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Challenges Posed by OTC Derivatives

Remarks of

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I am very pleased to have an opportunity to participate in this timely program developed by the National Futures and Options Society for its annual meeting. Since joining the Federal Reserve Board a year ago, I have been keenly interested in the emerging debate over appropriate public policy responses to the rapid growth of the over-the-counter (OTC) derivatives markets. As a former regulator of the futures markets and a current member of one of the banking regulatory agencies, my perspective on these issues is perhaps a bit different. What I see emerging as banking organizations expand their activities in the OTC derivatives markets is a clash of cultures, both within banking organizations themselves and within the regulatory community. Today, I would like to share with you my views on how public policy could help resolve these cultural clashes in a way that best serves the public interest.

A Clash of Cultures

The rapidly expanding activities of banking organizations in the derivatives markets clearly has been a source of interest and even concern to some banking regulators. Regulators are understandably concerned that rapid growth may be a sign of trouble ahead. At the level of individual institutions, rapid asset growth in the 1980s very often was followed by credit quality problems that burdened not only shareholders but also taxpayers. Too often, rapid growth at an individual institution has been a sign that internal risk controls were inadequate or that intermediation services were being provided at unprofitable margins. At the industry level, every banking regulator is aware of how industry-wide deterioration of credit standards produced huge losses in the LDC, HLT, and commercial real estate sectors.

But, in my view, cultural differences appear to have magnified concerns about banks' participation in OTC derivatives markets and threatened to produce an overreaction to the risks that derivatives participation actually entails. Activities in these markets too readily can be characterized as speculative activity and the economic value of speculation too readily can be overlooked. In the commodities industry and among commodities regulators, the economic role played by speculators in facilitating the transfer of price risk by providing liquidity to futures, options, and other derivatives markets is clearly appreciated. By contrast, I see signs that, in some segments of the banking industry and the banking regulatory community, activities in derivatives are seen solely as speculative activities. Speculation, then, in turn, is seen as gambling or the creation of risk rather than the assumption of risk from entities less capable or less desirous of managing it. These differences in perception reflect the fact that the banking industry historically has played a relatively limited role in intermediating price risks, the major exceptions being those banks acting as dealers in foreign exchange, in U.S. government or municipal securities, or in securities markets overseas.

In shaping a supervisory program for banks' activities in the OTC derivatives markets, I believe it is critical that we not lose sight of the important public benefits that are produced by these markets or of the important role that banks are playing in providing liquidity to these markets. We should not seek to discourage banks from assuming risks in the OTC derivatives markets. Rather, we should seek to ensure that the risks they assume are prudently managed through the implementation of appropriate capital requirements, examination procedures, and accounting and reporting standards. In addition, as the central bank, the Federal Reserve has a role to play in encouraging and supporting initiatives by market participants, both banks and nonbanks, designed to reduce the potential systemic risks that could emerge should a major participant in the OTC derivatives markets encounter financial difficulty.

In the remainder of my remarks I would like to describe the various efforts underway at the Federal Reserve to achieve these objectives. I will then conclude with some observations on regulatory issues which might receive further attention by the Congress in the next several years.

Initiatives to Enhance Supervision and Regulation of Banks' Derivatives Activities

Perhaps I should begin by noting that the Federal Reserve has supervisory responsibility for many of the largest participants in the OTC derivatives markets. We are the primary federal regulator of state-chartered banks that are members of the Federal Reserve System, including several derivatives "giants." While the Comptroller of the Currency has primary responsibility for national banks, some of these banks have nonbank subsidiaries active in the derivatives markets for which the Federal Reserve has supervisory responsibility under the Bank Holding Company Act. Finally, we have regulatory responsibility for U.S. operations of foreign banks, many of which conduct a substantial share of their global derivatives activities from their U.S. offices.

I suspect that the most visible element of the Federal Reserve's supervisory program related to OTC derivative products is the treatment of credit risks associated with derivatives that is contained in the Basle Capital Accord. These capital requirements were developed by the Basle Supervisors Committee and included as part of the original Accord that was announced in 1988. They apply to all internationally active banks that are chartered in the group of major industrialized countries known as the Group of Ten. The Basle Supervisors currently are considering various refinements to the treatment of OTC derivatives. In particular, the current capital requirements give only very limited recognition to the risk-reducing effects of netting contracts, which are now widely utilized by participants in the OTC derivatives markets, largely as the result of the efforts of the International Swap Dealers Association (ISDA).

