Banking by Richard Freeman

Greenspan, Summers extoll derivatives

Two oracles of the financial establishment deposited a load of manure before the Senate Agriculture Committee.

The Senate Agriculture Committee on Feb. 10 heard testimony by Federal Reserve Board Chairman Alan Greenspan and Treasury Secretary Lawrence Summers, who vied with one another to see who could most vigorously defend the cancer of financial derivatives speculation, which is destroying America's productive economy and threatens to bring on the biggest financial crash in modern history.

Greenspan spoke on a report of the President's Working Group on Financial Markets, entitled "Over-the-Counter Derivatives Markets and the Commodity Exchange Act." He participated in writing the report, which was released the same day.

The report concludes that over-the-counter derivatives should be exempt from regulation of the Commodity Futures Trading Commission (CFTC), and from the provisions of the Commodity Exchange Act, which established the CFTC. Greenspan said that over-the-counter derivatives must be allowed to grow without any government interference—that they should be "exempt" from the oversight of the CFTC.

He continued: "Over-the counter (OTC) derivatives have come to play an exceptionally important role in our financial system and in our economy. . . . A growing number of financial and non-financial institutions have embraced derivatives as an integral part of their risk capital allocation and profit maximization. In particular, the profitability of derivative products has been a major factor in the significant gain in the finance industry's share of American corporate output during the past decade—a reflection of their value to non-financial industry. Indeed, this value added from derivatives itself derives from their ability to enhance the process of wealth creation throughout our economy."

Greenspan's statement that "the profitability of derivative products has been a major factor in the significant gain in the finance industry's share of American corporate output," is an endorsement of the fact that derivatives trading has swelled the revenues of banks, and of Wall Street, which has increased the speculative size of what is called "Finance, Insurance and Real Estate," which is now 19.4% of total U.S. GDP. This is larger than the manufacturing portion of GDP.

This speculative cancer must not even be controlled, let alone wiped out, Greenspan stated. "In light of the importance of OTC derivatives, it is essential that we address the legal uncertainties created by the possibility that courts could construe OTC derivatives to be futures contracts subject to the CEA [Commodity Exchange Act]. The legal uncertainties create risks to the counterparties [the speculators] in OTC contracts and, indeed, to our financial system, that are simply unacceptable."

If OTC derivatives were to be construed to be futures contracts (which they are, in fact), then they could not be privately negotiated between financial institutions in the way that they currently are. Thus, all OTC contracts become legally questionable, and, if the OTC derivatives were held to the standard of the CEA, the vast majority of them could be declared null and void. This would affect tens of trillions of dollars worth of OTC contracts—which constitute the lion's share of U.S. derivatives.

To avoid the possibility that some future CFTC commissioner would rule that OTC derivatives are subject to the rules of the CEA—as Brooksley Borne, who was CFTC commissioner in 1999, was intimating she might do (before Greenspan had her sacked)—Greenspan said that the Congress must rewrite the CEA, to specifically give an exemption to OTC contracts.

Treasury Secretary Summers, who also participated in writing the report of the President's Working Group on Financial Markets, hailed the OTC derivatives market as "an important component of the American capital markets and a powerful symbol of the kind of innovation and technology that has made the American financial system as strong at it is today." The continued development of this market, he said, "will depend a great deal on the development of a clear and effective regulatory environment."

Summers summarized the report's recommendations:

"1. Create an exclusion from the CEA for most swaps agreements."

Swaps are a leading form of derivatives transaction.

"2. Create an exclusion for electronic trading systems."

Derivatives swaps dealers use electronic trading systems to trade derivatives swaps.

"3. Permit the use of appropriately regulated clearing systems for OTC derivatives.

"4. Clarify the original intent of the Treasury Amendment." This amendment pertains to whether certain types of derivatives trades and activities are allowed. . . .

"6. Clarify the exempt status of hybrid instruments."

Summers said that these recommendations are needed to "advance" the derivatives market.