Global Derivatives:
Public Sector Responses

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Introduction

This occasional paper contains speeches by three regulators and one legislator, commenting on the study of global derivatives "Derivatives: Practices and Principles" which was published earlier this year by the Group of Thirty. All four spoke at the Group of Thirty Seminar on Derivatives held on September 27, 1993, at the Federal Reserve Board in Washington, D.C. The speeches reproduced here by James Leach, William McDonough, and Brian Quinn were presented there. The speech by David Mullins is from an earlier occasion, the July 1993 International Swaps and Derivatives Association conference in New York on the Group of Thirty study, which anticipated many of his remarks at the September Seminar.
A Legislative Perspective on Derivatives

By The Hon. James A. Leach
(Ranking Minority Member of the Committee on Banking, Finance and Urban Affairs of the U.S. House of Representatives)

Thank you for inviting me to give a congressional perspective on a subject that most in this audience understand better than any of us do on Capitol Hill. Let me begin by noting the fine work that the Group of Thirty has done in promoting research related to the complex world of international finance. I would particularly like to commend Dennis Weatherstone, Chairman of the steering committee overseeing the derivatives project, and Charles Taylor from the Group’s Washington office, for their efforts in coordinating such a comprehensive research effort. What meager knowledge most of us have in this subject, I suspect, is largely derivative from theirs.

The Group of Thirty report helps “de-mystify” derivatives and highlights the potential uses of these products for purposes of risk management and financial engineering. The 20 recommendations for industry practices represent a constructive first step to protect against imprudent or risky activities. Such recommendations, if widely implemented, may calm certain fears among policymakers that these products may be too complex or entail too extraordinary risks for market participants, especially those backed by the government’s deposit insurance safety net.

With the Group of Thirty report as background, I would like to share some of my thoughts on financial derivatives based on my limited experience as a Member of the House Banking Committee. Legislators should take care not to exercise too presumptive judgments about a market that has developed on its own without government
direction. If the government is to engage the derivatives issue, it must be with extreme caution, particularly in terms of legislation. Likewise, if the private sector wishes to avoid irrational governmental constraints, it must exercise caution as well. And that, in a model way, is what that Group of Thirty report symbolizes: an industry taking responsibility out of its self-interest for a circumstance that, among other things, may be beyond the ken of understanding by all but a very few public officials.

Nevertheless, in analyzing the public policy concerns related to derivatives, legislators and regulators have an obligation to look at a number of questions, including the following:

- What are adequate capital, accounting, and disclosure standards for derivative products?
- Is there adequate coordination between US and foreign regulators?
- Are there unique issues regarding the payments, clearing, and settlement systems related to derivatives?
- What are the benefits realized by users of derivatives for risk-management purposes?
- Do dealers and end-users of derivatives have adequate internal controls?
- Are there adequate protections in place to protect unsophisticated end-users?
- How extensively are derivatives used for purposes of speculation and what should be the role of speculators? and
- What is the level of systemic risk posed by derivatives?

I have recently submitted an extensive questionnaire on this subject to the appropriate regulatory bodies with hopes of providing direction and greater coordination within the Executive branch and between the Congress and the Executive.

In examining sophisticated financial products such as derivatives, it is necessary to begin with the question of what is the role of government in legislating or regulating these products. Derivatives pose an interesting conundrum in that the area may be too sophisticated for a congress of generalists to deal with legislatively. However, legislators should still expect sophistication from those parts of the Executive branch charged with overseeing the financial markets. The role of any legislation addressing derivatives, if deemed necessary, should be based on an instinct for which Capitol Hill is not noted—temperate modesty. When confronted with an issue beyond the background and
realm of understanding of most legislators, it is crucial that—with or without new legislation—responsibility for understanding and, if necessary, constraining derivatives markets be vested in appropriate parts of the Executive and/or Federal Reserve Board. In particular, as with the Basle Accord, the regulators, most likely the Fed, should attempt to establish international standards comparable to American practices or adopt standards developed for use elsewhere if such are more responsible than our own.

When we talk of derivative instruments, policymakers must be careful to understand the broad array of products and services that are subsumed under this term. For example, the ratings agencies assign widely varying levels of credit risk to different products which are all considered derivative instruments. Commodity or equity contracts, currency swaps, currency options, currency futures or forwards, interest rate options, and interest rate futures or forwards represent different types of derivative products, all with an entirely separate risk factor. This highlights the sophistication in the market and also highlights the problems that policymakers may confront as they consider the need to supervise this market. It also demonstrates the level of complexity in the market that would make overly intrusive legislation in this area difficult, with a reasonable likelihood that it could miss the mark or prove counter-productive. A legislative and possibly legislated call for broad regulatory vigilance may be merited, but specificity in congressional standard setting would appear to be unrealistically imprudent.

In examining the different types of derivative instruments, it is important to acknowledge the benefits that derivative products provide as a risk management tool for both financial and non-financial firms. By allowing companies to better manage the risk on their balance sheets, the prudent use of derivatives helps market participants guard against market volatility, thus providing a more stable environment for job creation. In particular, prudential use of derivatives products insulates companies from volatile interest rate and foreign currency exposures.

In addition, the lower cost of funds made possible by the growing use of derivative instruments has provided more affordable housing and cheaper student loans while decreasing taxpayer exposure at government-sponsored enterprises such as Fannie Mae, Freddie Mac, and Sallie Mae. In fact, some wonder why the US Government does not take advantage of these products to lower its funding costs and thereby reduce the budget deficit. Sovereigns throughout the industrialized world use sophisticated financial techniques, including derivatives, for more efficient management of their financial needs to the direct benefit of their taxpayers. Although risks exist in the speculative use of derivatives as evidenced by Malaysia’s wanton loss of its government surplus, a strong case can made that for hedging purposes, greater use of derivatives
should be contemplated by the US Government. In fact, the US Treasury
today may be assuming a greater risk in its current efforts to shorten
maturities of US borrowings than it would be in using derivative
products for financial management purposes.

Here, statistics contained in the Group of Thirty report concerning
the levels of counterparty credit losses experienced by swap dealers are
instructive. According to statistics contained in Appendix A of the
Group of Thirty report, only $5.55 million in counterparty losses to swap
dealers were reported over a 10-year period. This is a very modest
figure, particularly when the fact is taken into account that nearly half
of these losses came from a single set of transactions with UK local
authorities. The entire amount of counterparty losses for the 10-year
period would only amount to a mid-level credit loss at one of the many
S&Ls for which Congress has already appropriated over $100 billion in
loss funds. The low level of these losses gives some comfort that
extensive risk management constraints have been put in place in the
private sector. However, all parties must recognize that the past is not
always a guide to the future, especially when a relatively new market
explodes in size. Hence, regulators have an obligation to stay on guard
as this marketplace expands in a time of unprecedented economic
uncertainties.