At the time of the initial accord, I understand a cautious approach to the recognition of netting seemed appropriate because of substantial uncertainty about the legal enforceability of such contracts. Although in some jurisdictions considerable uncertainty remains, in the United States legal certainty has been achieved for a wide range of contracts and counterparties through legislation, including amendments to the bankruptcy code and provisions of FIRREA and last year's FDIC Improvement Act. Capital requirements for OTC derivatives need to take account of these developments and I hope that the Basle Supervisors will act soon to recognize netting in cases where a high degree of legal certainty has been achieved.

A broader review of the capital requirements for credit risk also is under consideration by the Basle Supervisors. Such a review appears warranted in light of the appearance in recent years of new classes of OTC derivatives, notably commodity and equity derivatives. In addition, more sophisticated techniques have been developed for measuring potential credit exposures on derivatives, and use of those new techniques may point to refinements of the existing approach.

Finally, the Basle Supervisors have been working for some time to develop capital requirements for market risk. Because derivatives play an important role in the management of market risk, those proposals will, of course, address the measurement of market risks associated with derivatives.

Although capital requirements are an essential element of our supervisory approach to OTC derivatives, in my view a far more important, though less visible, element is our program of on-site examination of banking organizations. As a general matter, the Federal Reserve recognizes that regulation cannot substitute for effective management of bank activities by senior bank management. This should be especially evident in the case of derivatives, where the very simple types of rules used in regulatory capital standards cannot be expected to measure accurately the risks entailed. Whether a bank prudently manages the risks associated with its derivatives activities depends critically on the policies, procedures, and information systems established by senior management and the board of directors. Consequently, the most critical element of our supervisory program is the on-site examination and assessment of the adequacy of internal controls.

Both the enhancement of internal controls by senior management and the enhancement of examination procedures by regulators pose difficult challenges, in part because of the cultural differences to which I alluded earlier. Some senior bank executives, who attained their current positions through credit experience rather than trading experience, have indicated unease about the risks posed by OTC derivatives activities, even though to date those activities generally have been highly profitable. A challenge for market participants is how to create information systems that provide senior management with a more accurate and comprehensible picture of the risks and returns that derivatives activities create. The Group of Thirty has recently launched a study of the derivatives markets, one objective of which is to demystify the derivatives business for senior management by describing clearly the risks involved and setting out sound risk management practices.

Likewise, the enhancement of examination procedures relating to OTC derivatives must include new training for examiners and other supervisory officials who, in many cases, have considerable credit expertise but relatively little exposure to trading activities. The development of new training programs is one element of a thorough review of supervisory approaches to derivatives that is currently underway in the Federal Reserve System.

In addition to the refinements to capital standards that I mentioned earlier, another important element of this review is a reconsideration of accounting and reporting standards. The fact that generally accepted accounting principles (GAAP) do not directly address interest rate swaps or many other types of OTC derivatives is clearly a cause for concern. Nor have reporting requirements kept pace with market developments, although the disclosures made by banking organizations generally are more thorough than those made by other OTC derivatives market participants. Indeed, the absence of generally accepted accounting standards and opaque reporting appear to me to be important factors in perpetuating cultural biases against OTC derivatives trading. Both regulators and market participants must do more to address concerns in these areas.

Initiatives to Limit Systemic Risk

Regulators have expressed concerns about the systemic risks that could result from the failure of a major dealer in the OTC derivatives markets. In part, they are concerned about the potential losses that a failure could impose on the dealer's counterparties.

But concerns about systemic risk are not limited to these direct effects on counterparties of a failed participant. Rather, they extend to the potential impacts on the liquidity of markets, not only the OTC derivatives markets but also the cash markets and the exchange markets to which the OTC derivatives markets are closely linked through the complex arbitrage strategies employed by major dealers. A loss of market liquidity would heighten both credit and market risks for all participants in the derivatives markets. Furthermore, the expansion of market linkages, which cut across national boundaries and embrace a wide range of financial and nonfinancial firms, raises concerns about the ability of central banks to contain systemic difficulties should they emerge.

The Federal Reserve has attempted to limit systemic risk in the OTC derivatives markets in two different ways. First, as I have already discussed, we have exercised our authority as a banking regulator to attempt to ensure that entities subject to our supervision are not a source of systemic disturbances. Second, we have encouraged a variety of market developments that would tend to contain systemic pressures should a major intermediary encounter difficulty.

