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Remarks by

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DERIVATIVES SUPERVISION AND REGULATION IN PERSPECTIVE

I am pleased to have the opportunity to speak to this very impressive group gathered to discuss public policies related to financial derivatives. I will focus my remarks on the implications of derivatives for the prudential supervision and regulation of banking organizations, that is, on what we have learned from derivatives and how we can apply those lessons more generally to banking activities.

Shortly after I began serving on the Board in December 1991, the debate over the appropriate regulatory approach to bank derivative activities intensified. As a former regulator of exchange-traded derivatives with new responsibilities for banking supervision, I think I brought an unusual perspective to the issues. At the time, I argued that derivatives posed important challenges to bankers and to supervisors but that those challenges were manageable within the existing regulatory framework. I also emphasized that derivatives were creating opportunities as well as challenges. Not only could banks offer new product lines to meet customers' risk management needs, but derivatives were part of a risk management revolution that would facilitate banks' efforts to manage their own risks and supervisors' efforts to ensure safety and soundness. For these reasons, I cautioned against premature adoption of fundamental changes to the regulatory framework.

I believe that this point of view has been generally supported by subsequent experience. Indeed, as I look back on the last five years or so, I see supervisors' efforts to address derivatives as having taught us some important lessons that are broadly applicable to banking supervision and regulation. Indeed, I believe these lessons are relevant to our analysis of some of the more radical regulatory reforms which are currently being advocated. I

suspect some of these proposals are unnecessary and would almost surely produce some unintended and quite undesirable consequences.

Lessons Learned

Perhaps the most basic lesson we have learned from our experience with the prudential regulation of bank derivatives activities is that what is important is the underlying risk characteristics of a financial instrument, not what the instrument is called. To be sure, because some elements of our legal and regulatory framework may be outdated, an instrument's name may have implications for its legal and regulatory compliance risks. But it is those risks, along with the market risks, credit risk, operational risk, and reputational risk, that are important to prudential supervisors. As the Group of Thirty's landmark 1993 study of derivatives observed, the use of derivatives does not involve any new types of risk. That said, some derivatives do combine or separate out different types of risk in new ways that require users to develop more advanced risk management capabilities. And, as some dealers have learned the hard way, the marketing of new, complex financial instruments may entail reputational risks that demand special attention.

A second lesson that has been reinforced is that risk must be measured and managed on a portfolio basis rather than instrument by instrument. Although this arguably is the first principle of finance and is widely appreciated by bankers and regulators, putting this principle into practice in banking has not been easy. Past banking crises have in part reflected a failure to recognize or to prudently limit concentrations of risk within portfolios. Derivatives dealers have developed the capability of measuring their market risks on a portfolio basis, using so-called value-at-risk (VaR) measures.

Although these measures are still evolving and have some significant limitations, they do facilitate the identification and quantification of concentrations of risk within trading portfolios. This is accomplished by analyzing derivatives and other financial instruments in terms of their effect on the sensitivity of the dealer's total portfolio to changes in a common set of underlying market risk factors--interest rates, exchange rates, commodity prices, and equity index values. The VaR measures also take into account the historical correlations among the common risk factors. In principle, the same types of techniques could be applied to the measurement and management of credit risk, although various conceptual and practical difficulties would need to be overcome. As an aside, I can't help but note that credit risk management is surely an area ripe for some theoretical and analytical breakthroughs comparable to what derivatives have produced for market risk management.

A third lesson that our experience with derivatives has driven home is the critical importance of firms' internal risk controls. This, of course, is the most obvious lesson from the various financial losses that the press often characterizes as "derivatives debacles." The technological advances and financial innovations of recent years, of which derivatives are merely a prominent example, today allow many banks and other financial and nonfinancial firms to adjust their risk profiles quite rapidly. With such capabilities, these institutions can limit the likelihood of substantial losses from adverse changes in market conditions by promptly liquidating or hedging risk exposures. However, as the various debacles underscore, the liquidity and leverage that make this possible also heighten the danger of losses from unauthorized or poorly understood trading activities. A comprehensive set of risk

limits, carefully monitored and strictly administered, clearly is the key to harvesting the benefits of new technologies and instruments while avoiding misadventures.

A final lesson that I would highlight is the need to align financial incentives with management objectives, and this lesson has at least two applications. The first relates to compensation, which is always a delicate topic, especially if regulators are participating in the dialogue. But I think there is broad agreement that compensation of traders and others who are empowered to commit a firm's resources should reflect not just returns, but also the risks assumed in generating the returns. Of course, this approach requires a firm to quantify its risk. As I have already discussed, derivatives dealers have been at the forefront of efforts to develop improved risk measures, and some institutions have begun utilizing risk measures when making decisions about compensation. The second facet of the need to align financial incentives with management objectives relates to capital and assurance that capital adequately reflects the risk the firm assumes. While much has been accomplished to make capital requirements risk-based, the final chapter is yet to be written in this area. More on this shortly.