While derivatives make up only a small fraction of the trading
activities at insured financial institutions, and while derivative products
often serve a useful role in reducing rather than increasing institutional
risk, the potential exists that these products can also be used for
speculative activities. There is no escaping the circumstance that derivative
activities in the '90s must be examined in the context of the decade of the
'80s where America over-leveraged itself with junk bonds, junk real
estate, and junk S&Ls of its own making and junk debt of LDC
manufacture.

The public sector must recognize what is at issue, and the private
sector must realize the dangers. As someone who represents an agricultural
constituency, which includes some of the most sophisticated agri-
businesses in the world, I would stress that no one knows better than
the farmer the fine line between hedging and speculating and the ease
with which this line can be crossed.

Human nature being what it is, the prospect of destabilizing
speculation in certain types of these products cannot be ruled out.
Financial markets and the risks involved change rapidly. New products
are introduced every day, and it is often difficult for private sector
participants as well as policymakers in government to judge adequately
new risks. Currency markets, for instance, which have been such a
source of money center bank profitability in recent years, could become
more problematic if new, less-sophisticated entrants attempt to play
leveraged games with other peoples’ money. It is crucial, at a minimum, that regulators assure that the 1980s S&L circumstance, where profit was privatized and loss socialized, not be allowed to repeat itself in federally insured financial institutions.

In recent years, the near perfect falling interest rate macroeconomic environment has produced record profits from traditional lending for most community banks. However, because of certain credit problems and other competitive factors, money center institutions have had difficulty turning a profit in traditional banking areas, but have found new profit sources in currency trading and other areas historically considered the province of investment banks. While community banks pay taxes to our government, money center banks appear to have figured out how to tax foreign governments. When foreign governments, à la the British, put pride above market forces, private sector money managers not unnaturally take advantage of circumstance. But when candy is taken from children one day, the possibility political kids may unite and rebel the next cannot be ruled out.

In the derivatives arena there is also a problem of the new kids on the block. If problems develop in the derivatives marketplace, it is a good bet that they will be less likely to stem from the major firms operating in the mainstream, than from firms that are new entrants or operating at the fringes of this market. Any regulation in the derivatives area must be premised on the assumption that all market participants are not equal in sophistication or integrity and that distinctions must inevitably be made between prudent and less prudent actors. Just as well-run, well-capitalized financial institutions have a powerful case for considerable deregulation today, poorly run, poorly capitalized institutions demand significant, if not Draconian oversight.

Hence, regulators must be extremely discerning in their supervision of derivatives. While not inherently de-stabilizing, derivatives provide ways of either leveraging or de-leveraging financial institutions. One institution’s hedge may be another’s speculations. In hindsight it is clear that in a rising interest rate market, derivative products would have been particularly useful for S&Ls during the late ‘70s and early ‘80s to hedge against interest rate risk. Such use of derivatives as a financial management tool could have saved the taxpayer significant sums of money.

Alternatively, over-use or mis-use of derivatives when markets turn can cause market participants to get into trouble. Questions still persist related to the case of Franklin Savings in Kansas. No S&L at the time put more effort into devising hedging tools. As the court case showed, it was extremely difficult to assess who was right. Management contended its techniques were simply too sophisticated for the government to understand. The government, on the other hand, maintained that
whether intended or not. Franklin was involved in imprudent speculation to the detriment of the taxpayer. Merits of the legal circumstance aside, the Franklin case underscores the need for industry and regulators to share on a timely basis their concerns, and for risk management education to be a mutual responsibility.

In leading to greater understanding of derivatives, the Group of Thirty is to be commended for developing and promoting responsible industry standards. But standards in and of themselves should never be considered static or sufficient for all market participants, particularly in a fast-changing arena. For example, Generally Accepted Accounting Principles (GAAP) defined many S&Ls as solvent in the 1980s when common sense indicated that different circumstances existed. Vigilant standards are never an adequate substitute for vigilant management.

The use of derivative instruments must be weighed from a policy perspective in terms of systemic as well as institutional risk, especially as such risk may relate to the federally insured deposit system.

In examining the risks posed by derivatives instruments, three issues stand out: capital, accounting, and disclosure. Of these three issues, capital would appear to be the most important factor. Capital is the cushion that protects a firm from credit and market risk. For an insured institution, capital represents the best protection for the taxpayer from the risks inherent in the marketplace.

With this in mind, it is nevertheless not an easy task to determine the amount of capital that should be allocated by a bank for purposes of its derivative business. The new proposed BIS capital standards would take into account netting and apply separate standards for interest rate and market risks.

I would caution, however, that it may be a mistake to view new interest rate and market risk standards as an adequate substitute for a strong leverage requirement. A strong leverage ratio remains the most important protection for taxpayers against risk in the financial system. It also remains the fairest way to constrain competitive growth within the banking sector. One of the least analyzed parts of the American S&L expansion in the 1980s was the degree to which lack of attention to capital standards caused disproportionate deposit growth in certain institutions in a certain industry in certain parts of the country. Attention to leverage ratios is not only important in assessing taxpayer risk, but also for competitive equity, and regional and industrial credit allocation.

It should be noted that the issue of capital standards for derivatives, unfortunately, was beyond the scope of the Group of Thirty report. This would seem to be an area in which further research should be encouraged recognizing that public sector judgments may not always coincide with private sector recommendations.
Concerning accounting and disclosure standards, the Group of Thirty's efforts to seek greater harmonization of international standards would appear right on. Greater transparency is critical to the integrity of our financial markets.

One final area for supervisory concern that is often overlooked is the question of the legal risk involved in derivatives activities. Legal risk is currently a wild-card in the system, and, as evidenced by the case of UK authorities in Hammesemth and Fulham, one that is unpredictable even in developed societies. The Group of Thirty report appropriately highlights this problem and recommends harmonized international standards. However, until this goal is reached regulators must be especially sensitive to this potential problem area.

In dealing with supervisory standards for capital, accounting, and disclosure, legislators have little choice but to rely rather heavily on the judgment of regulatory agencies. This leads to one of the least emphasized but most pressing challenges of government in a modern world—the need for careful attention to quality control in appointments. In general, the private sector, because of incentive motivations, is much smarter with money than the public sector. This is why it is particularly important to have people at government agencies with proven expertise. The government cannot be run with campaign managers, particularly at organizations that demand sophisticated knowledge such as the financial regulatory agencies. Appointments to these agencies must be made based on merit and not as a reflection of political indebtedness by a candidate to an individual or industry group.

Nothing underscores the need for a government of meritocracy more than the challenges the Executive branch faces in regulating products such as derivatives. The best and the brightest may make mistakes, but generally they will be less often with less devastating impact.

