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Session III: Price Transparency -- A quote is a quote is a...

Remarks by

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before the

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It is my pleasure to appear on this panel to discuss price transparency and derivatives. The main focus of my remarks will be the Principles and Practices for Wholesale Financial Market Transactions. Thus, I will focus on the wholesale over-the-counter financial markets, in general, and the derivatives market, in particular. But before delving into that topic, I would like to set out what I see as some of the benefits of price transparency.

First, valuation is essential to a firm's effective management of its participation in the financial markets. Oscar Wilde defined a cynic as: A man who knows the price of everything and the value of nothing. In the area of complex over-the-counter derivatives, marketplace participants may not know the price of the thing, but they certainly must attempt to ascertain its value. Wilde's statement might cause some confusion today. Price is evidence of fair value. As FASB Statement No. 107 puts it:

Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models).

In sum, valuation is a major aspect of risk management. Frequent valuation is a major component of oversight. Transparency assists in this process.

Second, price transparency assists in the orderly functioning of a market, by providing an indication of where market participants are willing to transact. In a market replete with competition, price transparency should foster liquidity in the market for the product and narrow spreads.

Third, on a macro level, financial markets will perform better when they have price transparency, market integrity, financial soundness, and customer protection. That also is certainly part of the regulatory regimes of the Securities and Exchange Commission and the Commodities Futures Trading Commission. However, thinly traded instruments on an exchange may also suffer from a lack of price transparency, much like many OTC products, because of the infrequency of market quotations. Therefore, sound valuation practices would factor in potential illiquidity.

More generally, however, price transparency exists on exchanges, such as those where securities, futures, and options thereon are traded. Price transparency is also a feature of screen-traded systems. One issue that arises is who has access to the price -- how visible is it. Is it visible by only those who are direct participants or others who have an interest in knowing the price? This morning, we have heard from my colleagues on this panel some of the arguments as to which is better.

For the balance of my presentation, I am going to focus on that aspect of the over-the-counter market where price transparency does not generally exist. Especially in the case of many OTC derivative transactions, the transactions do not always involve a broker, a middleman or agent, who have a fiduciary responsibility to treat both sides to the transactions fairly. These are cases of direct dealing. In the case of a swap, is it truly correct to speak of a "dealer" and an "end user"? Both are parties to the swap contract between them. It is not unusual, however, for a registered broker/dealer to act on behalf of an affiliate which is the issuer or counterparty of the swap.

Some swap transactions are virtually standard products. In these cases, brokers can obtain a quote for a simple swap transaction. A party can easily shop the price to see whether it is competitive and at market. Prices are available over Bloomberg and other services. But the more tailored the transaction and the more complex the transaction, the less transparent will be the price. Indeed, in the case of some products, there is no market price. The transaction cannot be marked to market, in a literal sense, because there is no market. Instead, the transaction will be marked to model (which, of course, takes into account market characteristics of similar instruments).

One question you might raise is how all of this parses with the December 4, 1994 agreement between the Federal Reserve Bank of New York and Bankers Trust regarding highly leveraged derivatives. That agreement represents an enforcement action taken by the Federal Reserve against a specific institution. The agreement is not an attempt to regulate through an enforcement action. Nonetheless, the terms of the agreement are instructive. Paragraph 3.(a) of that agreement sets out the general proposition: Bankers Trust must conduct its LDT business in a manner which seeks to ensure reasonable transparency of LDT pricing to its customers. More specific requirements were set out in Paragraph 3.(b) which required Bankers Trust to prepare written policies and procedures to accomplish the objective I have just mentioned. Those policies and procedures must address: (1) the provision of indicative quotes and firm quotes to customers, (2) the provision of daily indicative quotes to customers with highly sensitive LDTs, and monthly indicative quotes to customers with all other types of LDTs, (3) the methodology for making valuation adjustments, (4) the analytical foundation for the valuation adjustment methodology, and (5) documentation and review of customer quotes as they relate to LDT values reflected in Bankers Trust's books, and all valuation adjustment decisions.