Incorporation into Supervisory Programs

The Federal Reserve and other banking supervisors in the United States and abroad have been working to incorporate the lessons learned from derivatives into our rules and supervisory procedures. The thrust of these efforts has been a strengthened emphasis on risk management, that is, on the process of identifying, measuring, reporting, and controlling risks. Mindful of the lesson that the risk characteristics of an instrument are more important than its name, the

Federal Reserve has emphasized risk management in all bank activities. For example, when we issued examiner guidance on bank derivatives activities in 1993, that guidance applied to all of a bank's trading activities, whether in derivatives or other financial instruments. The examiners' 1994 Trading Activities Manual made that concept even more explicit as did the subsequent guidance tailored to end-users of derivatives. Most recently, examiners have begun to assign a formal rating to a bank's overall risk management capabilities as part of the management component of a the CAMEL rating for safety and soundness.

The need to measure risk on a portfolio basis has begun to be reflected explicitly in our capital guidelines and our disclosure requirements. The Federal Reserve has been a strong supporter of efforts to base regulatory capital requirements for market risk on banks' internal risk measurement models. The amendments to the Basle Capital Accord that were announced last December would allow banks that meet certain qualitative and quantitative standards for risk management to calculate market risk capital charges on the basis of their internal VaR measures. Unlike earlier proposals, the amendments encourage diversification of market risks by allowing banks to make use of empirical correlations among risk factors when computing VaR. In the disclosure area, we have encouraged portfolio-wide measures of risk and returns. And we have opposed efforts to require disclosures of the risks and returns to derivative instruments alone, because such disclosure would ignore the reality that these instruments typically are managed as components of portfolios that include other financial instruments.

For supervisors as well as bankers, the importance of internal controls cannot be overstated. I believe supervisors have long understood the importance of internal controls, especially in

trading businesses, but we no doubt now have a fuller understanding of what is required. Among the points to which we are giving greater emphasis, I would highlight the need for an active oversight role by a bank's board of directors and its senior management, and the need for an internal control process that actively and independently monitors adherence by business units to policies and procedures that the board or senior management establishes.

Finally, supervisors, like bank management, have learned the importance of ensuring that banks' financial incentives are compatible with supervisory objectives. Efforts to enhance public disclosures of the scale and scope, results, and risks of trading activities have been motivated by a desire to bring greater market discipline to bear on banks. In addition, supervisors have begun to attempt to build financial incentives into regulatory capital requirements. The recent amendments to the Basle Capital Accord are designed to provide incentives for accurate VaR measurement by requiring banks that appear systematically to underestimate day-to-day trading losses to maintain higher capital. The Federal Reserve has also been exploring a so-called "pre-commitment" approach to capital for market risk that seeks to provide banks with stronger regulatory and market incentives for improvements to all aspects of market risk management. This approach is currently being studied by a group of U.S. banks organized by the New York Clearing House.

Proposals for More Radical Regulatory Reform

Others apparently have drawn different lessons from experience with banks' derivatives activities. Members of Congress, some commentators on bank regulatory structure, a few academics, and even some people within the Federal Reserve System have argued that

certain trading activities in derivatives and in other financial instruments should be conducted in separately capitalized affiliates of banks. These individuals appear to differ on the scope of trading activities that should be forced out of the bank. Some focus on derivatives, others on all proprietary trading, whether of derivatives or of other financial instruments. Some apparently advocate prohibiting insured banks from engaging in proprietary trading or market-making activities in any financial instruments, including instruments like foreign exchange and Treasury securities. The latter would represent a major policy change, since U.S. banks have traded such instruments throughout their history. All of those advocating such steps seem to share the view that trading activities, especially those involving derivatives, are more difficult to manage and supervise than "traditional" banking activities, such as the origination and funding of loans. Indeed, these advocates seem to believe that trading activities inherently pose unacceptably high risks to banks, the Bank Insurance Fund, and taxpayers.

From my remarks today you no doubt can tell that I do not share this belief or endorse these proposals. The conclusion that trading activities are more difficult to manage than lending activities certainly is not supported by experience to date. Bank experience with trading activities too often is summarized in two words--"Barings" and "Daiwa." But the experiences of these two institutions are far from typical, and deeper analysis indicates that both can be traced to basic internal control problems.

Although trading revenues can be quite volatile from quarter to quarter, major U.S. money center banks have seldom reported quarterly losses, and in no case in the last twenty years has a trading loss at a U.S. bank resulted in a significant decline in

capital, much less a bank failure. We cannot say the same for loan losses. The last several years of highly profitable returns from lending have not erased from my memory the difficulties that greeted me when I joined the Board. I remember quite clearly that massive losses on commercial real estate loans had produced a wave of bank failures, a bloated problem bank list, and a seriously depleted insurance fund. Banks were said to be going to same way as S&Ls. Earlier episodes of serious losses on real estate loans, loans to developing countries, loans concentrated in energy or agriculture, and loans to highly leveraged businesses I believe reinforce my point.