Sophisticated financial products pose a particular challenge to bank regulators such as the Federal Reserve that have been rightfully forceful in guarding their independence. Any failure to supervise prudentially federally insured institutions which leads to another financial debacle for the taxpayer would inevitably force Congress to re-address structures. One needs to look no further than the old Federal Home Loan Bank Board to see what happens to an independent agency that fails in its regulatory responsibilities. The only thing more dangerous than a Congress faced with a problem over its head is a Congress asked to correct a problem exacerbated by people who should have known better.

Derivatives also underscore the need for the government to work with private groups like the Group of Thirty to monitor complex financial products. While the history of industry self-regulation has not
been overly impressive, clearly to date, in the derivatives area, the
private sector is leading the public, not only in the development of new
market instruments, but with techniques to manage and constrain risk.
Care, however, must be taken to ensure that we not have a least
common denominator approach taken to regulation which might be
adequate for one kind of institution in one time frame. Tomorrow’s
market circumstances and market participants may not be the same as
today’s.

Thank you again for inviting me to comment on a subject which so
profoundly tests legislative judgment. I look forward to an ongoing
dialogue with the Group of Thirty and its members on these issues.
A Regulatory Perspective on Derivatives

By William J. McDonough
(Chair, the Federal Reserve Bank of New York)

I welcome the opportunity to comment today on the excellent study on
derivatives by the Group of Thirty. The report and especially its
appendices provide a comprehensive overview of derivatives activity
and their risks, a survey of current risk management practices, and
recommendations on sound practices for risk management and on
regulatory and accounting measures. This report belongs at the top of
the reading list for the senior management of all institutions active in
derivatives markets, as well as for regulators and the legislative community
concerned with the safe operation of these markets.

I have long been convinced that the extraordinary growth of
derivatives activity over the past decade has provided real benefits in
the form of a more efficient allocation and management of risks. By
lowering the costs of risk intermediation and providing more finely-
tuned hedges, derivatives enable investors, financial institutions, and
corporate treasurers to achieve exposures in their financial transactions
that are more consistent with their overall business strategies. As a
result, derivatives have facilitated the financing of investment in physical
assets.

These important benefits of derivatives require the continuous,
smooth, and safe functioning of derivatives markets. To this end, the
first line of defense against disruptions to the derivatives markets is the
risk management capabilities of all firms active in these markets. The
Group of Thirty study on derivatives helps fortify this line of defense
by distilling the present wisdom on the nature of risks in derivatives
activities and on sound practices for risk management. Let me stress
how important it is that those end-users of these products who become
quasi-market makers, have the same sound practices we expect from
financial institutions. Other end-users should use these practices as
guides. Indeed, I believe that the adoption of the full set of
recommendations in the report by all major users of derivatives would
significantly reduce the chance that a major financial disruption will
originate in any one firm’s derivatives activities.

I find myself even more challenged to add to the report’s discussion
of the nature of systemic risks that might arise because of the effects
that derivatives activities have had on the functioning of the financial
system. At the end of my remarks, I will provide my own perspective
on this issue.

Beyond these critical risk management and systemic risk concerns
lies another set of issues that we at the New York Fed and our
colleagues at the Board of Governors are committed to better
understanding—that is, the ways in which the expanded use of derivatives
by a wide variety of end-users has altered the channels of influence of
monetary policy. This concern clearly lies outside the scope of the
Group of Thirty’s study; but I mention it today because this important
topic has just begun to get the attention it deserves.

I do not mean to suggest that the use of derivatives has undercut
the ability of monetary policymakers to achieve their broad macroeconomic
goals. I have no such presumption, nor do I exclude the possibility. I
simply wish to underscore that derivatives have become so pervasive
that their potential macroeconomic consequences can no longer be
ignored.

Let me cite two examples to give you a sense of the issues
involved. First, much of the transmission process operates, in the first
instance, through the impact of monetary operations on financial
intermediaries, particularly banks. How have derivatives altered banks’
liquidity and interest rate management practices, and might these
alterations affect the transmission process? Second, has the improved
ability of corporations to hedge interest rate and exchange rate risks
altered the sensitivity of their investment decisions to interest rate and
exchange rate movements?

I give these examples in the form of questions because, as yet,
economic research provides little guidance as to the answers to these
queries. The Federal Reserve is exploring these issues, and we hope
that we can also spark the interest of other researchers, both in the
public and private sectors.
Comments on the Group of Thirty’s Recommendations

I turn to my specific comments on the recommendations offered in the Group of Thirty report.

The role of senior management. The Group of Thirty is exactly right to stress in its first recommendation the importance of senior management’s involvement in the formulation of risk management policies. However, our vision of the role of senior management in derivative activities is even broader.

Senior management must be actively engaged in the risk management process on an ongoing basis, and not just at the policy formulation stage. Let me again emphasize that I am speaking of the top management at all firms—both financial and non-financial—active in derivative markets. Senior management should critically evaluate risk-taking in their organization, reviewing risk management reports as appropriate. They should regularly ask probing questions of line management about the nature of risks in their area, insist on prompt discussion of internal control or loss recognition problems, and engage area managements in the discussion of which events could expose the firm to substantial loss. Senior managers should also be in a position to give a concise summary of risk control mechanisms to appropriate regulators. Only this active involvement by senior management will ensure a full discussion of the often rapidly evolving vulnerabilities of the firm. The Board of Directors should be actively involved in reviewing both policy and performance, including management proposals of changes in the acceptable levels of risk.

I do understand that people of my generation who are not astrophysicists have to strain to understand these products. But it is simply not responsible to use that difficulty as an excuse for non-involvement. To put it simply and directly, if the bosses do not or cannot understand both the risks and rewards in their products, their firm should not be in the business.

A comprehensive approach to risk management and control. To enable senior management to assess evolving vulnerabilities, internal risk management systems need to integrate all aspects of risk in a way that allows an overall risk profile to emerge. Risk of substantial loss in a particular scenario could derive from market, credit, liquidity, and operational risks. As a result, firms must be able to aggregate, at least roughly, the consequences of major market events across all product and activity groups for all of these areas of risk. This requires that the risk management approach to market and credit risks outlined in the Group of Thirty report be extended to include funding liquidity and operational risks within a unified framework, perhaps in the context of stress tests.
The development of a comprehensive approach to risk management would be facilitated by the articulation of a broad conceptual framework to risk measurement, risk management and control, and the management information system that produces reports for all levels up to senior management. Here, one important issue is how to link tightly the "value at risk" approach to market risk, as advocated in the report, with the price risk limits frequently used by trading desks. Trading limits sometimes appear to be derived rather intuitively instead of directly from the "value at risk" framework.

The Group of Thirty report provides recommendations on many of the building blocks that could go into the development of such a comprehensive approach to risk management and control, but does not provide advice on how to assemble the building blocks in a coherent manner. We believe that market practitioners rather than regulators are best equipped to design workable ways to solve this problem and would welcome further recommendations by the G-10 on this issue.

