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Banking by John Hoefle

Bashing the CFTC

The Senate punishes the regulatory agency for even considering new derivatives regulations.

The Senate Agriculture Committee held a hearing on Dec. 16, nominally to discuss the over-the-counter (OTC) derivatives market and hedge funds, but the primary purpose of the hearing seemed to be to browbeat the Commodity Futures Trading Commission (CFTC) into abandoning any plans it might have to re-regulate the OTC market.

The mood was set by committee chairman Richard Lugar (R-Ind.), who said that the hearing was being held "because after the Commodity Futures Trading Commission issued a concept release on swaps in May, many public and private leaders in the financial community expressed alarm over the legal uncertainty which the concept release injected into the financial markets." The hearing, he said, "is another attempt to provide a degree of certainty in the area of our committee's oversight authority."

Lugar made it clear that it was the CFTC, not the derivatives market, that was under the microscope. He stated that "only Congress should make the fundamental decisions" about whether and how the OTC derivatives markets are to be regulated, and warned that the Agriculture Committee would "systematically explore the underlying purposes and objectives of futures and derivatives regulation" as part of the "reauthorization of the CFTC."

His threat was reinforced by a string of former CFTC officials, who testified that the derivatives markets were sound, and that re-regulation is unacceptable.

Former Federal Reserve Governor Susan Phillips, who headed the CFTC from 1983-87, claimed not only that "no special oversight, facility, or Federal protection is necessary" for the OTC derivatives market, but that, "to take the argument a step further, exchange-traded futures and options could also be considerably deregulated."

Also trotted out was Dr. Wendy Gramm, Phillips's successor at the CFTC (1988-93), whose active deregulation of the derivatives markets helped pave the way for the explosive growth of the bubble. (Gramm's husband is Sen. Phil Gramm, who will head the Senate Banking Committee in the next Congress.) Mrs. Gramm cited "the challenge of keeping laws and regulations from stifling innovation or otherwise damaging markets," and said she saw no need for new regulations, because "the regulatory structure seems to be working."

Adding to the pressure was William Albrecht, who served as a CFTC Commissioner with Gramm. Albrecht stated that "the CFTC should not regulate OTC derivatives or hedge funds," and reinforced Lugar's threat by suggesting that the CFTC be merged into the Securities and Exchange Commission.

To her credit, current CFTC Chairman Brooksley Born stood her lonely ground, insisting that the lack of reporting requirements for most OTC derivatives market participants "potentially allows them to take positions that may threaten our regulated markets without the knowledge of any Federal regulatory authority."

The most cogent remarks at the hearing were made by Martin Mayer, author of a number of books on financial matters. Mayer stated bluntly that "the law gives CFTC jurisdiction over commoditized financial derivatives—many of which would otherwise, let me note, be illegal under the gaming and anti-bucket-shop laws of some states, including New York, which provides the governing law for most international swap contracts."

As an example of the "folly" of the current regulatory regime, Mayer cited the case of nondeliverable forwards—contracts which represent bets on the relative future value of two currencies—involving the now-infamous Russian government bonds. The Western financial houses bought large amounts of these ruble-denominated bonds, then entered into offsetting derivatives contracts with Russian banks, to protect themselves against declines in the ruble.

"Under the inadequate rules governing bank supervision in this country and elsewhere, the banks were then permitted to say they had no exposure to changes in the value of the ruble," Mayer said. "For each contract they had with an American entity—or Cayman Islands or Guernsey entity—that left them exposed to losses if the ruble lost value, they had an offsetting contract with a Russian entity that covered those potential losses. Without objection from their supervisors, they simply netted out pairs of contracts on their books. To this day, nobody really knows the volume of these contracts, though the number appears to be somewhere north of $5 billion."

"Given our experiences in this decade and the weight of the argument that promiscuous creation of OTC derivatives can imperil the world financial structure," Mayer concluded, "it is preposterous, even sinister, that the CFTC, charged with regulating this area, should be prohibited from undertaking a study of its responsibilities."

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