Our observer would have noted quite a few financial disturbances, even major ones, which did not lead to a full-blown worldwide financial crisis. . . . [But] these arguments do not alleviate my concern. . . . The authorities have been quite good at crisis management, but this praise should not be misunderstood. . . . Luck has been on our side. . . . But the hard fact is that the resilience of our new financial system has not yet been tested by a genuine worldwide recession."

With the entire banking system of many countries—Sweden, Norway, Finland, the United States, Canada, the United Kingdom—today being hit with the greatest crisis since the 1930s Great Depression, little wonder that some central bankers are nervously reaching for the alarm bell.