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Remarks by

Susan M. Phillips

Member, Board of Governors of the Federal Reserve System

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Thank you for inviting me to address your conference this morning. The study of derivatives sponsored by the Group of Thirty is an important private-sector effort to enhance understanding of these instruments. It also comes at a time when public policy discussions of derivatives are intensifying. The publication of the G-30 study, along with the recent release of a report by the Commodity Futures Trading Commission and the forthcoming study by the General Accounting Office, will, no doubt, serve to keep derivatives at the forefront of policy discussion for some time.

The G-30 study serves a dual role in framing discussions of derivatives. First, it provides an excellent description of derivatives activities and enhances our understanding of these instruments. Second, it provides important guidance for market participants with regard to risk management systems. Despite these very important contributions, the study also leaves much work to be done in the future by both market participants and regulators. In order for the benefits of the study's recommendations to be realized, market participants must turn principles into practice. Thus, this conference is very timely. Perhaps more important, from the perspective of a regulator, are the issues left open or unresolved by the study. These largely relate to the infrastructure for derivatives activities, including their regulatory framework.

I would like to begin my remarks today by noting the contributions of the G-30 study, particularly as a guide for market participants. Looking forward, however, I will concentrate upon the issues that are left open and that thus represent the next focus for market participants and regulators.

Contributions of the G-30 Study

The G-30 study is a document prepared by practitioners for practitioners. Anytime derivatives are dealt with in detail, there is necessarily a heavy dose of theory because of the complexity of the instruments. But the bulk of the recommendations lay out broad principles to guide managers in evaluating the adequacy of the risk management systems of their own firms. The strength of the study, in my view, is the spotlight it shines on risk management systems and the involvement of senior management. Guidance in designing risk management systems is best obtained by collaboration among market participants who, day in and day out, confront the management of risk. This exercise of identifying best practices will help firms target aspects of risk management that need more resources. In addition, it will increase senior management's involvement in a variety of risk management issues.

Another area in which the G-30 study makes a notable contribution is its discussion of the value of sound risk management for end-users. This is a topic that will deserve much more attention as the use of derivatives spreads. I support efforts such as those announced by Joe Bauman, Chairman of the International Swaps and Derivatives Association, to reach end-users through trade associations. End-users, by their nature, are more diverse and dispersed than the dealers of derivatives. These characteristics of end-users argue for creative strategies to improve their understanding and management of derivatives. I believe that derivatives dealers and their oversight authorities must take a role in educating end-users about appropriate risk management policies. Such efforts are particularly important because problems at end-users, while not

necessarily generating systemic concerns, certainly could have legislative and regulatory repercussions for the markets as a whole.

The ultimate value of the G-30 recommendations will depend on their effect on the operations of firms. The survey of market practice indicated that many end-users and even some dealers currently do not meet all of the benchmarks laid out in the recommendations. Therein lies the critical nature of efforts such as this conference that emphasize the implementation of principles. Firms are now challenged to see how they measure up and make changes appropriate to the nature and level of their derivatives activities.

The study also contributes to public policy discussion with recommendations directed at regulators, supervisors, and legislators. These recommendations generally seek to focus attention upon the infrastructure of derivatives markets--the validity of netting, other legal uncertainties, tax treatment, accounting principles, and financial disclosure. On some of these fronts, we have made significant progress in the United States. On others, a need for significant improvement remains.

Netting issues were highlighted by the study, and this has been an area of particular emphasis at the Federal Reserve. A far-reaching provision of the FDIC Improvement Act has addressed the enforceability of netting agreements, validating under U.S. law all netting contracts between and among depository institutions, securities brokers or dealers, and futures commission merchants. The Act also authorized the Federal Reserve Board to broaden the coverage of this provision to other financial institutions, if doing so would promote market efficiency or reduce systemic risk. In early May, the Board proposed a 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 between banks and other entities that already meet the statutory definition of a 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 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. 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.

Progress also has been made on the tax front. The Internal Revenue Service has begun dealing with the infamous *Arkansas Best* problem in just the past few weeks, revising its position on the tax treatment of hedging transactions. The new temporary rule removes one impediment to the use of derivatives in managing risk, although some issues remain outstanding.

