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Thank you for this opportunity to present the views of the Federal Reserve Board on safety and soundness issues associated with derivatives activities of banking organizations. The Board believes that these are important issues and is devoting substantial resources to improving understanding of derivatives and to developing appropriate public policies for these instruments. Today I shall begin by sharing with you our perspective on the public benefits and public policy concerns associated with use of derivatives by banks and by others. Then I shall summarize the Board's strategy for addressing those concerns and discuss the specific policy actions that we have taken and are planning to take in order to implement that strategy.

Public Benefits and Public Policy Concerns

A derivative is a financial contract whose value is derived from the values of one or more underlying assets or reference rates or indexes of asset values. Derivatives include standardized contracts that are traded on futures and securities exchanges and also customized, privately negotiated contracts known as over-the-counter (OTC) derivatives. Both types of derivatives have been in existence for hundreds of years In the United States, commodity futures exchanges date to the mid-nineteenth century, and foreign exchange forward contracts have been offered by some U.S. banks since early this century

Since around 1980, however, the scale, diversity, and complexity of derivatives activities have increased greatly. On the futures exchanges, interest rate derivatives, which were first introduced in the mid-1970s, today account for more than half of total activity OTC interest rate derivatives did not emerge until the early 1980s, but today these instruments are available and used actively in all of the major financial centers in North America, Europe, and Asia Foreign exchange contracts also are actively traded over the counter and on exchanges in all the major financial centers, and commodity-linked and equity-linked derivatives are now widely available

The Board believes that the development of new derivative products and the overall expansion of derivatives activities have provided important public benefits. The primary economic function of derivatives is to transfer market risk, that is, the risk of an adverse change in the price of an asset or portfolio of assets The importance of this function has increased as competitive pressures have intensified in many economic sectors and interest rates, exchange rates, and other asset prices have tended to be quite volatile In this environment, many financial and nonfinancial businesses, federally sponsored agencies, and state and local governments have concluded that active management of their exposures to financial market risks is essential They recognize that such risks, if left unmanaged, can jeopardize their ability to perform successfully their primary economic functions Because derivatives, especially customized OTC derivatives, allow financial market risks to be adjusted more precisely and at lower cost than is possible with other financial instruments, many entities have come to rely on such contracts to achieve their risk management objectives.

At the same time, the Board recognizes that derivatives are complex instruments and that, if not clearly understood and properly managed, their use can threaten the safety and soundness of banks and other users To date, few institutions have suffered significant losses from derivatives activities, and no commercial bank has failed as a result of such activities. But the potential clearly exists for an individual bank or other institution to misuse derivatives in ways that create risk exposures that could materially weaken its financial condition, either because of ignorance or because of an imprudent attitude toward risk.

The Board also is concerned that derivatives activities could have implications for the stability of the financial system. Whether derivatives have increased or decreased systemic risk still is a subject of ongoing review and analysis. Derivatives have fostered greater awareness and understanding of risks and enhanced methods of risk management It is clear, however, that derivatives activities have become a significant factor in the overall risk profiles of some banks and other financial intermediaries. While still relatively few in number, these institutions are among the largest and most active in the financial and banking markets If one of them failed to manage its derivatives activities prudently, its financial condition could be weakened and concern about its financial health could jeopardize the smooth operation of financial markets More generally, derivatives have been a major factor in tightening linkages among markets and potentially altering the transmission of economic and financial shocks If a firm that was very active in these markets came under extreme financial stress, regardless of the source of its difficulties, the unwinding of its outstanding derivatives positions and related positions in other financial markets could pose significant challenges both to the firm and to regulatory authorities seeking to contain the effects of its difficulties

It is also clear that weaknesses in the financial infrastructure for derivatives activities are a potential source of systemic problems. In fact, the largest single source of losses from derivatives activities to date resulted from a court decision that invalidated derivatives contracts with certain local authorities in the United Kingdom. In the United States, prior to the passage of the Futures Trading Practices Act of 1992 and subsequent regulatory action by the Commodity Futures Trading Commission, the exchange-trading restriction of the Commodity Exchange Act had raised serious concerns about the legal enforceability of many OTC derivatives contracts Of remaining infrastructure problems, perhaps the most serious relate to the legal enforceability of so-called netting agreements for derivatives contracts, which still is questionable in several important foreign jurisdictions.

