Congressional hearing defends speculation in derivatives

by Richard Freeman

Fighting to keep the extent of derivatives speculation hidden from view, the supporters in the U.S. Congress of Federal Reserve Board Chairman Alan Greenspan, and the top U.S. derivatives trading banks, appeared at a contentious Congressional hearing on Oct. 1. The hearing, by the Republican-dominated House Banking Committee Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises, was an undisguised attempt to derail implementation of proposed new rules changes, formulated by the Financial Accounting Standards Board (FASB), that would require, effective Jan. 1, 1999, that all publicly traded corporations and banks report their derivatives holdings on their balance sheets, at fair market value.

The FASB was established in 1973 as an independent, national body entrusted with setting corporate accounting standards. Most derivatives instruments, if they are reported by a corporation, are reported off-balance sheet, buried in footnotes, in small type in annual reports. Many corporations do not report certain categories of derivatives at all. The FASB also exposed at the hearings that several corporations have adopted the dishonest, rather fantastic practice of reporting derivatives losses as increases in valuation of their assets. FASB Chairman Edmund Jenkins told the hearing, "The information about derivatives and hedging reported in financial statements today is incomplete, inconsistent, and just plain wrong."

Jenkins was attacked by Subcommittee Chairman Richard Baker (R-La.), Spencer Bachus (R-Ala.), and Tom Campbell (R-Calif.), who argued for putting off the date of implementation of the proposed FASB derivatives reporting rules changes. Susan Phillips, the Federal Reserve Board governor who spoke officially for the board and for Greenspan, said that derivatives should not be reported on-balance sheet.

Derivatives are speculative side-bets which suck dry the underlying physical economy. Since 1987, derivatives have grown cancerously in the United States and worldwide. The top eight U.S. derivatives-holding commercial banks have $22.6 trillion worth of derivatives, against only $93 billion worth of equity, but the derivatives holdings of non-financial corporations are also growing rapidly. On Sept. 30, the *Wall Street Journal* reported that during the third quarter of this year, Salomon Brothers investment bank lost at least $200 million in bad derivatives investments; the actual loss could be much higher. Few could forget, that in 1994-95, Orange County, California suffered a $1.7 billion derivatives loss; Barings Bank experienced a $1.1 billion derivatives loss, which caused the bankruptcy of the bank; and corporations such as Procter and Gamble, and Gibson Greetings Cards, bought exotic derivatives contracts from Bankers Trust and suffered multimillion-dollar losses.

Yet, the bankers swear from here to eternity, that derivatives are only hedges, that they know what they're doing, and that it would only "confuse people" if derivatives were reported on-balance sheet.

When Greenspan speaks, Republicans listen

The leading Republican members of the subcommittee openly stated that they were convening the hearing to act on behalf of the interests of the banks, and Greenspan. Subcommittee Chairman Baker told the Oct. 1 *Washington Post* that he might "consider sponsoring legislation to block the [FASB] rule," if he believed "*it will unfairly hurt banks' reported earnings*" (emphasis added). In an opening statement, Bachus said that the FASB should listen to Greenspan's opposition to its proposed rules. "With me," Bachus stated, Greenspan's "a lot like E.F. Hutton—when he talks, I listen."

It seems that the Congressmen's ability to "listen" to Greenspan and the banks, has been helped along. For example, in the 1995-96 election cycle, Baker received more than $135,000 in contributions from banking and derivatives industry groups. So far this year, he has received at least another $35,000.

The banks had their representatives at the hearing. A lawyer for a New York City law firm told this author, that he had travelled to the hearing because "my law firm works for a single New York bank, and everybody is freaked out that this new rule change would go through."

Jenkins: 'The public has a right to know'

FASB Chairman Jenkins testified that the FASB's primary focus is to put into effect rules that would require that corporations report their derivatives holdings on their balance sheet, at fair market value, which would require marking the derivatives to their current market price. He stated, "If ever a case can be made for reporting something in more detail, it is for derivatives. . . . Different companies may report very similar activities differently, and even an individual company may report similar activities differently. . . . Gains and losses [on derivatives] are not explicitly disclosed today, and their effect on earnings is difficult, if not impossible, for an investor or creditor to determine. Again, we believe that the public has the right to know." (See *EIR,* Sept. 12, p. 4, for a detailed discussion of the FASB rule changes.)