To be sure, the past is not necessarily prologue. Indeed, it would be unrealistic to expect that going forward major U.S. banks could continue substantial trading activities and not register a single significant quarterly trading loss. As I have acknowledged, the liquidity and leverage obtainable through trading pose challenges to banks and to their supervisors. But these challenges can be met through a combination of sound risk management practices and proactive regulatory oversight. As I have discussed, banks have made substantial progress implementing comprehensive and robust internal controls, while supervisors have responded to the growth of bank trading activities with significant enhancements to their rules and supervisory procedures.

In fact, I worry that some of those who are concerned about trading activities may be underestimating the difficulty of managing and supervising the old-fashioned, plain-vanilla credit risks that lending activities entail. Indeed, an argument can be made that credit risks of lending are currently much more difficult to manage and to supervise than the market risks that are the predominant risks in trading activities. To be sure, trades can be made more quickly

than loans. But loan losses become apparent much more slowly than trading losses. And, even when loan losses are recognized, it is much more difficult to stem further losses, because loans tend to be less liquid and more difficult to hedge than traded instruments, and because of fears of damaging long-term relationships with borrowers. Finally, we should not lose sight of the fact that at the vast majority of banks the size of the loan portfolio dwarfs the size of the trading book.

I also fear that forcing trading activities into separately capitalized affiliates of banks could have several unintended adverse consequences. Implementation of such a proposal would appear to require the booking of trading activities into at least two separate legal entities in the United States--securities activities would need to be booked at a broker-dealer but current SEC capital rules effectively preclude the booking of OTC derivatives at such entities. Many more legal entities would need to be established to permit U.S. banks to participate in foreign markets.

Of course, the Glass-Steagall Act and other U.S. laws and regulations already require or encourage the use of multiple legal entities as booking vehicles. In such circumstances, we find that banking organizations nonetheless tend to manage risks essentially looking through the specific legal entities in which the business is booked. Supervisors have warned that management must take account of legal entities, because even if a risk position of one legal entity is in principle offset by a risk position at another legal entity, in an insolvency situation the gains at one entity may not be available to offset losses at another. What banks are asked to do, in effect, is to measure and manage the risks to the consolidated organization in a way that ignores diversification across legal entities while

recognizing concentrations of risk across entities. This already is extremely complicated. Requiring additional legal entities for foreign exchange and derivatives trading activities would greatly increase this management problem for banks. The problem would increase not only because of the proliferation of legal entities, but because the activities that would be segregated in many cases are integral to management of the liquidity, interest rate, and exchange rate risk of the banking book.

Another unintended consequence of forcing such a complex legal structure on trading activities by banking organizations could be a significant erosion in their competitive position. It would clearly put U.S. banking organizations at a disadvantage vis-a-vis foreign banks. Foreign regulators have not seen fit to require separation of trading activities for foreign exchange, government securities, and derivatives activities from other banking activities. Moreover, in most important jurisdictions outside the United States, Glass-Steagall-type restrictions are not imposed either. I am aware of no plans by foreign authorities to force such a separation, even in those jurisdictions where banks have been involved in trading debacles.

U.S. banking organizations might also be disadvantaged vis-a-vis U.S. securities firms. Some may argue that allowing banking organizations to conduct trading activities through insured banks gives them an unfair advantage over securities firms. Of course, banks do benefit from deposit insurance and their access to the discount window and the payment system. But securities firms can freely engage through affiliates in a wide range of financial activities that, for banking organizations, are either severely restricted or prohibited. Thus, it is not clear to me that when all

relevant aspects of regulation are considered, one can conclude that banking organizations currently have a competitive advantage over securities firms. Consequently, forcing existing trading activities out of banks risks tipping the competitive scales in favor of securities firms.

Summary

In summary, as I look back on our experience regulating bank derivative activities, I believe that it has taught banks and regulators several important lessons. Banks have made significant progress in implementing risk management practices that embody those lessons. Likewise, banking supervisors have made significant strides in incorporating those lessons into their rules and procedures.

In light of these risk management improvements and supervisory enhancements, I see no need to force banks to move trading activities in derivatives or other financial instruments into separately capitalized affiliates. The fundamental premise underlying such proposals apparently is that trading activities expose the safety net to inappropriate risk; alternatively stated, trading activities are more difficult to manage and to supervise than "traditional" activities, such as lending. This premise simply is not supported by historical experience with losses in trading and lending activities. Nor does it stand up to critical analysis of the nature of the risks involved and the effectiveness of the management controls and supervisory procedures that are currently available to contain those risks. Moreover, implementing such proposals would greatly complicate risk management by banking organizations and would likely erode significantly their competitive position.