A Strategy for Addressing Public Policy Concerns

The strategy that the Federal Reserve has pursued to address concerns about the risks associated with derivatives activities has three basic elements. First the Board has used its banking supervisory authority to attempt to ensure that the risks associated with the derivatives activities of the institutions it regulates are managed prudently and do not pose a threat to the deposit insurance fund. Along with other banking supervisors in the United States and abroad, the Federal Reserve has worked to incorporate such risks into regulatory minimum capital requirements At the same time, however, the Board's policies have emphasized the responsibility of a bank's senior management for ensuring that risks of the institution's derivatives activities are effectively controlled and are limited to levels that do not pose a threat of seriously impairing its capital. This emphasis reflects the Board's belief that regulation cannot substitute for effective risk management, especially in the case of activities as complex and diverse as derivatives activities

Second, the Federal Reserve has strongly encouraged private sector initiatives to foster sound risk management of derivatives activities. Because banks are not the only large-scale users of derivatives, concerns about risks to individual institutions and to the financial system must extend to other entities, some of which are not subject to prudential regulation by banking supervisors or by other authorities. Private sector initiatives offer the promise of strengthening risk management practices of both regulated and unregulated entities in the United States and abroad.

Third, the Board has worked with users of derivatives, other regulators in the United States and abroad, and legislators to strengthen the financial infrastructure for derivatives activities. To date, these efforts have focused on legal enforceability issues. Further efforts are needed, both on legal issues and on other issues, notably accounting and financial reporting issues.

Bank Regulatory and Supervisory Policies

Before discussing the specific regulations and supervisory policies and procedures that the Federal Reserve has implemented to address the risks of bank derivatives activities, several points about the extent and nature of such activities should be noted. Most important, very few banking organizations make use of derivatives. As of midyear, only 13 percent of U.S. bank holding companies and just 8 percent of state-chartered member banks reported any positions in either exchange-traded or OTC derivative contracts

Moreover, for the vast majority even of these banking organizations, exposures related to derivatives activities do not appear significant relative to their exposures from their other activities or relative to their capital. In fact, most of these institutions appear to use derivatives solely or at least primarily for hedging, that is, to reduce the interest rate risks and other market risks associated with their traditional portfolios of loans, securities, and deposits The use of derivatives, especially OTC derivatives, by these institutions does create credit exposures to counterparties Analysis of reported data indicates, however, that these credit exposures tend to be quite small relative to credit exposures from traditional activities

By contrast, for at most a dozen or so very large banks and bank holding companies, nearly all of which have their headquarters in New York or Chicago, derivatives activities have become a significant component of their overall risk profile. Like the other banks, these banks use derivatives to hedge market risks associated with more traditional activities, but by far the largest share of their activity relates to their role as "dealers" in OTC derivatives. These banks compete with other large financial institutions in the United States and abroad to meet demands from a wide range of end-users for customized derivatives contracts to achieve specific risk management objectives. They also use derivatives (both exchange-traded and OTC) as vehicles for proprietary trading, that is, trading designed to profit from movements in absolute or relative levels of interest rates, foreign exchange rates, or other asset prices Internal bank data gathered in the examination process suggest that the derivatives activities of these dealer banks have been quite profitable and no serious losses have been incurred Nonetheless, the magnitude and complexity of the risks these banks manage quite naturally have been a focus of concern for the Federal Reserve and other banking supervisors.

A key element of the Board's efforts to strengthen regulatory and supervisory policies relating to derivatives activities has been the incorporation of measures of credit risks, market risks, and interest rate risks associated with these activities into risk-based capital requirements. Risk-based capital requirements for credit exposures on OTC derivative contracts were part of the original Basle Accord that was published in 1989 These requirements provide a methodology for translating market values and notional amounts of derivatives contracts into amounts that are comparable to credit exposures on balance sheet assets. It is important to note that these "credit equivalent amounts," which include both the current exposure to loss from default of a counterparty and an estimate of potential future increases in exposure, are a very small fraction of the notional values. Nonetheless, for a few of the largest U.S. bank holding companies these credit equivalent amounts equal as much as 20 percent to 35 percent of their balance sheet assets.

At the end of April, the Board made available for public comment proposals by the Basle Supervisors Committee to revise the Basle Accord. The revisions would recognize reductions in credit risk from use of legally enforceable netting arrangements for derivatives contracts and would incorporate measures of market risks on foreign exchange and traded debt and equity positions, including derivatives positions. Implementation of the netting proposal would provide incentives for wider use of netting agreements in legal jurisdictions in which concerns about enforceability have been addressed; it also would encourage efforts to reduce legal uncertainty in the remaining jurisdictions, through legislation if necessary. With regard to market risk, the treatment of derivatives is an integral component of the proposal Market risk would be assessed on a portfolio basis, taking into account the cash flows associated with both derivatives and the underlying instruments.

