The Federal Reserve Board

Testimony of Governor Susan M. Phillips

Implications of trading losses by Sumitomo Corporation

Before the Committee on Banking and Financial Services, U.S. House of Representatives

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Thank you for the opportunity to discuss the recent trading losses by Sumitomo Corporation and their implications for U.S. banks and markets. These losses, which relate to copper trading, may be as large as $1.8 billion and once again highlight the importance of sound internal controls by all parties with significant trading activities. At this time the losses appear to be limited to the Sumitomo trading company, which has been meeting all of its obligations to U.S. banks arising from its transactions in the copper market.

In my remarks today, I would like to address the general nature of U.S. bank involvement in trading and financing physical commodity transactions, the Federal Reserve's actions in the immediate aftermath of the announcement of Sumitomo's losses, and the lessons we believe should be drawn from this and similar episodes. In doing so, I would emphasize at the outset that, as a nonfinancial company, the Sumitomo Corporation is not regulated by the Federal Reserve or by any other banking supervisory or regulatory agency in this country or abroad. Consequently, the Federal Reserve's involvement has related principally to reviewing the exposure and role of U.S. banks that lent funds to Sumitomo or that dealt with the company in its copper-related business and to assisting the Commodity Futures Trading Commission in its evaluation of Sumitomo's U.S. activities.

Commodities Trading and Financing Activities of U.S. Banks

U.S. banks have long been involved in financing commodity activities through their agriculture lending programs directed at the production and sale of agricultural products, both domestically and abroad. Indeed, more than one-quarter of all U.S. banks have farm loans in excess of 25 percent of their total loans. Such lending, however, has become less important to our banking system, as the relative importance of primary agricultural products in real gross domestic product has declined. At mid-year 1996, farm lending accounted for roughly 2.7 percent of total lending by U.S. commercial banks, compared with 5.2 percent in 1970. U.S. banks have also, of course, been active in financing the production, distribution, and sale of many other physical commodities ranging from metals to oil.

Beyond that traditional financing, banks--and, more importantly in this country, nonbank financial institutions--have also participated in agricultural and other commodity markets through their trading of commodity derivatives both on and off organized exchanges. Unlike the banks' more traditional functions, their trading of commodity derivatives has increased in recent years, largely for the same reasons trading activities, in general, have grown: expanded international trade, increased demand for hedging instruments and improved methods for managing and controlling risks, advances in computerization and communications technology, and other factors.

Nevertheless, commodities trading at U.S. banks remains a very small component of their overall activities. Ownership of actual, physical commodities--an activity underlying much of the copper trading of Sumitomo--is generally limited for U.S. banks to gold, silver, and other precious metals. Even their trading of physical commodities contracts on organized exchanges or through privately negotiated transactions is small, accounting for less than 1.0 percent of all their derivatives positions. These contracts, in turn, are about evenly divided between (1) gold and other precious metals and (2) all other commodities.

As you may know, the Sumitomo Corporation has been a major participant in the trading of copper derivatives for many years, largely through the activities of its chief copper trader, Yasuo Hamanaka. Consequently, following indications of problems in the company's copper trading operations copper prices fell sharply. Copper markets appear to have stabilized, and the Federal Reserve is not aware of any material spill-over effects to other markets.

Federal Reserve Actions Following Sumitomo's Announcement

Immediately following Sumitomo's announced loss, the Federal Reserve took steps to determine the size and nature of U.S. bank exposures to the trading company and to the copper market. Several banks had trading or financing transactions with Sumitomo relating to its copper trading and were owed payments by Sumitomo in connection with those transactions. Shortly after the announcement, the banks contacted Sumitomo to review and confirm all outstanding transactions relating to copper, and Sumitomo has been meeting all of its obligations as they come due. At this time, any losses appear to be limited to the Sumitomo trading company, itself, but it should be noted the company, regulators, and others are reviewing the events leading to the June announcement.

The Federal Reserve also sought to coordinate its review of U.S. banks' copper-related activities with the CFTC, which was reviewing Sumitomo's conduct. To this end, shortly after the announcement of Sumitomo's loss, senior staff of the Federal Reserve and the CFTC began meeting together to share information pertinent to their respective enquiries. This effort is still on-going.

Importance of Sound Management Controls

This event highlights, yet again, the importance of a sound management process for controlling risks in both banking and nonbanking organizations. As we have seen time and again in recent years, individual traders today have the capacity to inflict tremendous losses on their institutions when they are allowed to operate in an environment lacking adequate operating procedures and controls. On the other hand, these incidents also illustrate the resilience of even specialized commodities markets and the ability of world markets to absorb dramatic shocks.

It is instructional that the well publicized losses at Barings, Daiwa, Sumitomo, and others have all derived from violations of fundamental, managerial principles of control, such as those dealing with the recording of all positions and the adequate separation of duties. Managements must build and maintain adequate systems for controlling risks, whether they operate bank or nonbank institutions.

Losses such as Sumitomo's raise the issue of more extensive regulation. Regulation, however, simply cannot substitute for sound management. Earlier episodes clearly demonstrate that the very same problems can occur in regulated as well as unregulated firms and with exchange traded contracts as well as with privately negotiated contracts. Thus, a more appropriate response--indeed, for nonfinancial companies the only practical response--is to continue to promote policies that foster greater market discipline.

Encouraging greater disclosure of risk levels is an effort that moves in that direction. Disclosures such as an organization's calculated "value-at-risk" have the potential to provide investors and other market participants with greater information regarding the organization's willingness to take risks and are currently being discussed. Official and market pressures to produce such statistics hopefully will continue to strengthen the internal auditing and information systems of many firms. By themselves, though, such quantitative disclosures will not suffice if large exposures are mismeasured or overlooked. Shareholders, boards of directors, and senior managers must absorb the lesson that strong management and control procedures are essential.

In the case of insured commercial banks, the Federal Reserve and the other U.S. federal banking agencies have stressed the need for adequate management processes in dealing with market conditions today and have announced new supervisory procedures to reinforce the point. Through the Bank for International Settlements and other international organizations, both the banking and securities regulatory communities have taken similar steps abroad. These regulatory efforts, combined with the lessons imposed by the markets, should begin to drive home to market practitioners the importance of sound operating procedures and controls.

Conclusion

Although managing and controlling risks in a large organization today can be a complicated, challenging, and expensive task, the costs of *not* adequately controlling risks can be much greater. One must conclude from recent events that some institutions have yet to recognize that fact and take adequate preventive measures. While financial risk-taking is essential to our economy, risks should be taken in an informed and intelligent manner, and then only when adequately supported with owners' funds.