New House Rules

How the Feds are seeking to make the world safe for derivatives.

BY CHRISTOPHER WHALEN

The Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Reserve, Federal Deposit Insurance Corporation, and Securities and Exchange Commission are worried. On May 13, the five regulators issued a joint statement, "Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities," seeking public comment on a new round of internal controls and risk management procedures to rein in financial institutions that engage in "complex structured finance activities," also known as derivatives. After having encouraged the use of imaginary securities in the 1990s as a way to offset risk in volatile markets, regulators led by the Federal Reserve Board now evidence a certain degree of hysteria. Why? Because the very derivatives that have long been promoted by regulators and Wall Street as useful tools to manage risk are showing signs of getting out of control.

A couple of months ago, Federal Reserve Board Chairman Alan Greenspan fretted about the "systemic" threat posed to the financial markets by government-sponsored enterprises such as Fannie Mae, but in fact it is the big derivatives houses—and their inept customers—that are giving regulators the shakes. The proposal states: "In light of recent events, the OCC, Federal Reserve, and SEC conducted special reviews of several banking and securities firms that are significant participants in the market for complex structured finance products. These reviews were designed to evaluate the product approval, transaction approval, and

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other internal controls and processes used by these institutions to identify and manage the legal, reputational, and other risks associated with complex structured finance transactions."

The proposed text seems focused on the idea that the banks have gone too far with existing derivatives activities. Most of the language is about reining in the troops and making managers and directors accountable, à la Sarbanes-Oxley, for what products they sell and who they sell them to and based on what disclosure. Yet the proposed statement on "sound practices" suggests that the SEC and other regulators consider derivatives-dealing activities appropriate and, indeed, co-equal with the other activities of a well-managed financial institution. Have American prudential standards fallen so far that we wish to publicly embrace the view that derivatives trading is actually a productive way to deploy capital? At the Greenspan-dominated Fed, the answer to that question seems to be a resounding "yes."

Derivatives shift wealth opportunistically. The theory behind them is to stabilize risk in volatile markets by providing a means of rectifying a portion of the losses incurred in less liquid activities. However, unlike selling real goods and services, every derivatives transaction is a wager that produces a winner and a loser. In other words, every trade results in a realized loss to one party. Thus derivatives enable smarter firms with deeper talent pools and better information to exploit lesser players. Herein lies the flaw for the financial industry. While volatility is stabilized for a few, the net effect on the system is negative as the mounting losses are merely passed to the dumbest player at the table.

The reality is that most banks and non-bank financial institutions do not have the scale, internal systems, and—most important—human resources needed to compete successfully in the derivatives market. Consider one example: the July 2001 failure of Superior Bank, FSB, a small community bank in Illinois that was rendered insolvent in a matter of months by losses from toxic derivatives, in this case residual interests in a portfolio of sub-prime loans. John M. Reich, Vice Chairman of the FDIC, told Congress in September 2001: "Since 1998, failures of institutions with risk characteristics similar to those of Superior have cost the FDIC insurance funds more than $1 billion."

Along with the new Basel II bank capital guidelines, the proposed procedures for complex structured transactions are, in a very simplistic sense, an attempt to make the world safe for derivatives. Unfortunately, every game of chance must have a chump, and the broadening of the pool of players, from private investors to mutual funds to banks, means that larger and larger swaths of American society are now put at risk to feed Wall Street's need for new suckers. Or to put it another way, if giant organizations the size of Washington Mutual or Fannie Mae cannot manage the duration risk of relatively pedestrian mortgage portfolios, what makes the regulators think that the vast majority of smaller institutions can do any better playing in the world of customized derivatives contracts, the type of dealings made infamous by Enron and Bankers Trust?

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Top U.S. Bank Derivatives Operations
Sorted by Margin to Risk-Based Capital

Name	Notional, (000) $	Rank $	Margin, bps
JPMorgan Chase Bank	39,622,611,000	1	11.341
Bank of America, NA	14,891,390,979	2	37.164
Citibank, NA	13,701,773,000	3	40.982
HSBC Bank USA	1,572,083,425	5	54.802
State Street Bank & Trust Co.	457,493,419	10	101.799
Wachovia Bank, NA	2,604,746,000	4	120.292
The Bank of New York	608,232,739	7	135.382
National City Bank	250,714,120	11	194.589
Bank One, NA*	1,151,411,000	6	197.740
Mellon Bank, NA	117,580,439	13	229.545
National City Bank of Indiana	143,356,580	12	265.160
Irwin Union Bank & Trust Co.	14,765,205	27	422.730
Fleet National Bank	469,243,000	9	431.674
Wells Fargo Bank, NA	581,120,000	8	504.027
Standard Federal Bank NA	103,778,626	14	523.400
NBank, NA	344,415	42	667.915
The First State Bank	45,000	48	728.000
The Northern Trust Company	35,280,913	21	781.345
First Tennessee Bank, NA	30,110,836	22	815.775

Source: FDIC
**Merged with JPMorgan Chase, June 30, 2004.*

The real risk posed to the U.S. consumer by derivatives is not that one of the larger players will suffer a catastrophic loss and collapse into the arms of Uncle Sam, in what is known as the "too big to fail" scenario. Rather, the hazard is that a steady procession of smaller banks and funds will be consumed by losses on derivatives, generating chaos and mayhem in their communities but going largely unnoticed by the servile politicians and big media that patronize the largest financial houses.

When the SEC and other regulators propose to issue guidelines for how financial institutions can "safely" engage in derivatives-dealing activities, they are effectively acting as shills for the largest money center banks, bringing new suckers to the derivatives table to keep the game growing. The imperative of keeping that derivatives market expanding is best explained in terms of the Fed's pandering to the ten largest banks. Because derivatives are so important to the profitability of large

dealers like JPMorgan Chase, Bank of America, and Citigroup, regulators have no choice but to encourage the use of imaginary securities by an ever-growing number of "investors."

