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Unease pervades markets as derivatives volume explodes

by Anthony K. Wikrent

The last week of September saw a number of institutions floating various initiatives and proposals for "regulating" the world's financial derivatives. Derivatives are financial contracts that have their value or market price set by values or prices of other financial contracts, known as "underlyings." The range of institutions—from a German commercial bank, to the U.S. Securities and Exchange Commission (SEC), up to the International Monetary Fund (IMF)—indicates that unease over financial derivatives pervades every corner of the world's financial and monetary systems.

The explosive growth of derivatives markets reported in the Sept. 23 *EIR* was confirmed by the latest *Quarterly Banking Profile* of the U.S. Federal Deposit Insurance Corp., the agency which regulates all federally insured commercial banks in the United States. The FDIC *Profile* showed that the derivatives portfolios of U.S. commercial banks swelled by $3.5 trillion, or 29%, during the first six months of the year, to $15.3 trillion. This follows growth of 35% in the entirety of 1992, when U.S. commerical banks' derivatives holdings leaped $3.1 trillion. The FDIC *Profile* confirmed once again that derivatives are concentrated among the largest institutions: The five top banks (Citicorp, Chemical Bank, Bankers Trust, J.P. Morgan, and Chase) held 75.5% ($11.6 trillion) in derivatives, compared to 19.5% ($3.0 trillion) by the next 10 banks, and 5% ($0.6 trillion) by the remaining 653 banks.

By comparison, assets of U.S. commercial banks rose 9%, and loans rose 8%, during the 12 months between June 30, 1993 and June 30, 1994, according to the FDIC *Profile*. Thus, the $15.3 trillion in "off-balance-sheet derivatives" at the end of the second quarter, is almost four times the banks' $3.9 trillion in assets.

Regulators ignore alarm, praise profits

But instead of sounding alarms about the explosive growth of the derivatives cancer, U.S. regulators chose to croon about the record profits of the commercial banks, which were $11.2 billion for the second quarter, the second most profitable quarter in history after the $11.5 billion third quarter of 1993. Added to the $11.1 billion reported for the first quarter of this year, that gives the banks $22.3 billion, "the highest total ever reported for any six-month period," according to the *Profile*.

"The banking industry's recovery from the troubles of the late 1980s and the very early 1990s has been most impressive," crowed FDIC Chairman Andrew Hove, although he conceded that "some caution is necessary" and that the "mistakes of overlending during the 1980s should not be forgotten."

Federal Reserve Chairman Alan Greenspan also got into the act, telling the Senate Banking Committee on Sept. 22 that "the improvement in the condition of the U.S. banking system since 1991 has been truly amazing." Then, taking aim at the "doomsayers" who are warning about the dangers of financial derivatives, Greenspan declared that "at present, we see no major problems looming," and opined that he has been "impressed by these sophisticated risk management and control techniques and policies that banks have used to manage their risk positions."

Comptroller of the Currency Eugene Ludwig, testifying in the same hearing, insisted that "the national banking system is sound."

Others issue warnings

But it may not be too long before these glowing words are blown back into the faces of their speakers. On Sept. 26, the American Institute of Certified Public Accountants (AICPA) issued the results of its three-year study of U.S. corporate accounting practices, bluntly warning that business reporting standards have lagged dangerously far behind the rapid changes in financial markets. This lag has left investors

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blindly taking unknown risks in new instruments such as derivatives.

"With the profound changes we've seen in business, traditional financial statements and other forms of business reporting often fail to meet some of the most critical information needs of investors and creditors," said Edmund Jenkins, chairman of the AICPA's Special Committee on Financial Reporting and partner in Arthur Andersen Co.

The next day, the SEC appeared before the House Subcommittee on Telecommunications and Finance with a proposal for policing the derivatives holdings of mutual funds, the pools of money collected from individual investors by professional money managers. Seeking higher returns than those available on savings accounts or certificates of deposit, increasing numbers of Americans have been entrusting their money to mutual funds rather than traditional deposit institutions. This has some in Congress concerned, because the money invested in a mutual fund is not insured, and several mutual funds have suffered hundreds of millions of dollars in losses so far this year because of investments in derivatives.