That agreement is precisely that -- an agreement between two parties based on negotiations. We do not expect all banks subject to Federal Reserve supervision to adhere to that agreement. We did, however, expect those banks to read and learn from the order. As simply stated by the Board of Governors in its announcement of the action, banks engaged in derivatives activities should maintain effective policies and procedures relating to pricing, valuation, and the provision of quotations to customers.

Are dealers providing the information required of Bankers Trust? I understand that most are reluctant to do so, claiming that their pricing models are proprietary. As derivative transactions become more customized and complex, the computer simulations needed to price them grow increasingly expensive. However, advances in computational techniques and raw computer power are reducing the cost of providing customer quotes and interim sensitivities at cutting edge firms.

The Principles and Practices is, in effect, a broad scale code of conduct for the wholesale financial markets. It is applicable to all financial instruments in those markets. It applies to all persons who regularly participate in these markets. It is grounded on the premise that, in these markets, all participants -- dealers and end-users -- should be treated similarly. The Principles and Practices was prepared by representatives of six financial trade organizations: the Emerging Market Traders Association, the Foreign Exchange Committee of the Federal Reserve Bank of New York, the International Swaps and Derivatives Association, the New York Clearing House Association, the Public Securities Association,

and the Securities Industry Association. The Federal Reserve Bank of New York hosted the project. This effort was co-chaired by Gay Evans of Bankers Trust and ISDA and Woody Teel of Bank of America and the Foreign Exchange Committee. Each association had to put up one attorney and one real person on the drafting team. That effort took over a year. Last August the six trade associations recommended the Principles and Practices to their members. Comment was sought from market participants and trade and other associations. The Principles and Practices is not binding. It does not relieve a market participant of statutory and regulatory responsibilities. It sets out a series of best practices that each market participant should follow. It deals with all instruments and does not focus on derivatives, although it is a product of its time, when derivatives issues including valuation was a lively topic.

The starting point is who is responsible for what when speaking of valuations. The Principles (Paragraph 3.6.1.) state:

A Participant should maintain policies and procedures for the valuation of Transactions at intervals appropriate for the type of Transaction in question, regardless of the accounting methodology employed by the Participant. These policies and procedures should address the specific methodology used for valuation, including as appropriate the use of market or model based valuations with reserves and adjustments.
This statement sets forth the general rule that each counterparty is responsible for the valuation of its own positions. I should note that the Principles and Practices address the question whether a market participant has a responsibility to provide a valuation to its counterparty (Paragraph 3.6.4.). They state:

Entering into a Transaction does not obligate a Participant to provide valuations of that Transaction to its counterparty.
What should be done if a party does not have the capability to do so itself? This situation too is addressed by the Principles (Paragraph 3.6.2.) in the following way:

If a Participant does not have the internal capability to value a Transaction and a price or market valuation is not publicly available or otherwise readily ascertainable, then the Participant should (I) ascertain the availability of external valuations (which may include valuations from its counterparty) prior to entering into the Transaction and (ii) obtain an external valuation of the Transaction at intervals appropriate for the type of Transaction in question.
When a Participant requests an external valuation for a Transaction, the Participant should clearly state the desired characteristics of the requested valuation (e.g., mid-market, indicative or firm price).

At this point, I would like to pose the question whether a firm should enter into a transaction that it itself is unable to value. My initial response is to say no. My second reaction is to say yes, if the firm is being advised by a third party which is not a party to the transaction or advised by its proposed counterparty.

We had encountered some transactions where one proposed counterparty required that the other agree not to show the transaction to any other person. Putting on my bank supervisory hat, I would question whether the latter's agreeing to that, if it is a bank subject to our jurisdiction, is an unsafe or unsound banking practice. I appreciate the rationale for the undertaking -- to preserve the designer's trade secret and to not make its effort in designing the product freely available to competitors. However, in my view, a potential counterparty should not be forced to rely only on its potential counterparty, unless they have entered into an advisory and fiduciary relationship.