Valuation procedures. While the report's treatment of credit risk management is extremely thorough, including the discussion in an appendix, the treatment of market risk is less detailed. In particular, the issue of valuation procedures is raised in the report's recommendations, but I wish more had been said.

For example, recommendation 3 suggests valuing derivatives portfolios at mid-market value less specific adjustments. The study suggests that these adjustments should capture such expected future costs as unsecured credit spreads, closeout costs, administrative costs, and investing and funding costs. The report also notes that these adjustments are implicitly assumed in the bid and offer method. Yet the precise nature of these adjustments remains unclear, and the devil may lie in the detail.

The mere fact that these adjustments to market prices are recommended for risk management purposes appears to be an acknowledgment that the market may not accurately value all these factors. No mention is made of liquidity premia, but I wonder if the market price fully reflects the liquidity of the more complex instruments with cross-market exposures that can be difficult to hedge.

For senior management to understand the implications of these adjustments, they would need to see the actual market values, with the adjustments listed separately and thoroughly annotated. The reporting of adjusted market values alone, without this disaggregation and elaboration, creates the potential for misconceptions. At worst, these adjustments could mask the consistent underpricing of sizable risks.

Management information systems. The Group of Thirty report may have underplayed the importance of developing the management
information systems that are required for all the Group of Thirty’s recommendations to be implemented. The limitations of a firm’s management information system are directly related to the effectiveness of risk management. For example, the problem I noted earlier about reliance on trading limits that are only loosely linked to a value at risk approach, may derive from an inability of the management information system to measure and monitor risks in the real time frame of the trading desks.

Because the development and ongoing modification of management information systems are very costly and time consuming, the limitations of these systems may prove a significant constraint on the ability of firms to rapidly implement some of the valuable recommendations in the Group of Thirty’s report. For this reason, senior management should carefully assess the state of their management information systems when deciding how rapidly to expand their firm’s derivatives activities.

**Accounting and disclosure.** I welcome the attention of the Group of Thirty study to the critical issues of accounting and disclosure. I see these as key areas for extensive further cooperative effort, both here in the United States and around the globe. These are crucial issues, because squeezing derivatives into existing accounting structures can conceal and distort information and the decision-making that depends on that information. In addition, the increased use of derivative instruments, combined with the inadequacy of current accounting concepts in this area, has reduced the transparency of a firm’s exposures, and of the financial system more broadly.

The Group of Thirty’s recommendations to harmonize accounting practices and standards, and to improve the quality of disclosures, may go a long way towards enhancing transparency. I would like to provide a few additional thoughts on the nature of accounting and disclosure measures that might further this process.

If you compare the effectiveness of current practices regarding accounting and disclosure for financial activity with those of yesteryear, one simple impression emerges. That is, formerly, you could look at the balance sheet of a financial institution and quickly get a sense of the nature and extent of exposures and risks. Today, balance sheet information is clearly inadequate for this purpose.

From this simple observation, a whole agenda for reform must be born. The basic question is: how can we revise our accounting and reporting practices so that we can, as readily as in the past, understand the nature of a firm’s risks and exposures? In particular, what key exposures need to be measured, and how can they be reported so that essential information is provided without compromising proprietary interests?
FASB in this country, and comparable bodies abroad, have struggled in recent years to respond to these questions. But the problems have proven formidable. I am thinking especially of the difficulties of capturing such key notions as the potential future credit or market exposures in derivatives transactions, which are typically assessed through simulation and sensitivity analyses. Similarly, an evaluation of the vulnerability of a firm's portfolio to extreme events may best be performed by comprehensive stress tests, perhaps supplemented by an analysis of possible liquidity problems. The present accounting and disclosure frameworks do not yet shed much light on these issues.

How can progress be made rapidly enough to avoid being greatly outpaced by the evolution of the financial markets themselves? One interim way to bridge this gap, while awaiting progress on accounting standards, would be to develop a detailed statement of sound market practices for those more complicated accounting and disclosure issues. These sound market practices could supplement the information provided by the formal accounting standards. The recommendations in the Group of Thirty’s study could provide a starting point for this effort.

**Steering committee on accounting and disclosure for derivatives.** To develop these sound practices, as well as to advise the ongoing efforts of FASB, a steering committee could be formed in this country. We could also encourage the establishment of similar groups in other countries. The composition of the committee could be designed to incorporate all relevant perspectives—FASB (or similar body in other countries), major market practitioners, end-users, and regulators. I envision that industry practitioners would take the lead in developing these sound practices, but the presence of the other members on the steering committee would ensure that a broad range of concerns were addressed.

One difficult problem that the steering committee would confront is that the fast pace of activity in today’s markets renders financial statements state almost before they can be prepared. Here the Group of Thirty’s recommendations provide little guidance. The report quite appropriately states that the degree and nature of risk must be disclosed; but in order for this disclosure to be meaningful, it must be timely.

In practice, more timely disclosures may need to involve partial information with respect to key aspects of a firm’s exposure. Of particular interest may be those factors which could directly affect a firm’s ready access to liquid markets. The steering committee could explore if some information could readily be provided on a much more frequent basis than is current practice. Over time, developments in electronic communications and systems technology may increase the feasibility of collecting and releasing information on a more frequent and timely basis.
International harmonization of accounting and reporting standards.

A final concern that I have in this area is that, given the global nature of derivatives markets, only a global approach to these issues will succeed in the end. Decreased transparency is not solely a domestic concern, and all of the initiatives I have discussed, as well as those in the Group of Thirty study, will require close coordination of efforts in all countries with developed financial markets. I would therefore underscore the sense of urgency conveyed in the Group of Thirty report to create harmonized international standards.

The Changing Nature of Systemic Risks

The section of the Group of Thirty report about which I have the most significant reservations is that on systemic risks. While the report identifies many of the potential sources of systemic problems, the discussion, perhaps inadvertently, appears to understate these concerns.

It may appear that central banks are unduly preoccupied with low-probability scenarios of possible systemic disruptions. However, it is precisely because market participants may only take minimal precautions for events in the tails of probability distributions that central banks must be vigilant. In those rare occasions of financial disruption, central banks must be prepared to assess the nature of the problem and to act swiftly. For this reason, we at the Federal Reserve Bank of New York will continue to work actively on improving our understanding of the evolving sources of systemic risk.

I wish to emphasize that I do not believe that derivatives are the sole, or perhaps even the principal, source of systemic risks in today's financial markets. At least equal risk of a sizable default or failure of a major financial firm, or group of firms, could result from losses on more traditional activities. Still, the increasingly widespread use of derivatives has altered firm-level exposures and market dynamics, and we must consider how these changes modify our thinking on possible sources of systemic disruptions and how they play out.

