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Remarks by

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Member, Board of Governors of the Federal Reserve System

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Remarks of Susan M. Phillips
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I want to thank you for inviting me to participate in this conference on global financial markets. Our perceptions of financial markets have changed dramatically in the last few years as the universe of products, intermediaries, and customers has expanded. Distinctions between domestic and foreign firms and among products have blurred. Market participants now think not just in terms of the legal and operational characteristics of the instruments they trade but also in terms of underlying risk factors.

Derivative products, which have received much attention of late, are an important part of these changes in global financial markets. Issues related to derivatives cut across the historical boundaries that used to separate the futures, securities, and banking industries. Similar risk management challenges face derivatives market participants, regardless of their organizational or regulatory structure. Likewise, the interests of regulators parallel each other both domestically and internationally: Regulators worldwide are debating standards for capital, disclosure, accounting, and internal controls.

Today, I would like to bring you up to date on our progress in addressing the regulatory challenges posed by derivatives. My remarks will be from the perspective of a central banker and a bank supervisor, but many of the same challenges face the Securities and

Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and regulators in other jurisdictions. As part of this progress report I will try to evaluate regulatory responses against market developments--in short, to address the oft-asked question of whether the regulation of derivatives is lagging behind market development.

Regulatory issues

The challenge for regulators is to balance economic efficiency and risk. How can we frame regulatory issues in a constructive way? That is, how can oversight be structured in a manner that respects both the desirability of accommodating user demands for financial services and the need to protect the financial system? The issues fall into several categories. First, there are supervisory issues, including both the examination process and capital requirements. Second, there are transparency issues, involving accounting, reporting, and disclosure. Third, there are infrastructure issues, such as those related to legal enforceability. I will discuss each of these separately, but I hasten to point out that they are closely interrelated.

Supervision. As a general matter, the Federal Reserve and other bank supervisors in the United States rely heavily on on-site examinations of banking organizations as a flexible means of achieving regulatory objectives. The emphasis on the examination process reflects the recognition that regulation cannot substitute for effective management by senior bank executives. This should be especially evident in the case of derivatives and other complex financial instruments. The types of rules that have been set out for these instruments in regulatory capital standards -- both for market

and credit risk -- cannot be expected to measure accurately all of the risks entailed. Indeed, legal and operational risks are not explicitly incorporated in capital standards because of measurement difficulties. Thus, prudent bank management of derivatives risks depends on the policies, procedures, and information systems demanded by senior management and the board of directors.

During the past two decades, banks, especially in the United States, have seen the profitability of traditional business lines come under pressure. Deregulation and innovation have forced them to develop new strategies and products to earn competitive returns on capital. As a result, the risk profiles of banks have been changing. At the largest banks, trading activities (both proprietary and customer accommodation) have been growing relative to traditional lending activities. Risks associated with trading activities pose new challenges. Credit exposures on derivatives can change abruptly as a result of movements in interest rates, exchange rates, or other market factors. Likewise, traders today can establish within minutes, or even seconds, positions that entail substantial market risks.

These changes in product mixes and risk profiles require banks and other financial institutions to develop new, more powerful approaches to risk management. These new approaches have been made possible by advances over the past twenty years in data processing technology and by advances in financial theory. The publication twenty years ago of the Black-Scholes options pricing model clearly was a watershed. Since then, product and theoretical innovations have fed off one another. The proliferation of derivatives has allowed the risks associated with traditional financial instruments to be unbundled and separately priced and managed. We are getting closer to the economic ideal of complete markets.

Efforts to rationalize the pricing and management of derivatives risks have set the stage for a revolution in risk management by leading banks and securities firms. This includes new approaches to the conceptualization, measurement, and control of risk. However, the methods involved are sometimes as complex as the derivative instruments themselves. The systems needed to implement risk management can be expensive, especially for firms that have multiple product lines and offices in numerous geographical locations. Thus, even for the largest and most sophisticated banks and securities firms, implementation of these systems poses significant challenges. Furthermore, the application of these risk management techniques to the pricing of loans and the management of loan portfolios is still in its infancy.

Encouragement of the use of new technology for risk management is an appropriate function of a bank supervisor. Indeed, a critical element in our on-site examination is the assessment of the adequacy of internal measurement systems and controls. This supervisory approach reflects an emphasis during examinations on systems and process as well as balance sheet entries. At the Federal Reserve, this emphasis can be seen in a comprehensive trading activities manual that was recently developed and distributed. In addition, the federal banking regulators have issued more concise guidelines for sound procedures of risk management, but these guidelines do not require specific risk management techniques.

Internationally, a similar approach has been adopted jointly by the banking and securities supervisors. The Basle Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO) issued coordinated documents stating the two groups' similar principles for promoting sound internal risk

management for banks and securities firms. This approach recognizes that specific features of individual risk management systems may differ but provides guidance on common features that should characterize sound systems.