This issue is somewhat obliquely addressed in the Principles (Paragraphs 3.6.3. and 3.6.4.) in the following way. As to the person receiving the valuation, it states:

In assessing any external valuation, it is essential that the Participant consider the circumstances in which the valuation was provided, including criteria such as whether the party providing the valuation is a counterparty to the Transaction, the time frame within which the Valuation was provided and whether the party supplying the valuation was compensated for its services. Participants should understand that a valuation of a particular Transaction may include adjustments for, among other factors, credit spreads, cost of carry and use of capital and profit, and may not be representative of either (I) the valuation used by a counterparty for internal purposes or (ii) other market or model based valuations.
And as to the person providing the valuation it states:

However, if a Participant does provide valuations of Transactions, it should maintain policies and procedures concerning the provision of valuations. Such policies and procedures should require the Participant to clearly state the characteristics of any valuation provided (e.g., mid-market, indicative or firm price). In those markets with specific conventions regarding valuations, Participants should supply valuations using those conventions, unless otherwise agreed.
As I see it, the dealer community is addressing this issue through representations that the two parties make to each other. This is reflected in language which reads along the following lines:

Each party will be deemed to represent to the other party on the date on which it enters into a Transaction that (absent a written agreement between the parties that expressly imposes affirmative obligations to the contrary for the Transaction)

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Evaluation and Understanding. It is capable of evaluating and understanding (on its own behalf or through independent professional advice), and understands and accepts, the terms, conditions, and risks of that Transaction...

Firms are also considering the use of disclaimers that would inform the counterparty that valuations are provided for information purposes only as an accommodation and without charge and are intended solely for the use of the counterparty. These firms would make clear that these indicative valuations do not represent the actual prices at which new transactions could be entered into or unwound, and they do not represent the amount that would be payable if the agreement were closed out under any early termination clause of the underlying documentation of the transaction. Some firms might also expressly disclaim any warranty that the valuations are representative of or more favorable than valuations provided by other firms. Finally, some firms might also clearly inform their counterparties that any indicative valuations provided may differ from prices reflected on the firm's own books and records.

As stated above, when one talks about valuation, one needs to be clear as to what type of valuation one is requesting or providing. One of the clearest forms of valuation is the firm, tear-up, or closeout price. This is the price that the counterparty is willing to put on, terminate, or modify the transaction.

A number of firms now offer subscription-based products capable of sophisticated portfolio analysis. Some of these products use sophisticated modeling to (I) mark the user's portfolio, including derivatives, to market, (ii) decompose each transaction into its component risks, (iii) calculate the historic volatilities and risk factors, and (iv) input this history into a simulation model to calculate capital at risk. I have not seen the contract for these products. I am sure that the offerors do ensure that they are not taking on too much risk in offering them.

I once addressed the question whether the closeout price must be the same value that the party providing the price maintains the transaction on its books. I see no reason why that has to be the case. For example, an early tear-up price might be attractive because it eliminates the risk of the trade. Another example might be where the transaction has been extremely profitable to a party, and it is willing to forgo a part of that profit to retain that counterparty as a continuing customer. Another example might be where Party A is restructuring its balance sheet and it is

particularly clear that Party A wants to close out a trade and apply the profit to some purpose. The counterparty, Party B, senses that Party A has a need to restructure the transaction and is willing to closeout at a price inferior to Party A than what Party B had determined to be the market value. It also should be understood that the tear-up price is good only for a stated period of time.