It may be useful to delineate two broad categories of systemic risks associated with derivatives. The first category, which encompasses many of the points noted in the Group of Thirty's discussion, includes disruptions which have their origin in derivatives activities at the individual firm level. Here, I would include oft-cited concerns about the underpricing of credit, market liquidity, or other risks, that can lead to large losses on derivative positions. I would also include the difficulties faced by senior management in detecting fraud in the internal reporting of complex derivatives positions.

A second category of systemic risks associated with the proliferation of derivatives is less well understood. I refer here to the ways in which
the spread of derivative instruments, coupled with advances in technology
and telecommunications, have altered the susceptibility of the financial
system to shocks.

A variety of issues falls into this second category. For example, the
decreased transparency of firms' exposures can contribute to the
development of a financial crisis. While it has always been impossible
to know precisely the nature of exposures at a counterparty, this
problem has been exacerbated by the lack of information about off-
balance sheet activities.

In the absence of timely and accurate information on exposures of
a firm rumored to be in trouble, other firms are more likely to back
away from providing funding to, or trading with, that firm. Under
these circumstances, liquidity problems can grow into a threat to
solvency. Similarly, if a major market maker in derivatives instruments
were to fail, it could prove difficult to find other firms willing to take
over or unwind a complex derivatives book whose risks are difficult to
assess quickly.

Another issue in this second category is the increased market
linkages and altered price dynamics created by derivative instruments.
One concern is the phenomenon frequently referred to as positive
feedback, that is, those mechanisms that have the potential to exacerbate
an already sharp price move.

Positive feedback mechanisms always have existed in financial
markets in one form or another, but the tremendous growth of options
and option-like instruments creates an added source of positive feedback.
This is because written options, as a matter of course, tend to be
dynamically hedged and hence require selling into a falling market. In
addition, margin and collateral arrangements are increasingly being
used to manage credit risk in derivatives transactions, and these provisions
also can amplify already sharp price moves in underlying markets.

In its discussion of this point, the Group of Thirty study notes that
academic research has shown that derivatives trading does not increase
volatility in underlying markets. An important distinction should be
drawn, however, between volatility in normal times and in times of
stress. Econometric studies do not shed much light on the experience
with volatility in times of stress, because these episodes occur infrequently
and tend to differ greatly in character, making them difficult to summarize
empirically.

I would like to underscore the critical role that more active
involvement of senior management can play in reducing the potential
for problems to escalate to a point that they pose systemic risks. The
problems with market dynamics noted in my second category of
systemic risks can contribute to the firm-level risks included in my first
category. As a result, both sets of issues should be on the radar screens of top management.

These examples, while brief, are intended to illustrate just how complex the evaluation of systemic risks has become. As we work to improve our understanding of these issues, we hope that the Group of Thirty and other private sector entities will continue to provide us with the sort of thought-provoking and educational material found in the present Study on derivatives.
Remarks on the Global Derivatives Study
By David W. Mullins, Jr.
(Vice Chairman, the Federal Reserve Board)

I appreciate the opportunity to offer my reactions to the much anticipated Group of Thirty-sponsored study of global "over-the-counter" (OTC) derivatives. Today I intend only to highlight what I see as the strengths and weaknesses of the study. I will then devote the bulk of my remarks to the challenges that the study poses for the derivatives industry, for central banks and regulators, and for legislators.

When one assesses this field, I think it is not hyperbole to suggest that the development and growth of financial derivatives constitute one of the most dramatic success stories in modern economic history. In the short span of 25 years, financial derivatives have sprung from conception to global prominence, spanning the world’s financial markets and institutions, permeating the global financial system.

To date the most visible element of central bank policies toward derivatives has been the capital requirements for banks’ activities in the OTC derivatives markets, manifested most notably in the Basel capital standards issued in 1988, and the recent proposals of the Basel Supervisors addressing netting arrangements, market risks, and interest rate risk.

But central banks’ interests in derivatives extend well beyond capital adequacy to include the overall stability, efficiency, and competitiveness of these markets, as well as their nexus with other markets and the financial system. This interest is also manifested in the recently released Promisiel Report on interbank bank activities under the auspices of the G-10 Governors and the recent G-10 study of last September’s episode in the foreign exchange markets.
The Federal Reserve has taken a keen interest in developments affecting the structure of the derivative markets including some important recent legislative and regulatory developments in the United States. And, this is the perspective we bring to the assessment of the Group of Thirty study—not only that of bank regulators, but concern about the stability, integrity, and efficiency of financial markets, institutions, and the overall financial system.

Though the Group of Thirty study has been completed, the debate about appropriate public policies toward derivatives is certain to continue. As you know, this study will be followed by others (indeed, many others) including, in particular, studies by the General Accounting Office (GAO) and the Commodity Futures Trading Commission (CFTC). In the United States, there are indications that once the studies are complete, Congress may undertake a thorough review of the appropriate regulation of derivatives markets.

In the interim, market participants have an opportunity to build on the Group of Thirty study in ways that increase the likelihood that a regulatory framework consistent with market efficiency and market integrity will, in fact, be the outcome of this process.

The Group of Thirty Study
As I understand it, the Global Derivatives Study Group had two major objectives. First, it sought to promote understanding and discussion of derivatives. The second objective was to help dealers and end-users manage derivatives activity by setting out principles of sound risk management in the form of a set of recommendations for dealers and end-users of derivatives.

The first objective is well met by an overview section, which, as advertised, sets out in relatively plain language what derivatives are, the needs they serve, their risks, and their relationship to traditional instruments. I can think of no better treatment of these issues for senior managers of financial institutions and interested regulators and legislators. Even those who are not mystified by derivatives will find valuable insights into derivatives activity.

The discussion of the benefits of derivatives activity is especially valuable because it not only presents these ideas in the abstract, but offers concrete examples of how financial institutions, institutional investors, nonfinancial corporations, and governmental entities use derivatives to manage risk.

Financial practitioners have long understood the obvious benefits of derivatives in reducing the transactions costs of participating in some markets, in effect arbitraging some of the administrative and
regulatory costs and other associated impediments and inefficiencies. For years, financial economists have explained that it is transparently obvious that derivatives improve Pareto efficiency—allowing different components of risk to be segregated and isolated and passed around the financial system to those willing and able to bear each risk component at least cost. This clearly reduces the overall cost of risk bearing and enhances economic efficiency.

Nonetheless, there is ample evidence in the public debate that some, for example, still cannot understand how contracts that seemingly constitute a zero-sum game can serve any need other than those typically met in Las Vegas or Monte Carlo. Concrete examples showing how local governments now use derivatives to manage the risks associated with volatile fuel costs or how exporters (and the jobs they create) depend on derivatives to manage foreign exchange rates make the point far more effectively than any abstract economic analysis.