"Although the reported problems to date have affected a limited number of funds and fund types, they raise investor protection issues that merit serious consideration," said the SEC report. Among the SEC's recommendations:

- Develop a new way to measure the risks a fund takes in derivatives.
- Reduce the percentage of total assets a mutual fund can hold in hard-to-sell or "illiquid" securities from the current 15% to 10%. This would force mutual funds to reduce their holdings of derivatives. At least one fund run by Piper Jaffrey Fund Management Inc. reportedly had 60% of its assets invested in derivatives.
- Study the possibility of applying the Investment Company Act of 1940 restrictions on leverage, to derivatives. Leverage refers to the ability to buy financial instruments using borrowed money. Many derivatives, such as futures or options contracts, for example, allow a purchaser to control up to $1 million of "underlying" bonds with only $5,000.
- Arm the SEC with enforceable powers to gather information from mutual funds. At present, the SEC relies mostly on voluntary compliance with its requests for information from mutual funds.

Hedge funds worry IMF

Also on Sept. 27, the IMF issued a report urging that greater reporting requirements be imposed on hedge funds, in order to prevent manipulation of financial markets. Hedge funds are similar to mutual funds, in that they are also pools of money collected from individual investors. But hedge funds are limited by law to less than 100 investors, each of whom must put in large sums of money. A typical minimum investment is $100,000, and minimum requirements as high as $1 million are not unknown.

Moreover, hedge funds do not have to comply with most of the rules regulating mutual funds. Hedge funds, for example, can use as much leverage as they want, and can invest in whatever they want. Consequently, hedge funds have emerged as the "party animals" of the investment world, using very high leverage to reap speculative profits of billions of dollars. In September 1992, for example, the Quantum Fund run by George Soros used high leverage to smash the European Exchange Rate Mechanism, and walked away with a reported $1 billion in profits.

The IMF study, however, follows the pattern of U.S. and British regulators over the past two years: The IMF wants more information, but it defends the hedge funds. According to the IMF, far from being looting mechanisms that suck up scarce capital, hedge funds have increased liquidity in bond markets because they have often been the only institutions willing to buy bonds at times when prices were collapsing. One central bank reportedly told the IMF authors, "Hedge funds have become the 'buyer of last resort' in some of these markets."

A few considerations of reality

On Sept. 20, the German BHF-Bank (Berliner Handels und Frankfurter Bank) published a study comparing the volatility of German financial markets during the first six months of 1994, with two other periods of high volatility during 1987, and 1989-90. The volatility of exchange rates is shown to be "extremely higher" than the long-term average during the first half of 1994.

So, the BHF-Bank asks, what is the reason for this? While the 1994 turbulence can be traced to interest rate increases, previous periods have seen even faster interest rate increases. Thus, the 1994 rate increases do not explain the extraordinary new degree of volatility. It is more likely, says BHF-Bank, that the intensification of volatility had been caused by structural changes in the German financial markets, especially the growing prominence of financial derivatives.

The most damning study of derivatives, however, was an unofficial discussion paper released on Sept. 25 by the U.S. Federal Reserve Board of Governors, "On Measuring Credit Risks of Derivatives Instruments," by Fed economist Gregory Duffee. Reviewing the statistical models used by commercial and investment banks to determine the probability that a counterparty will default on the terms of a derivatives contract, as well as the average and maximium amount that the bank will lose in the event of a default, Duffee finds that "a number of simplifying assumptions have been made, either explicitly or implicitly, in order to produce actual estimates of credit risk." The use of these assumptions "can produce large errors in the measurement of both expected credit losses and upper bounds on those losses."

So much for the "sophisticated risk management and control techniques and policies that banks have used to manage their risk positions," touted by Greenspan.