The flexibility embodied in the examination process is a complement to capital requirements. A number of efforts are underway, both internationally and within the United States, to modify the existing risk-based capital standards to deal with derivative instruments.

In 1993 the Basle Supervisor's Committee put forward a proposed framework for assessing capital to cover the market risk associated with traded debt, equity, and foreign exchange. Various working groups are now developing revisions to the 1993 proposals. A key aspect of current work is consideration of the use of banks' internal risk management models for determining regulatory capital. I believe it is extremely important for supervisors to find a way to use banks' internal models for regulatory purposes -- at least for the more sophisticated banks. It would permit supervisors to take advantage of evolving technology and would reduce the burden on banks. Otherwise banks would have to maintain separate models for internal risk management and regulatory purposes.

Before the use of internal models can be accomplished, however, several issues will need to be addressed. For example, one such issue involves validation, that is, finding a way for supervisors to be confident that the internal model accurately reflects the risk being assumed by the institution. One might argue that requiring the use of internal models is not appropriate for all banks. Some banks' activities are sufficiently straightforward so as not to warrant investment in elaborate risk management models. That may be

true now, but as sophisticated risk management technology becomes more accessible, many banks are likely to want to move in the direction of greater use of internal models. Nevertheless, the final capital proposals will have to take into account both banking firms that have in place sophisticated internal models and those that do not.

The Basle Supervisor's Committee also has been active in the credit risk area. In July, changes to the accord were proposed that would more accurately capture the potential future credit exposure of long-maturity, equity, and commodity contracts. The Board issued a request for comment on this proposal in August.

Transparency. Accounting and financial disclosure represent an area in which intensive effort is ongoing but also one in which much more progress needs to be made. I also believe that it is one of the areas that public policymakers, both in the United States and abroad, should continue to emphasize. The complex uses to which derivatives are put clearly complicate the development of accounting standards. Derivatives highlight our need to view positions in a portfolio context, and they have generated discussions of the need to develop an accounting framework more focused on risk. Ultimately, of course, it will be important to work toward international harmonization of accounting and disclosure standards. I recognize that the task is even more difficult at an international level, but that argues for pressing forward.

Many firms active in these markets find increased disclosure in their own best interest as one part of an effort to communicate better with investors and the public at large. Private sector efforts to develop disclosure frameworks (such as that of the Institute of International Finance) play an important role in this process and demonstrate the widespread interest in improved disclosure. But there

is not yet consensus on the precise form and content of appropriate disclosure either in the public or private sectors. Nevertheless, a lack of consensus on disclosure issues should not deter individual firms from pursuing better ways to disclose the nature and magnitude of the risks associated with these activities.

Regarding reporting, U.S. banks already report more information than most other participants have been required, or have chosen, to divulge. However, expanded reporting requirements may be appropriate both for U.S. banks and for other financial institutions in order to place derivatives in the context of these institutions' overall portfolio activities. Indeed, changes to bank call reports are in process for 1995.

Under the auspices of the Working Group on Financial Markets, the banking supervisors, CFTC, and SEC are exploring ways to share information. However, the cross-border dimensions of derivatives markets and the geographic scope of the firms that are active in them make a compelling case for international coordination with respect to reporting. Any attempt to measure market size, for example, must be made on a global basis. Governors of the central banks of the G-10 countries have decided to collect data on derivatives in conjunction with the next foreign exchange turnover survey scheduled for the spring of 1995. This survey is conducted every three years and has been quite valuable to monetary authorities and market participants alike. Also under consideration by central banks through a BIS working group is the development of a proposal for a meaningful, standardized system of reporting data on derivatives more frequently.

Infrastructure. One of the most important infrastructure issues is the use of master agreements and the legal enforceability of netting that occurs under such agreements. (A master agreement

creates a single legal obligation covering multiple transactions between two counterparties.) In a legal environment in which master netting agreements are binding, credit exposures can be significantly reduced. The payment netting provisions of such agreements allow counterparties to reduce both the amount and the number of payments in comparison to settlements that would occur on a gross basis. In addition, such agreements require the netting of obligations if contracts are closed-out as a result of a default by one or both counterparties. A sound legal basis for close-out netting ensures that a bankruptcy trustee or statutory liquidator cannot pick and choose, honoring contracts in its favor but defaulting on losing positions.

Netting issues have been an area of particular emphasis at the Federal Reserve. For example, provisions of the 1991 FDIC Improvement Act addressing the validity and enforceability of bilateral netting agreements have now been fully implemented in the United States. But a continued focus on issues of legal enforceability internationally, and on netting in particular, is a necessity given its importance in accurately assessing exposure to counterparties. Review of these issues will be strongly encouraged under a new amendment to the Basle capital accord. That amendment would allow recognition of legally enforceable bilateral netting in the calculation of current exposure for risk-based capital. Banks will need to demonstrate the enforceability of their netting contracts on a continuing basis in order to obtain recognition of reductions in credit risk when calculating capital. To the extent that netting agreements involve counterparties in different jurisdictions, the validity of netting will have to be demonstrated to the satisfaction of supervisors in all relevant jurisdictions.