The analysis of the risks associated with the use of derivatives also is comprehensive and lucid. The essential message is that the types of risk associated with derivatives—market risk, credit risk, legal risk, and operational risk—are no different than the types of risk associated with traditional instruments—loans, securities, and deposits. But, as clear as the exposition of these risks is, I suspect that for most readers it will underscore the other key conclusion about risk—the complexity and diversity of derivatives activities make the measurement and control of risks more difficult and more important than is the case with traditional instruments.

A concluding section goes beyond the risks posed by derivatives to individual firms that use them to consider the risks derivatives might pose to the financial system as a whole. For some time I have felt that it is important not to overstated the systemic risk potential of derivatives. In that respect, the report is entirely successful. Perhaps a bit too successful, in my view. Of course, it is the job of practitioners to focus on managing risk at the firm level. Public policymakers necessarily consider the external impact of individual firm problems on the financial system and the economy. In particular, it is the job of central bankers to worry about events that have small probabilities of occurrence, but would impose large costs on the financial system and the economy were they to occur.

While the analysis contained in the report does provide useful perspective to systemic risk issues, in my view it does not offer new insights that are likely to alter materially one's estimates of the probability of a systemic disturbance or of its potential costs. (Indeed, at some point it may be worthwhile to clarify the nature of systemic concerns. I shall defer that task in favor of focusing on this report.) Nor does the report contain a rigorous examination of the appropriate capital levels required...
to support the risk associated with derivatives activities, an issue of
interest to central bankers and regulators. Moreover, the report’s state-
ment that the existing regulatory framework is adequate does not appear to
be derived from or supported by an extensive analysis of the full range
of public policy issues associated with derivatives activities. In my
view these should not be viewed as notable deficiencies in the report,
since addressing public policy issues was not the primary objective of
the study.

Of course, there is no question that sound risk management at the
level of the individual firm is a key ingredient in addressing and
reducing systemic risk. It is through this avenue that the report con-
stitutes a useful public policy contribution. Concerns about systemic risk should
be diminished, perhaps appreciably diminished, if market participants
strengthen their risk management systems in the ways recommended
in the report.

Recommendations

Thus, as useful as the overview of derivatives is, the most valuable
product of the study is a set of sound risk management principles for
dealers and end-users, summarized in a set of recommendations and
elaborated in a series of working papers. The recommendations also
point to ways in which legislators, regulators, and supervisors could
work with market participants to strengthen the financial infrastruc-
ture for derivatives activities. I believe this is the right approach for practitioners
to take and responds to articulated public policy concerns about risk
management.

Overall, the recommendations seem to me to address quite
successfully the full range of issues associated with the measurement,
control, accounting, and disclosure of derivatives activities.

A study so comprehensive can be expected to contain some details
which one might question; in this study it is no exception. A few examples
might illustrate the sorts of issues raised by the recommendations.

* With respect to the role of senior management (Recommendation 1),
the flavor of the Group of Thirty recommendation is one of general
awareness by senior management that derivatives merit attention,
approval of policies and control procedures, and shared responsibility
for policy enforcement with all levels of management. In contrast,
central banks and supervisors tend to stress the importance of a
clear understanding by senior management of the nature and
magnitude of the institution’s exposure to risk, an affirmative role
in establishing the limiting parameters of risk-taking, and assumption
of ultimate responsibility for overseeing the management of risk;
arguably somewhat different perspectives, leading perhaps to a
more stringent standard. The supervisors' perspective is reinforced by survey evidence reported under Recommendation 16 that senior management is "worried about its own lack of understanding... and about overreliance on a few specialists."

- With respect to market valuation models (Recommendation 3), more guidance would be useful since bid and offer prices for many products, especially options, must be determined by statistical models, subject to specification error and judgemental inputs.

- Valuation based on mid-market levels less adjustments (Recommendation 3) may lead to inconsistent reporting without greater agreement on the adjustments that are necessary and how to perform them.

- Although "value at risk" is, in my view, the best approach to measuring market risk (Recommendation 5), the one-day time horizon might be given more thought. Despite daily marking to market, for some products it may be unrealistic to assume large positions can be promptly liquidated without substantial adverse market impact. Although stress tests (Recommendation 6) are important and useful, they seem to be focused on contingency planning for extraordinary conditions, rather than routine risk management for less liquid products.

- The report strongly and in my view, correctly, endorses an independent risk management function (Recommendation 8), then notes that "the risk management function is rarely involved in actual risk-taking decisions." This invites an obvious question. If involved at all in risk-taking, how can it be independent? Left unaddressed is the compensation dilemma. If risk managers do not share in the benefits of risk-taking, how can they be compensated adequately to avoid migration of the best personnel to risk-taking functions? But, if they reap the benefits of risk-taking in some direct manner, how can they truly be independent?

- The recommendation on systems (Recommendation 17) seemed less forceful than the Subcommittee report (Appendix 1, Section 4), which makes an excellent case for the importance of strong back-office systems in view of the complexity and diversity of the derivatives business. Shouldn't adequate systems be in place before new activities are pursued in scale?

- The greater scope for deferral of losses under "risk management accounting" (Recommendation 19) could be subject to abuse, especially if the amount of deferred losses is not disclosed.
Finally and importantly, one wonders whether the recommendations on disclosure (Recommendation 20) go far enough to address the serious deficiencies that the study notes. Noticeably absent from recommended disclosure is a summary measure of market-risk exposure.

On the other hand, a very useful aspect of the recommendations on accounting and disclosure is the affirmative view that the industry should move ahead on its own to strengthen these areas, and not wait for the accounting profession, not known for rapid response to change, to mandate progress.

And I was especially gratified that the recommendations imply that certain dubious practices should be abandoned. Examples of these discredited practices include "limited two-way payments" (walkaway clauses as regulators see them) which could jeopardize the orderly wind-down of a troubled dealer and so-called "guard-slam netting" of receivables and payments which grossly understates credit exposures.

The report also sounds an appropriate note of caution about the potential adverse impact on liquidity of contractual unwind provisions based on a downgrade in a counterparty's credit rating or on a material adverse change in its financial condition. Indeed, even in the absence of such provisions, supervisors of regulated entities may encounter significant difficulties dealing with weak and failing institutions active in derivatives.

The strengthening of policies and procedures for dealing with such situations is a regulatory task not listed in the report.

Despite criticism of some of the specifics, the chief strength of the report is its emphasis on an independent risk management function responsible for an intensive, at least daily, mark-to-market approach to the measurement and management of risk exposure with rigorous market risk limits and stress simulations. As a set, the report's recommendations do constitute an important and useful contribution to developing practice in this market.

Implementation

Looking to the future, the study suggests two central questions. First, how widely are the recommended practices employed by active market participants? And, secondly, what mechanisms, both regulatory and self-regulatory, are available or need to be developed to encourage firms to adopt sound risk management practices consistent with these recommendations?