The incorporation of risks associated with derivatives in risk-based capital requirements has required banking regulators to set out rather complex and detailed rules. Nonetheless, the rules arguably do not fully capture the complexity and diversity of the risks involved. In particular, the proposed treatment of market risks on options positions is crude and may need to be revised in light of public comments and further analysis More elaborate rules could be developed, but the added complexity would be burdensome to banks and still might not fully capture the risks of complex portfolios. These difficulties underscore a point I made earlier--regulation simply cannot substitute for effective risk management, especially management of such complex activities. One potential solution to these difficulties is to allow banks to use their own internal models to compute capital requirements for market risk, subject to examiner review of the models and in accordance with parameters set by regulators. Indeed, the Basle supervisors have requested comment on the merits of such an approach to assessing market risks on complex options portfolios and on foreign exchange positions. Likewise, the Federal Reserve and other U.S. bank regulators have proposed the use of internal models, subject to examiner review, as a means of determining capital requirements for interest rate risk.

The on-site examination and evaluation of internal risk management models, systems, and controls already are the most important elements of our supervision and regulation of derivatives activities. Examiners assess the risk management systems and internal controls in the banking organization's core trading and derivatives activities and devote special attention to new products and new approaches to risk management and control. Accordingly, the Federal Reserve has made the continuous updating and strengthening of policies and procedures for on-site examination of derivatives activities a top priority. These efforts have built on our many years of experience supervising foreign exchange derivatives and on experience with supervising merchant bank subsidiaries in London, which were among the first entities to begin actively trading OTC interest rate derivatives in the mid-1980s. In fact, our first attempt to formalize examination objectives and procedures for derivatives activities was contained in a Merchant and Investment Bank Examination Manual that was field-tested in 1987 and published in 1988.

Just recently, Federal Reserve staff, including examiners from the Federal Reserve Bank of New York who have considerable experience with bank derivatives activities, have completed an extensive effort to consolidate and enhance examination procedures for derivatives activities and trading activities generally. The result is a new Trading Activities Examination Manual that provides examiners with procedures for evaluating a firm's organizational structure, front-office and back-office operations and systems, and its approaches to measuring and managing market, credit, and liquidity risks associated with derivatives Examiners in each of the Reserve Banks have begun field-testing this new manual. When the testing is complete, the Board will review the proposed manual and make revisions where necessary.

Of course, examiners need to be trained to make effective use of these new materials. As with other banking activities, examiner expertise in derivatives activities is being developed through an apprenticeship program that combines various types of formal education programs with on-the-job training under the supervision of senior examiners. The Federal Reserve and the other bank regulatory agencies have been working for some time to enhance the coverage of derivatives activities in the core examination curriculum and have offered a variety of specialized courses, conferences and seminars on derivatives issues. The Federal Reserve also is making special efforts to ensure a sharing of expertise in examining derivatives activities between Federal Reserve Districts where this activity is widespread and those where it is just developing.

Looking ahead, the Board believes that accounting and financial reporting standards for bank derivatives activities will require further attention from U.S. and foreign regulators. The accounting profession in the United States has not yet developed consistent accounting principles for derivatives activities, and there is a diversity of accounting practice among major U.S. banks. With respect to financial reporting of derivatives activities, U.S banks already report more information than most foreign banks have been required or have chosen to divulge. Nonetheless, expanded reporting requirements may be appropriate for U.S banks whose derivatives activities are a significant element in their overall risk profile and profitability. The Board believes that the Interagency Task Force on Derivatives that recently has been formed by banking regulators should focus on assisting other existing interagency groups in resolving these accounting and reporting issues.

Encouragement and Support for Private-Sector Initiatives

The Board believes that concerns about risks to individual institutions and systemic risks cannot be fully addressed unless actions by regulators are complemented by private efforts to promote sound risk management Users of derivatives are a broad and diverse group. Of the leading derivatives dealers, only a handful are U.S banking organizations. Other leading dealers in these highly competitive markets include some U.S. securities firms and insurance companies and many of the leading banks and securities firms in Canada, France, Germany, Japan, Switzerland, the United Kingdom, and other countries. Major end-users include a variety of regulated and unregulated entities in the United States and many other countries

Accordingly, the Board has encouraged and supported private-sector initiatives to address risks in derivatives activities. In particular, the Board believes the Global Derivatives Study that was published recently by the Group of Thirty holds considerable promise for strengthening the risk management practices of a wide range of derivatives dealers and end-users. The study is a complete and lucid source of information on the nature of derivatives activities and the types of risks that such activities entail. Potentially an even more important contribution of the study is the practical guidance it provides on risk management.