In contrast to progress on netting and tax treatment, accounting and financial disclosure standards are an area highlighted by the study in which I believe much more work needs to be done. This is one of several open or unresolved issues that represent the next series of challenges to market participants and regulators.

Issues for Future Consideration

I would like to turn to several issues that are of particular concern to policy makers that were not dealt with extensively in the study. First, what are the implications of the principles articulated in the study for the Federal Reserve's bank supervisory standards. Second, are there implications of the study's recommendations for the financial system -- the systemic risk question. I might note that it is not surprising that the study did not address these topics exhaustively because it was not intended to be a template for regulators.

Supervisory Standards

In the past few years, bank supervisors have devoted considerable effort to developing capital standards that reflect the risk associated with derivatives products. Capital treatment of the credit risk associated with derivatives was part of the 1988 Capital Accord developed by the Basle Supervisors Committee. More recently, the Basle Supervisors have developed a proposal that would recognize reductions in credit risk from the use of legally enforceable netting arrangements. Another proposal would incorporate market risks on foreign exchange and traded debt and equity positions, including derivatives positions. In addition, the Federal Reserve has issued for public comment a proposal for incorporating interest rate risk into the risk-based capital framework. Because derivatives play an important role in the management of interest rate risk at many banks, the proposed measurement scheme encompasses such products.

In evaluating these capital proposals, one can reasonably ask what the appropriate relationship should be between the risk management techniques recommended by the study and the supervisory

standards set by regulators. The recommendations of the study have been characterized by their authors as a set of "best practice" principles. Supervisors, by contrast, have the responsibility of designing minimum standards that will ensure safe and sound operations of the institutions they regulate. Accordingly, the principles supervisors are developing can be regarded as "sound practice" principles.

The extent to which the study's principles should be embedded in minimum prudential standards is an important area under review by supervisors. Currently, the risk management principles set out in the G-30 study are addressed in a sound-practices paper that is part of a new trading activities manual for Federal Reserve examiners. This manual is being field tested by the Reserve Banks. The extent to which various risk management principles should actually be specified as examination requirements will be reviewed as part of the field testing. Given the wide diversity among banking organizations in their level of derivatives activity and extent of risk taking, there is need for considerable flexibility in tailoring the examination requirements to the specific practices of individual institutions. The circular on risk management of financial derivatives released by the Controller of the Currency is another supervisory effort in this vein.

Determining the appropriate role of the G-30 principles is not easy, in part because of the complexity and cost of implementing many of the recommendations and because of the diversity in the activity at firms. A good case can be made that widespread adoption of these recommendations by major dealers would yield benefits for the financial system as a whole likely far exceeding the costs. For firms with limited activity, the weighing of benefits and costs is more

delicate. Supervisors have the responsibility of striking the right balance, giving adequate consideration to the potential benefits of reductions in systemic risk, but being mindful of the costs imposed on the private sector.

Another topic of interest to bank supervisors highlighted by the study is accounting and financial disclosure issues. As I indicated earlier, this is an area in which much more progress needs to be made. I also believe that it is one of the areas in which bank supervisors, both in the United States and abroad, should enlarge their agendas to provide a leadership role. Despite intensive efforts, the accounting profession in the United States has not yet developed consistent principles for derivatives activities. As a result, our examiners have observed a variety of accounting practices among major U.S. banks. With respect to financial reporting of derivatives activities, U.S. banks already report more information than most other participants have been required or have chosen to divulge. Nonetheless, expanded reporting requirements may be appropriate for banks whose derivatives activities are a significant element in their overall risk profile. Firms active in these markets should perhaps consider disclosure as one part of an effort to communicate better the scope and implications of their activities with the public. Ultimately, of course, it will be important to work toward international harmonization of accounting and disclosure standards.

Systemic Concerns

In addition to its bank supervisory responsibility, as the nation's central bank, the Federal Reserve has broad responsibility for maintaining the stability of financial markets and payment and

settlement systems and for containing systemic risks. The G-30 study contained a working paper on systemic issues, although no recommendations were put forward on this topic. That paper appropriately emphasizes the role of prudent management of risk and effective oversight policies within firms as a first line of defense for systemic problems. Bank supervisors have traditionally operated with the view that regulation cannot substitute for effective internal management. The paper on systemic issues also noted that implementation of the recommendations to strengthen the infrastructure of derivatives markets will produce systemic benefits. I agree. Other infrastructure changes not discussed in the study also merit consideration.