On the first question, the recommendations are anything but a sanctification of the status quo. With respect to the match between recommendations and current practices, the findings of the study are decidedly mixed. The Survey of Industry Practice suggests that most ex-
users and many dealers do not follow all (or, in some cases, very many) of the report’s recommendations. The clear implication is that, as far as implementation is concerned, much work lies ahead of this industry.

Nonetheless, an answer to the second question, the issue of implementation, seems noticeably absent from the report. Despite a tone that some may find sanguine, these are not timid recommendations; they are, in part and in sum, an ambitious approach and require a substantial commitment of financial resources and expertise to the process of risk management.

As the report indicates, implementation of the recommended portfolio approach to risk management has required the most sophisticated dealers to make substantial investments to integrate back-office systems for derivatives with front-office systems for derivatives as well as with other risk management systems.

The report also notes that implementation of such an approach requires a new breed of specialized, qualified operational staff. This implies substantial training costs. It also requires development of new compensation policies adequate to attract and retain staff in areas that are not typically seen as profit centers.

One wonders whether we can depend solely on the forces of managerial responsibility and market discipline as sufficient incentive to motivate firms to incur these implementation costs. The cost and difficulty of implementing the recommendations seem to offer a powerful motive to find excuses for avoiding implementation. Nonetheless, the report does not discuss the appropriate mechanisms to encourage implementation of its recommendations.

Also absent from the report is a clear statement concerning what types of firms need to implement which specific recommendations. In fact, the study offers the caveat that the recommendations "are not necessarily the only means to good management." No doubt that is true. I myself would take issue with some of the details. But, it would seem that an inarticulate implication of the study is that every active dealer should study the recommendations carefully and implement each one unless it can demonstrate that it employs an equally effective means of achieving the risk management objective to which the recommendation is directed. If this is not implicit in the report, then a clear and rigorous delineation of which firms need to do what would have been useful.

Regulation. Central banks, regulators, and supervisors must do their part and, I am confident, will do their part to ensure implementation of sound risk management procedures consistent with the conclusions of the report as well as to strengthen the legal and regulatory infrastructure for derivatives activity.
• We must continue to work to strengthen the legal framework for derivatives in the United States and abroad. As many of you know, the Federal Reserve has supported past legislative efforts to ensure enforceability of netting contracts under US law. For example, acting upon authority provided by legislation that we supported and Congress passed in 1991, the Board has proposed to expand the coverage of provisions legally validating netting contracts to include contracts between all active dealers in OTC derivatives, including affiliates of securities firms and insurance companies as well as banks. And we have worked to ensure that US commodities laws cannot be used to challenge the legality of OTC derivatives transactions among institutional counterparties.

• We must ensure that inconsistencies and uncertainties in tax laws and regulations do not inhibit the use of derivatives for risk management.

• We must continue to push for modernization of accounting and disclosure standards to address the new products and new risk management techniques that have emerged.

• And, we must promptly implement the recent proposal by the Basle Supervisors to recognize, in capital adequacy standards, the risk-reducing benefits of legally enforceable netting arrangements.

• Finally, and perhaps most importantly, we must continue to improve our supervisory policies and procedures for regulated financial institutions and build supervisory expertise in light of the report’s recommendations.

In my view, there is clearly no simple, mechanical mapping of the report’s recommendations into supervisory standards. We must be concerned about efficiency and flexibility in the regulatory process. Regulatory micromanagement would be particularly counterproductive in this innovative marketplace. The appropriate focus of supervisory standards derived from public policy fundamentals is not identical to the perspective of the report—that of the private sector practitioner. Thus, compared with the report’s recommendations, appropriate supervisory standards are likely to be different and in some specific dimensions perhaps somewhat more stringent. Nonetheless, this study provides a most useful input to the ongoing process of developing sound supervisory standards and practices for derivatives. In this respect, I share the hope and expectation, expressed by former Chairman Volcker in his foreword to the study, that market practices and regulatory practices can be harmonized.

The Role of Self-Regulation. Of course, central banks and regulators alone cannot ensure implementation of sound risk management by all
relevant parties. As the report notes, some major dealers are not subject to regulation nor are most end-users. Thus, I believe the industry generally should do its part to encourage implementation.

As to the role of the Group of Thirty in fostering implementation, one can’t help but note the contrast between this report and the Group of Thirty sponsored study of securities clearance and settlement systems. In the latter case, the report set a timetable for implementation of its recommendations and created a secretariat to monitor implementation efforts in more than a dozen countries.

To be sure, implementation of the clearance and settlement recommendations may inherently require a higher degree of coordination and cooperation among market participants. Nonetheless, I think the excellent quality, timeliness, and importance of this report argue for the Group of Thirty to promote implementation of the recommendations by market participants. The presentations at this conference by Dennis Weatherstone and others who contributed to the study constitute a good first step toward the goal of widespread implementation. Serious thought should be given to how the momentum created by this effort and the release of the report can be maintained, perhaps through periodic surveys of industry practice or other monitoring mechanisms. ISDA may wish to consider its appropriate role in this process as well.

Other Public Policy Issues

Turning now from the specific focus of the report to broader issues, the industry, whether through the Group of Thirty Study Group, through ISDA, or by other means, needs to do its part to ensure that the full range of public policy concerns about derivatives are addressed. Those concerns extend beyond the sound management of individual firms, the primary focus of the Group of Thirty study, to include not only systemic risk issues but also the traditional concerns of market regulators—market integrity, customer protection, and market transparency.

What other avenues might market participants explore to reduce systemic risks? An example might be the discussions among some market participants examining the potential benefits of a clearing house for OTC derivatives. However, such a multilateral netting facility would not necessarily reduce systemic risk. The report correctly notes that a clearing house would concentrate credit risks in the central counterparty. The impact on systemic risk would be determined primarily by the quality of the risk management structure employed by the clearing house.

Provided that the clearing house adopted a sufficiently robust risk management system, systemic risk could be reduced. Useful guidance on the appropriate credit, liquidity, and operational safeguards for
such a clearing house are provided by the standards outlined in the Lommidnes Report on netting systems published by the Bank for International Settlements (BIS) in 1990. If market participants chose to develop a clearing house, a by-product would be the centralization of information about market prices and transactions. This might provide a cost-effective means of addressing concerns expressed by some about market transparency that are deemed necessary or desirable.

Moreover, the industry also needs to be alert to the possibility that more attention may be focused on other public policy issues such as customer (or investor) protection issues. My approach to the customer protection issue would be to start with the fundamental concerns of public policy and derive policy prescriptions from a careful and rigorous assessment of the need to achieve specific public policy objectives in an effective and efficient manner. Who are the participants in these markets? Are they unsophisticated parties in need of protection? If market participants are sophisticated institutional investors what (presumably very different) investor protection measures are appropriate? Do existing regulatory frameworks, for example banking and securities regulation, provide the necessary protection? If not, how can it be provided most efficiently and effectively? Applied to derivatives activities, essentially a wholesale business among institutions, this conceptual approach would seem to elicit very little concern about customer protection public policy issues in the derivatives markets.