Several banks have complained that derivatives are just hedges, and that reporting earnings or losses from derivatives on their balance sheets would distort earnings. Jenkins responded that "gains or losses on derivatives that qualify for hedge accounting should have little or no net effect on a company's earnings because they will be offset by comparable losses or gains on the thing that is being hedged—and the result is little or no volatility in earnings." What Jenkins is referring to, is that in a hypothetical hedging operation, if the underlying instrument falls, then the hedge instrument should gain by an offsetting amount; and, if the underlying instrument rises, then the hedge instrument should fall by an offsetting amount. Jenkins said that if the hedge is not matched by, and does not move in the opposite direction from the underlying instrument, then "maybe the hedge operation wasn't an effective hedge," i.e., it really was a speculative instrument. After the hearing, in a short discussion with *EIR,* Jenkins acknowledged that he knows of reports showing that a large amount of the derivatives trading of banks is purely speculative.

Jenkins revealed some creative accounting, which on-balance-sheet reporting would do away with. He said that some banks and corporations hide their derivatives losses by counting them as an asset on-balance sheet. "Assets are supposed to be things that are of benefit to an entity. A loss just does not fit that description," he said.

Republicans on the subcommittee, as well as Bruce Vento (D-Minn.) (who represents the interests of Norwest Bank), attempted to bushwhack Jenkins. Bachus, for whom regulation is superfluous, asked Jenkins, "When the banks that trade 96% of the nation's derivatives tell you that they think your rule is inappropriate, doesn't that raise a red flag?" and, "When the Federal Reserve, the FDIC [Federal Deposit Insurance Corp.] and the OCC [Office of Comptroller of the Currency] object to the rule, doesn't that raise a red flag?" and so forth. He continued, "Don't these banks know better what's best for them?"

Bachus discussed the virtual fail-safe system that banks have, obviating derivatives losses, because of superior "risk management systems." (Someone should explain that to Bankers Trust, which blew itself out with gigantic derivatives losses in 1994-95, and was quietly reorganized by the government.) Bachus and his colleagues called for delaying implementation of the FASB rule changes by at least one year. (The final version of the proposed FASB rule changes will be released in December 1997, and are scheduled to go into effect on Jan. 1, 1999.)

Levitt warns of Russian roulette

The chairman of the Securities and Exchange Commission, Arthur Levitt, testified after Jenkins. The SEC enforces the FASB accounting rules for 15,000 American companies which are public, and therefore their stock trades on some American stock exchange. Levitt warned that the FASB must remain independent, and that he was there "to shield it from political pressure." He said, "It is very inappropriate for the Congress to suggest any further delays. I believe that we would be playing Russian roulette with our markets."

Levitt said of the rising stock market, "Whatever goes up, must inevitably come down." He reported that in 1994, following several large corporate derivatives failures, such as Procter and Gamble, "in a [Congressional] hearing . . . I was badgered and asked and pressed to ban derivatives products." Now, Levitt said, "The stock market has gone up for 14 years, and there has been no derivatives accident for two and one-half years, so people know only a rising market, but to believe that something else won't happen is to play Russian roulette."

Unfortunately, Levitt described derivatives as "necessary instruments."

The presence of Greenspan

Federal Reserve Board Governor Susan Phillips postured that "the desirability of meaningful disclosure is not the issue." She then stated, "These problems can be minimized by placing market values in meaningful *supplemental* disclosures rather than by forcing their use in the primary financial statements" (emphasis added). This is a call to continue reporting derivatives off-balance sheet. She warned, "Indeed, placing financial instruments in regulatory or accounting pigeonholes . . . can create disincentives for prudent risk management." That is, this could threaten unbridled speculation.

Robert Trupin, the comptroller of Citibank, America's second-largest bank, complained that complying with the FASB rules would add "extra cost," and that under the FASB rules, "derivatives would have to be reported as if they are bets rather than as hedges."

That, of course, is the central issue: Derivatives are highly leveraged, very large bets.

Though he was not there, Greenspan's presence was felt throughout the hearings. On July 31, he had written the third in a series of letters to FASB Chairman Jenkins, stating that proposed FASB derivatives accounting rule changes should be abandoned. What Greenspan and the banks fear from this minimal step of reporting derivatives on-balance sheet, is that it would uncover large derivatives losses, and simultaneously, the scope of the bankruptcy of the derivatives-soaked U.S. banking system. As of the second quarter 1997, U.S. commercial banks held $23.8 trillion notional amount of derivatives; it is estimated that investment banks held $9.5 trillion, and insurance companies $2 trillion. The banking crowd fears that reporting derivatives holdings could help provoke the demise of that bubble.