Most recently, the G-10 central banks prepared a report on Recent Developments in International Interbank Relations (the Promisel Report), which was published by the BIS in October. This report focused on the growth and implications of derivative markets, stressing the linkages to other markets. It urged market participants to enhance their own risk management procedures and continue efforts to improve the institutional infrastructure that would enable markets to reduce risks.

Another important effort by the Federal Reserve and other central banks has been the encouragement of sound arrangements for netting OTC derivative contracts. In November 1990, the BIS published the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (the Lamfalussy Report). The central conclusion of that report was that netting schemes have the potential to reduce systemic risk, provided that certain conditions are met. With respect to those conditions, the report set out minimum standards for the design and operation of cross-border and multicurrency netting and settlement schemes.

In the case of bilateral netting arrangements, such as the ISDA master agreement, the condition that is perhaps most relevant and certainly the most challenging is that a netting scheme should have a well-founded legal basis under all relevant jurisdictions. As I noted earlier, a series of legislative changes that have been supported by the Federal Reserve have created legal certainty with respect to the netting of most derivative contracts by most participants in the United States. In other jurisdictions, the legal effectiveness of netting is often less certain, although ISDA has obtained favorable legal opinions with respect to each of the G-10 countries.

The Federal Reserve also has supported efforts to reduce legal uncertainty by clarifying the Commodity Futures Trading Commission's authority to exempt classes of OTC derivative instruments from regulation under the Commodity Exchange Act, including the Act's prohibition on off-exchange trading of futures. The Futures Trading Practices Act of 1992 indicated explicitly that the Commission has this authority, and the Commission has acted promptly to exercise it, issuing for public comment in early November a broad exemption for interest rate swaps (and other OTC derivatives). I was pleased to see that the proposed exemption would remove all restrictions on the use of bilateral collateral and margining procedures to limit credit risks on derivatives trades. In addition, while transactions subject to multilateral netting (clearing house arrangements) were not exempted, the proposal seemed to leave the door open to such proposals in the future. I believe that the application of clearing house methods to OTC derivatives has considerable potential, but I share the view that such arrangements should not go unsupervised. Indeed, the Governors of the G-10 central banks (including the Federal Reserve) have endorsed a principle set out in the Lamfalussy Report that an OTC derivatives clearing house that conducts settlements in foreign currencies or has foreign bank participants should be subject to official oversight.

Prospects for Additional Regulation of the Derivatives Markets

The Congress does not appear to regard passage of the Futures Trading Practices Act of 1992 as the last word on regulation of OTC derivatives. Rather, it has called for additional studies of these markets, including study of the need for additional regulatory controls, and signaled an intention to act on the issues raised by the studies when they are completed. I hope that consideration of proposals for additional regulation of the derivatives market proceeds cautiously. At times I have heard expressions of concern about "regulatory gaps" in the OTC derivatives markets, with the underlying presumption that every financial market is in need of regulation.

Before introducing any additional regulations, we need to identify clearly the public policy objectives that the regulations are intended to achieve. We should also consider whether official encouragement of private sector initiatives is a more effective means of meeting those objectives. And we should be mindful of the potential adverse effects of regulation on competition, efficiency, and innovation in the OTC derivative markets.

I believe that further efforts by private industry could do much to allay the concerns that have been expressed by regulators and to ensure a favorable outcome to legislative deliberations regarding the OTC derivatives markets. The Group of Thirty study is a promising initiative that, at a minimum, should promote understanding of markets that are viewed with suspicion in part because of their complexity and lack of transparency. As I suggested earlier, further study needs to be followed by concrete action to improve accounting and reporting standards.

In addition, because I am a former futures regulator, you should not be surprised to hear that I believe some further elements of self-regulation might be both prudent and appropriate. For example, industry agreement on a "code of conduct" for dealings with commercial and other "end users" of derivatives would lessen the likelihood that isolated abuses could lead to excessive regulation. I also think the industry should give further consideration to the potential problems that might be encountered in assigning or terminating a complex derivatives book in the event of the failure of a major dealer. I am aware that to date the liquidation of failed intermediaries has been accomplished relatively smoothly, but I can assure you that it remains a concern to many regulators and central bankers. Either the Group of Thirty or the ISDA crisis management committee could make an important contribution by identifying potential problems and ways to avert their realization.

To use an old expression, in all of the areas I have just cited, "an ounce of prevention may be worth a pound of cure." Just because derivatives markets don't look "broken" doesn't mean they can't be made to work better or be used more broadly.