Banking by John Hoefle

Decriminalizing the Derivatives Market

Pushing two bills in Congress, bankers are battening down the hatches for a major derivatives crisis.

The urgency with which the big derivatives dealers and their regulators, i.e., protectors, are pushing two derivatives bills through Congress, strongly suggests that a major derivatives crisis is under way. One of the bills would legalize trillions of dollars of derivatives transactions which are illegal under current law, while the other would enforce the "netting" of derivatives contracts, were a big financial institution to file for bankruptcy.

On Oct. 19, the House of Representatives passed H.R. 4541, officially designated the Commodity Futures Modernization Act of 2000, but which could more precisely be called the Derivatives Decriminalization Act of 2000, given that it would legitimize many of the currently illegal over-the-counter derivatives activities of the big banks and investment houses.

The champions of the bill included Federal Reserve Board Chairman Alan Greenspan, Treasury Secretary Lawrence Summers, the major financial services associations and institutions—in short, all the major derivatives dealers and their regulators.

One of the major components of the bill is the explicit legalization of trillions of dollars of over-the-counter futures transactions, an issue of contention for the better part of a decade. The problem was succinctly described by Enron's Mark Haedicke in an appearance before Congress in April 1997. Haedicke, testifying in his capacity as an official of the International Swaps and Derivatives Association, complained that "legal uncertainties continue to exist" in the over-the-counter derivatives market, because the Commodities Exchange Act "flatly prohibits off-exchange futures contracts." "If certain swaps transactions were ever classified as 'futures contracts,'" Haedicke continued, "they would be illegal and unenforceable as a matter of law." That, Haedicke arrogantly asserted, "is obviously unacceptable in the global marketplace."

The point was made again by Chase Manhattan Bank director of global markets Dennis Oakley, in a July 17, 1998 hearing before the House Banking Committee. Oakley testified that "the Commodity Exchange Act requires that all commodity futures contracts be traded on a board of trade, and that since 1974, financial products have been considered commodity futures, unless they fall within the exception of the Treasury Amendment. If a product is deemed to be a future, and is not traded on a board of trade, it is null and void." The problem, he continued, "is that some of our fastest-growing products, such as equity and credit derivatives, are not covered by the exemption." Unless the law is changed, Oakley threatened, "Chase will be forced to move this business to another location, probably London."

The issue of illegal derivatives came to a head in 1998 when Commodity Futures Trading Commission (CFTC) Chairman Brooksley Born suggested that her agency might review the issue of over-the-counter futures. The response from the derivatives gang was venomous, with the President's Working Group on Financial Markets (known informally as the Plunge Protection Group) virtually ordering the CFTC to stand down, and demanding that Congress pass a law making sure that the agency did. Born was run off, and the CFTC was effectively neutered. H.R. 4541 completes the process by removing the issue from CFTC jurisdiction.

The other derivatives bill before Congress involves the handling of derivatives contracts in a bankruptcy filing. When a company files for bankruptcy, many of the monies it owes are written off, while the monies owed to it by others are collected and paid to creditors. Were a major derivatives player to go under, this could cause a big problem for the system. Imagine if bankrupt Bank A owed Bank B $1 trillion in derivatives contract settlements, while Bank B owed Bank A $1.5 trillion. Under bankruptcy law, the $1 trillion A owes B could be written off, while B would still have to pay the $1.5 trillion it owed. Such a deal could bankrupt B.

The "solution," strongly endorsed by Greenspan and Summers, is a netting provision which would allow institutions to settle the difference between the various contracts, rather than the full amount. Under netting, Bank B would have to pay $0.5 trillion, the difference between what it owes A, and what A owes it.

The larger aspect of both bills is that they would further remove the resolution of a derivatives crisis from the jurisdiction of the U.S. government. From the Fed's standpoint, the prospect of a U.S. Federal judge asserting jurisdiction over a derivatives bankruptcy is frightening and unacceptable. From the bankers' perspective, the government should just keep the money flowing, but otherwise stay out of the way.

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