This potential may not be realized, however, unless concerted efforts are made to ensure implementation of the recommended practices. A survey conducted as part of the study revealed that significant numbers of dealers and end-users have not yet implemented the recommended practices. Moreover, implementation of some of the recommendations is not straightforward and may be quite costly. Partly in response to concerns that Board members and other regulators expressed about prospects for implementation, the International Swaps and Derivatives Association (ISDA) recently announced a set of new initiatives to foster adoption of the report's recommendations by derivatives users. These include a follow-up survey of practices, conferences and workshops, and special efforts to reach end-users through their trade associations The Board believes that further efforts of this kind, whether by the Group of Thirty, ISDA, or other groups, are highly desirable

Efforts to Strengthen the Infrastructure for Derivatives Activities

The Board has worked with central banks in other countries to develop a clearer understanding of the implications of derivatives activities for systemic risk These efforts have culminated in publication by the Bank for International Settlements of several reports In particular, a working group chaired by a Board staff member prepared a Report on Recent Developments in International Interbank Relations that provides perhaps the most complete discussion of the systemic risk issues. This report emphasized not only the importance of sound risk management practices at individual institutions, but also the need to strengthen the legal and institutional infrastructure for derivatives activities.

As I have noted, in the United States, legislators, regulatory authorities, and derivatives users already have taken a series of steps to ensure the legal enforceability of netting agreements for derivatives The Board believes that the enforceability of such contracts is critical from a systemic risk perspective. If a counterparty measures its credit exposure on a net basis but the netting agreement is not enforceable, the true exposure is the gross exposure The counterparty thus could face losses and liquidity pressures far larger than expected and, perhaps, larger than could readily be absorbed

The latest effort to address enforceability concerns was a far-reaching provision of the FDIC Improvement Act. This provision validated under U.S. law all netting contracts between and among depository institutions, securities brokers or dealers, and futures commission merchants. Furthermore, it authorized the Federal Reserve Board to broaden the coverage to other financial institutions if it determined that doing so were appropriate to promote market efficiency or to reduce systemic risk. In early May, the Board issued a proposed rule that would broaden the definition of financial institution to include all legal entities that are large-scale dealers in the OTC derivatives markets. Implementation of this proposal would eliminate uncertainty about the legal enforceability of netting agreements between certain affiliates of securities firms and insurance companies that are active dealers in the OTC derivatives market and banks and other entities that already meet the statutory definition of financial institution. The Board is currently considering public comments on the proposal and plans to take final action early next year.

The Federal Reserve also has worked with the Commodity Futures Trading Commission and the Congress to eliminate the threat that OTC derivatives contracts could be deemed unenforceable off-exchange futures contracts, an event that, were it to have occurred, clearly could have caused systemic problems. The Futures Trading Practices Act of 1992 provided the CFTC with explicit authority to exempt OTC derivatives from most provisions of the Commodity Exchange Act, including the exchange-trading restriction that had posed the threat. When the CFTC moved promptly to utilize the new authority to eliminate the threat to OTC derivatives, the Board supported its action.

As I indicated in discussing bank supervisory issues, one area of the infrastructure that needs immediate attention is the development of consistent accounting and financial reporting standards for derivatives The Federal Reserve and other banking regulatory agencies plan to press ahead in developing appropriate standards for U S banking organizations But, clearly it would be preferable for the Financial Accounting Standards Board to develop and implement standards that would apply to all U.S. firms. The Working Paper of the Accounting and Reporting Subcommittee that was included in the Group of Thirty's Global Derivatives Study discussed some promising approaches to these issues that deserve further consideration by banking regulators and by FASB. FASB and the banking regulators have been discussing these issues but need to intensify discussions with each other and with dealers and end-users of derivatives. Ultimately, it will be important to work toward international harmonization of accounting and reporting standards for both regulated and unregulated entities.

Conclusion

In conclusion, the Board believes that it has developed a sound and appropriate strategy for addressing public policy concerns about potential risks from derivatives activities. The Federal Reserve and other banking supervisors have made significant progress in strengthening policies relating to bank derivatives activities and have the authority necessary to address such issues as accounting and financial reporting. With respect to other users of derivatives, at this time the Board believes that official encouragement of private-sector initiatives is the most effective way of addressing public policy concerns about risks to individual institutions and systemic risks. Nonetheless, the Board continues to analyze these issues and plans to monitor carefully the progress of the private-sector initiatives and to consider carefully the results of the study on OTC derivatives regulation that the CFTC just recently completed. At the same time, regulatory and supervisory programs related to derivatives activities of banking institutions will be reviewed frequently as these instruments evolve and as banks' use of them develops further.