Despite record profits on Wall Street, derivatives are one of the few areas of finance that is growing in terms of turnover and headcount—at least in a notional sense. Yet there is the scent of danger in the air. The spreads on most derivatives products have collapsed as more and more traders and capital are thrown into the great virtual casino. Three big banks now control most of a market where the dealers measure their "notional" profits in mere basis points.

Of the 575 U.S. bank holding companies and single-unit institutions active in derivatives at the end of March 2004, over 130 held notional value positions in excess of their weighted Risk-Based Capital (RBCW), as reported to the FDIC. Significantly, the top twenty institutions represent 97.6 percent of the notional contracts held by banks involved in derivatives, some $67.2 trillion out of the total $68.8 trillion reported by domestic banks.

Top of the pile at the end of March was JPMorgan Chase with $39.6 trillion dollars in notional contracts outstanding (not including the derivatives book of BancOne), roughly half of total derivatives positions held by all U.S. banking institutions. JPMorgan Chase is also the most tightly run;

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a relatively small realized loss in the notional position—a mere 11 basis points—will create a loss equivalent to JPMorgan Chase's entire capital base. JPMorgan Chase is said to have in excess of 800 derivatives traders, a tribute to a business that grew several times faster than the economy—or even the cash markets—for a decade. But just one mistake by one of those young derivatives trades could literally bring down JPMorgan Chase and with it the entire derivatives market.

Every trade results in a realized loss to one party.

The inverse relationship between the size of the derivatives business and the apparent margin in basis points reminds us of author Martin Mayer, who observed on more than one occasion that 1) there are no economies of scale in banking; and 2) the derivatives market is really about shifting the risk to the dumbest guy in the room. JPMorgan Chase seems to fit that pair of shoes, but don't blame the bankers. Credit Alan Greenspan and the mandarins at the Federal Reserve Board for encouraging the formation of a single bank that is effectively counterparty to every derivative contract on Wall Street. Is this an example of diversification of risk? Since the last U.S. banking crisis in 1991, it has been the policy of the Fed to encourage big banks to merge and to embrace derivatives as a primary source of profitability.

But not all mega institutions are following JPMorgan Chase's example. Notice that Citigroup, whose bankers created the derivatives market in London during the mid-1980s and who once led the market in terms of dealing volume, is now just one-third JPMorgan Chase's size and number three behind Bank of America, with a higher but still paper-thin margin on its derivatives book. Since the start of 2004, however, all of the major derivatives dealers have seen their notional positions grow significantly while spreads have likewise narrowed.

As the regulators gather comments from the financial community about how to tailor new internal control and risk management procedures for financial institutions that create and sell derivatives, one lawyer who represents some of the larger players

Continued on page 87

Continued from page 57

before the various regulators worries that the new "house rules" for the once wide-open derivatives bazaar will open the door to all types of new oversight—and litigation—without making the market for these products any less hazardous. This thirty-year veteran of the Washington regulatory arena foresees suitability rules and other compliance tests applied to derivatives through the new procedures, meaning that customers who get burned by their investment bankers will have greater incentives to sue the dealer banks. That seems to be precisely the point because regulators clearly are concerned about what they see in the derivatives markets—and also by what they don't know.

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Most of the products and valuation methods in the derivatives marketplace are opaque, part of the façade needed to protect the profitability of these "complex" instruments. The fact is, the market for "complex structured financial instruments" depends on a certain lack of transparency that turns off fundamental investors such as Warren Buffet. The details of the current vintage of derivatives are known to only a handful of practitioners because the first synthetics tout to launch a new idea usually makes most of the money. As soon as a new type of instrument hits the markets, the other dealers immediately seek to imitate the trade, but at a lower price. This is why official attempts to, *a priori,* understand the secretive world of derivatives will ultimately fail. The regulators will always be one step behind.

In his column on June 16, 2004, John Kay of the *Financial Times* wrote: "Why would anyone want to buy a bond whose return is proportional to the square of the current interest rate? Why would someone in search of high income buy a security that offers it, but also offers a risk of large capital loss if one of three stock market indices should fall more than 25 percent below its initial level? Why would anyone looking for a guaranteed investment return accept such a return from a share whose only recourse for that guarantee is a portfolio that is itself invested in similar securities?" Why indeed.

Kay continues: "The only good reason for taking these peculiar bets is that you have calculated that they are mispriced, the prospective returns outweigh the risks, and you are well enough off to invest a small fraction of your assets as part of a broad diversified portfolio… The only people well-equipped to assess the value of these instruments are the people who are selling them… The essential nature of Bankers Trust's trading programme with Procter & Gamble, precipice bonds and split level trusts is that people who understood the products they were selling sold to people who did not understand the products they were buying. There was no other rationale."

The attempts by the financial regulators to get the derivatives pony back in the barn will fail miserably. Of course, the regulators can always ponder yesterday's train wreck, clean up the mess and assess guilt. The one thing that is certain is that the derivatives market will deliver to us a regular series of financial calamities à la Enron and Long Term Capital Management, perhaps even before the November election. Whatever anyone tells you about derivatives, remember that trading complex synthetic securities is not investing but rather a form of high-tech gaming. At its best, it helps to shift risk from you to somebody else with deadly speed and effect, but now the sucker could be the community bank that holds your mortgage and checking account.

Benjamin Graham and David Dodd defined investment in their 1934 book, *Security Analysis:* "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative." Regarding speculation, including most equity investments, the authors concluded: "The value of analysis diminishes as the element of chance increases." ◆