

October 8, 2002 12:18 a.m. EDT

ECONOMY

Greenspan Cautions Banks Against Speculative Excess

Growth of Derivatives Markets Has Left
Financial Institutions Highly Leveraged

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Staff Reporters of THE WALL STREET JOURNAL

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WASHINGTON -- Proliferating financial derivatives have helped banks withstand rising corporate defaults, but they also can fuel speculative excess, Federal Reserve Chairman Alan Greenspan said.

"Financial derivatives ... have grown at a phenomenal pace over the past fifteen years," Mr. Greenspan said in prepared remarks to the American Bankers Association convention in Phoenix. "Banks appear to have effectively used such instruments to shift a significant part of the risk from their corporate loan portfolios" to other institutions. For example, significant exposures to telecommunications firms were laid off through credit-default swaps and collateralized debt obligations.

"These transactions represent a new paradigm of active credit management and are a major part of the explanation of the banking system's strength during a period of stress," the Fed chairman said.

But more-sophisticated risk-management techniques and "especially the various forms of derivatives, are, by construction, highly leveraged. They are thus prone to induce speculative excesses, not only in the U.S. financial system but also through the rest of the world." This potential for systemic risk can be contained through a combination of regulation, supervision and private-sector action, including better public disclosure, Mr. Greenspan said. But ultimately, some of that systemic risk must also be absorbed by central banks, he said.

A derivative is a financial contract derived from an underlying security, commodity, interest rate or currency. It can be as simple as an option to buy or sell a stock or bond, or a way of profiting from changes in interest rates, or even a kind of complex insurance that banks can obtain against the possibility that a loan will default.

The volume of derivatives has exploded in recent years, with trillions of dollars of derivatives now in existence; most cancel each other out.

A key element of some derivatives is that they allow an investor to protect large investments with relatively little capital, but the resulting leverage makes outsized gains and losses possible. Mr. Greenspan has long been a fan of derivatives, as well as a leading opponent of moves to impose new regulations on them. He has opposed a recent proposal by Sens. Tom Harkin (D., Iowa) and Richard Lugar (R., Ind.) to regulate some energy derivatives. That proposal was sparked by alleged abuses by Enron Corp,

Mr. Greenspan said the Asian and Russian financial crises in 1998 sent a "strong and timely message" to the U.S. financial system to raise its credit standards and work harder to manage risk. This led to a far stronger position heading into recession.

GREENSPAN SPEAKS

[See the complete text of Mr. Greenspan's remarks.](#)¹

"Our banks have been able to retain their strength in this business cycle, in contrast to the early 1990s when so many either failed or had near-death experiences," he said. He urged banks to take careful note of the current problems. Many banks didn't keep proper records during the early 1990s and are now regretting it, he said.

"Now is the time to collect and maintain these default and loss data in a disciplined and uniform fashion," the Fed chairman said.

Meanwhile, in a sign of some further cooling in the economy, the Fed said that consumer borrowing grew in August by the smallest amount in eight months. Consumer credit expanded by an annual rate of 2.9%, or \$4.2 billion, in August, to a seasonally adjusted \$1.73 trillion, following a gain of 7%, or \$10 billion, in July, revised down from the initial \$10.8 billion estimate.

Outstanding credit-card debt and other revolving consumer loans rose 6.5%, or \$3.9 billion, to \$725.9 billion. Nonrevolving credit rose 0.3%, or \$200 million, to \$1.004 trillion.

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Updated October 8, 2002 12:18 a.m. EDT