Another form of valuation may be required for valuing the transaction on a counterparty's books. As I stated earlier, it may obtain that valuation from an independent third party or from the counterparty. In either case, the person receiving the valuation should request information regarding the methodology used and assumptions made in obtaining the valuation. If the person is the counterparty, that valuation might well be the value the transaction is carried on the valuator's books. And if it is a non-customer, it will be the value based on the model. The party giving the valuation will not stand behind it and may well require the party receiving it to attest to that fact. If a mid-market value is requested, that is fairly clear. It will be the value midway between the bid and offer spread. Due to the varying size of bid/offer spreads for some transactions, a mid-market valuation could be significantly higher than the bid side indications and lower than the offer side indications. Some cases will involve the use of an estimate if offer indications are not available. An indicative value might be a value close to the valuer's offer value. That is, it will give a value that it would provide to any person who would want to put on that transaction at that time. That raises the issue of whether a person must provide the same value for the same transaction to two different customers. With respect to a new transaction, even if the two customers present the same credit risk, there may be good business reasons for providing different prices. I understand that there are also indicative tear-up prices. A firm's tear-up price would involve more effort at calculation and, therefore, could produce a different number that the indicative tear-up price.

Another issue that can be raised at this point relates to Party A's certified financial statement. What responsibility does Party A's external auditors have to determine whether the value of the transaction on Party A's books fairly reflects the value of the transaction.

The Derivatives Policy Group in its March 1995 report entitled "Framework for Voluntary Oversight" in respect of counterparty relationships did address valuations and quotations. The report stated:

A professional intermediary should exercise good faith in the determination of valuation and quotations for OTC derivatives transactions and should not prepare or communicate valuations or quotations to a nonprofessional counterparty with a view to misleading the counterparty
If a professional intermediary believes that the nature of any quotation or valuation given by it to a nonprofessional counterparty is unclear to the counterparty, the professional intermediary should take steps to clarify the nature of the quotation or valuation (e.g., whether the valuation or quotation is an indicative price quotation, a firm price quotation or a mid-market valuation) and should consider indicating, where appropriate, that valuations may vary from firm or indicative price quotations as a result of various factors and may vary from valuations that would be given by another professional intermediary.

Finally, it would not be appropriate for me to close without addressing the bank supervisory aspects of valuation. The Federal Reserve has set out its position in its Trading Activities Examiner Guidelines and Trading Activities Manual. These documents provide guidance to examiners in assessing the safety and soundness of a bank's policies and procedures. They do not focus on derivatives trading but, instead, focus more generally on all trading activities.

Simply stated, banks engaged in trading must have the ability to mark trading positions to market daily. Banks should strive to monitor more active instruments on a real-time basis.

The risk-measurement provisions of the Nontrading Activities Examiner Guidelines highlight that failure of a bank that is an end-user of derivatives to understand adequately the risks involved in its positions constitutes an unsafe and unsound banking practice, whether occurring owing to lack of internal expertise or inadequate outside advice. A bank should obtain pre-acquisition price quotes and risk analyses from more than one dealer and, in doing so, assume that each party is dealing at arm's length for its own account, absent a written agreement to the contrary. As a general sound practice, unless the dealer or counterparty is acting under a specific investment advisory relationship, a bank should not enter into a transaction if its fair value or analyses required to assess its risk cannot, under any circumstances, be determined independent of the originating dealer or counterparty. I do not find these Guidelines to be inconsistent with those of the Principles and Practices. Both take the same view, a bank whether it is an active or occasional user of derivatives must have or acquire the ability to value its transactions.

In view of all of this, where are we now? I believe that, as we are beginning to better understand these instruments, we are also developing market conventions that should overcome some of the difficulties market participants have encountered in the past year or so. In the area of valuation, as in other areas, market participants are developing a better picture of their responsibilities. Some basic ground rules needed to be established; that has occurred and should help market participants as they go forward. To the extent that market participants keep refining these conventions to keep up with their learning, some futures problems can be avoided. We all recognize that developments in this area move with impressive speed. Those of us on the public side and those of you on the private side (and those of you in between -- the academic side) cannot let down our guard and sit on what we have accomplished to date. One of the benefits of programs such as this is that it helps us to focus on what needs to be done. Thank you for your attention.