One of these changes is the creation of a clearing house for interest rate swaps. Now that the CFTC has left the door open for the application of clearing methods to OTC markets, I hope market participants will carefully explore the benefits of a clearing house. Multilateral netting is a potentially powerful tool for reducing counterparty credit exposures. With the continued growth of the swaps markets, concerns about the concentration of counterparty credit risks, especially in the interdealer markets, may otherwise become an important factor limiting market liquidity. While some highly creditworthy swap dealers may fear that a clearing house would harm their competitive position, it is not clear to me why a clearing house that served the dealer community would undercut their advantage in competing for the business of end-users. Such end-users still would have incentives to deal with the most creditworthy dealers. However, the clearing house would allow such dealers to reduce credit exposures and related capital charges in the interdealer market.

I do not underestimate the time and effort that would be required to implement such a project. Designing the clearing house with appropriate controls so that it serves to reduce risk, rather than increase it, is a formidable task. But that strikes me as an argument for pressing forward rather than for delaying. Creation of a clearing house probably needs more coordination from the private sector than the public sector. Some of the established clearing organizations could play an important role here. In any event, additional private-sector effort is warranted.

Other than infrastructure issues, the study generally suggested that systemic concerns posed by derivatives could be addressed within existing regulatory frameworks. The adequacy of the existing regulatory structure for derivatives markets is the issue that will dominate public policy discussion in the coming months. I do not have any easy answers to advance on this very difficult subject. However, I would like to make a few observations about why this is a particularly challenging question.

In considering the regulation of OTC derivatives, it is first and foremost important to recognize the international character of these markets. U.S. firms make up roughly one-sixth of the members of ISDA. A recent survey of derivatives market participants by *Risk* magazine asked them to identify the leading dealers in various product groups. Relatively few U.S. firms placed among the top three in many products. Second, it is important to remember that derivatives products are constantly evolving. No matter how you slice and dice regulation in such an environment, you face jurisdictional problems. These problems can range from the appropriate supervision of firms operating in many markets to the appropriate regulatory regime for a new product. Virtually all of the jurisdictional problems that have

arisen in U.S. financial markets of late have come about as a result of product innovations that do not fit neatly into the regulatory pigeonholes. The international character of derivatives markets and products only exacerbates the problem and raises the risk that regulatory actions in the United States could place U.S. firms and markets at a competitive disadvantage.

These characteristics of derivatives suggest that any regulatory structure must accommodate a wide range of products and market participants organized along different lines. Derivatives represent the provision of risk-management services. A flexible regulatory regime is crucial if we are to let market forces allocate these services in a manner similar to the way that the market allocates credit. The character of derivatives also suggests that regulation will require cooperation among domestic and international regulators. The CFTC's recent report on derivatives suggested an interagency group modelled after the Working Group on Financial Markets to coordinate on issues related to derivatives. Comptroller of the Currency Ludwig has also made proposals for interagency cooperation. Both of these efforts should help us accommodate our regulatory regime to these evolving products, rather than accommodating products to regulation, as has too often been the case in the past.

At the most fundamental level, the regulation of OTC derivatives is challenging because public policy makers have not yet fully assessed the potential systemic effects of these instruments under various market conditions. The Federal Reserve is devoting significant attention and resources to this issue, given our responsibility to contain systemic risks. A wide range of remedies for potential problems can be encompassed within the current

regulatory structure. Legislative changes might ultimately be necessary, although I do not think the case for such changes has yet been clearly made. Nonetheless, we must continue to re-evaluate our supervisory focus as derivatives issues are debated in the coming months. And policy makers must continue to make progress on resolving the issues identified in the G-30 and CFTC studies.

Conclusion

In conclusion, I would like to commend the Group of Thirty once more for its sponsorship of the study of derivatives. The study has made a very valuable contribution to our understanding of the risks that derivatives entail and the management of those risks. I hope the goal of those that produced the study and its recommendations is to go beyond understanding to actually influencing risk management practices and procedures. Both the industry and regulators have more to do. The discussions of the next two days should help set that process in motion.

Thank you.