The validity of netting is an issue that should, and will, command high priority attention by policymakers in coming months and years. As part of the coordinated international effort to recognize netting in the Basle standards, the Federal Reserve and the other U.S. banking supervisors have issued notices of proposed rulemaking on the use of bilateral netting in the calculation of current exposures for U.S. banks. These steps are part of implementation of the changes in the Basle accord domestically. Staff currently are evaluating comments on the proposals. In addition to these changes related to the measurement of current exposures, the Federal Reserve and the Comptroller of the Currency also have published for comment a proposal that would recognize some of the effects of netting in the calculation of potential future exposures.

In yet another domestic area relating to legal enforceability, the Federal Reserve also has worked with the CFTC and the Congress to eliminate the threat that OTC derivatives contracts could be deemed unenforceable off-exchange futures contracts. Were such an event to have occurred, systemic problems clearly could have resulted. As many of you are aware, 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. The Board supported the CFTC's prompt utilization of that new authority to remove this legal uncertainty.

A particular aspect of enforceability concerns the legal capacity of parties such as government entities, insurance companies, pension funds, and building societies to enter into derivatives transactions. Litigation regarding contracting capacity continues to be a concern among market participants both in the U.S. and in other countries. A separate, but related, issue that some people have

raised is sales practice guidelines. For example, are additional regulatory measures needed to protect less sophisticated end-users from the risks involved in complex derivatives transactions? This latter issue is still being debated.

Evaluation of regulatory responses

The supervisory, transparency, and infrastructure issues I have just discussed are being addressed in the United States and in international forums. That does not mean that agreement has been reached on how to implement all of the various ideas, or certainly that all the details have been worked out. But there is widespread acceptance of the basic objectives that I have outlined.

Throughout these policy debates, some have asked whether regulators have gotten behind the curve in terms of the oversight of derivatives markets. I believe the answer is "no" for several reasons.

First, we have made significant progress in strengthening the framework for supervision of derivatives activities. Moreover, participants in financial markets have increased enormously their understanding of the risks involved. These developments have occurred in tandem. Parallel developments in public and private sector policies also are going forward. In risk management, for example, there is no single correct way of measuring and controlling risk. Individual firms are devoting substantial resources to enhancing risk management systems. This process should continue and be encouraged by the regulatory process. However, the regulatory process should not attempt to get out in front of these developments, locking us in to a "solution" that is second or third best.

Second, I do not think regulators are behind the curve simply because new products are being developed at a rapid pace. Public policy must allow, and even encourage, development of new markets and new instruments. We must not stifle innovation if we want to benefit fully from the risk reduction afforded by properly designed derivative transactions.

Finally, regulators have not been shy about identifying and pursuing issues that potentially pose problems. One need only look to the extensive amount of work that has been done on the validity of netting and the enforceability of contracts. This work reflects efforts of regulators to head off problems, in contrast to the perception that regulation is always behind market events.

Concluding remarks

Despite this progress, we cannot be complacent. Supervisors of individual institutions must continue to ensure that senior managements of those institutions understand the risks and are implementing appropriate risk management procedures regarding complex financial products. Regulatory regimes also may have to change as the markets develop, but these changes should be made after careful deliberation.

In considering the regulation of derivatives, it is important first to recognize the international character of these markets. Second, it is important to remember that derivatives products and markets are evolving. These characteristics of derivatives suggest that any regulatory structure must accommodate a wide range of products and market participants organized in different locations and along different lines. Issues such as the appropriate organizational or regulatory structure for dealers undertaking derivatives activities

remain open. Derivatives represent the provision of risk management services. A flexible regulatory regime is crucial if we are to let market forces allocate these services efficiently. Whether regulatory schemes emphasizing examination of systems and procedures or those utilizing more prescriptive approaches best achieve our desired balance between efficiency and risk in the regulatory process is an important consideration for policy discussions.

The character of derivatives also suggests that regulation will require cooperation among domestic and international regulators. This cooperation is already underway in areas ranging from capital standards to disclosure and data sharing. More undoubtedly will be needed.

But I see no reason to believe that derivatives activities, despite their phenomenal growth, are jeopardizing individual institutions or the stability of the financial system as a whole. As I noted, internal procedures and risk management techniques have been developed that can successfully contain the risks of derivatives and other activities. My hope is that as techniques for managing derivatives become better understood and more widely applied, these products will become even more accessible to those who can benefit from their use.