However, the industry should be aware that this approach to customer protection issues may not be fully shared by all those in influential public policy positions. There is intense interest in investor and customer protection issues in the public policy arena. Much of securities regulation and many recent initiatives in futures regulation have been motivated by the desire to protect investors. Although users of derivatives products mostly are institutions, they are not necessarily sophisticated institutions. The report highlights the legal risks of dealing with a counterparty that is legally incapable of entering into a contract (i.e., ultra vires), but it does not address the political risk of entering into a contract with a counterparty that may be viewed, rightly or wrongly, as incapable of understanding the risks entailed. We have had notable examples of this in the government securities market. In an analogous fashion some may ask this industry to develop and promulgate suitability standards for transactions with end-users (e.g., local governments) that may be viewed by legislators as unsophisticated and in need of protection.

In the United States, at least, market participants have ample motive to address the full range of public policy concerns that I have noted. They need only look to the recent history of the banking industry or to the ongoing battle over regulation of the government securities
markets to convince themselves that if the industry does not assume the responsibility for addressing public policy concerns and do this job well, others are quite willing to take discretion out of the industry’s hands and do the job perhaps much less well.

Conclusions
I have ranged far afield from the narrowly stated purpose of reviewing the Group of Thirty-sponsored study of derivatives, and let me now return to it to sum up. In my view, the Group of Thirty study is an excellent effort. The focus is on the right issues. The recommendations are comprehensive and, by and large, compelling. I share the study group’s conviction that the derivatives markets provide important benefits to the financial system and the economy. However, to continue to be successful, the derivatives market must, in my view, develop in a manner consistent with sound risk management principles, and this study constitutes a ground-breaking contribution to that end. While the report provides an excellent blueprint, it is clear that recommendations are not reality, and the important task of implementation lies ahead. In the public policy arena, we at the Federal Reserve are committed to doing our part to ensure and enhance the efficiency and integrity of this important market.
Derivatives—Where Next for Supervisors?

By Brian Quinn

(Director, the Bank of England)

One thing which I think we need not fear is that derivatives as a subject will suffer from benign neglect. The markets, the media, the industry, and the regulators have all had their say in recent months, and the volume of paper generated on the subject, like derivatives themselves, has to be subject to a substantial discount to the nominal amount to get to the underlying issues. I do not think this is a bad thing necessarily, first because the various parties come at the subject from somewhat different angles of attack. Both the Group of Thirty Report and the study conducted by the Bank of England and published earlier this year have concentrated on identifying possible problems and looking for remedies primarily at the level of the individual firm. The work done by the BIS—notably the Promised Report—and by The Federal Reserve have looked more closely at implications for the financial system.

Secondly, if, like me, you believe that the truly dangerous phenomena are those that sneak up on you without either the analysis or the data required to detect them being available, then there is some comfort to be drawn from the attention that derivatives have received. There seems to be a good prospect that we will have the subject surrounded before it can do too much damage. I hope you will not think that I am making this into an infallible rule of the supervisor; there are always exceptions. Nor does it mean that there is not work still to be done on derivatives, and it is part of the work of this Seminar to get clear in our minds what that might be.
Group of Thirty Report—Areas of Agreement

The Bank of England study on derivatives appeared in April this year, some three months before the publication of the Group of Thirty Report, and it is therefore useful to look for a moment at the two together since, as I have indicated above, they both approach the subject from the viewpoint of the individual firm: the Group of Thirty Report from the viewpoint of the practitioner and the Bank of England study from the viewpoint of the supervisor of banks.

The first and most striking thing is the broad measure of agreement between the two reports on some of the principal findings. The Group of Thirty Report and the Bank of England study find there are no fundamentally new or different risks in derivative products, rather that familiar kinds of risks are presented and combined in novel ways. Both reports identify the main areas of risk—counterparty risk, valuation methods, etc.—and attach broadly the same order of priority to them.

The complexities are recognised but are not thought to represent an insuperable problem. The Group of Thirty Report also makes explicit what is implicit but nevertheless clear in the Bank of England study, namely that the primary responsibility for understanding and managing these products lies with the management of the individual firm.

I make this rather obvious point because it was by no means quite so obvious when the first Basle Capital Accord appeared in 1988. The first reaction of many institutions to that exercise was to incorporate the capital weights unquestioningly into their own management decisions, whereas a large part of the intention was to prompt management to think about the relationship between risk and capital in a more consistent and systematic way. It seems to me that the Group of Thirty Report has started from the correct premise in that it proposes that management should itself be thinking through the risk characteristics of derivatives and not awaiting the supervisory response. I think this is a healthy approach. It may lead to disagreement between the parties for a period, but there is much common ground between the supervisors and the practitioners and I do not therefore believe we face negotiations of Balkan dimensions.

Recommendations for Regulators

It might be useful if I comment on each of the four recommendations to legislators, regulators, and supervisors in the Group of Thirty Report offering, where possible, some indication of the outlook. On the question of capital adequacy, regulators and supervisors have, as you will know, published a Consultative Paper which expands the scope of the original Basle Capital Accord to encompass all off-balance sheet transactions,
including derivatives. These proposals, on which comment is invited by end-December, are very similar to those in the Capital Adequacy Directive recently approved in Brussels and coming into effect from January 1996. It is a matter of regret that the securities supervisors represented in IOSCO were not able to reach agreement amongst themselves on the subject. But I certainly have not abandoned hope that they will do so, sooner rather than later. The Basle Committee are also fully seized of the importance of recognising the effectiveness of netting agreements.

Perhaps the most important thing to say here is that the supervisors are not dragging their feet and start with a good prior understanding of the issues. The proposals on capital adequacy came only after very detailed discussions with the industry. This should simplify and speed up the dialogue. The report on netting by the Lamfalussy Committee, published in 1990, carried out a very thorough analysis of the subject and recognised the contribution that it could make both to the efficiency of the financial sector and to the reduction of systemic risk. It also pointed out the dangers of resting supervisory treatment on insecure assumptions about the robustness of netting agreements and, in particular, about their vulnerability to legal challenge.

This takes us quite naturally to Recommendation 22 of the Group of Thirty Report relating to the resolution of various legal and regulatory uncertainties. Here again I can say that the supervisors, both nationally and internationally, are working hard to address the uncertainties identified in that recommendation.

One difficulty here is that, for the most part, the response has to be country by country; and the system of law, and the procedures for changing laws, may vary quite considerably. The Group of Thirty Report notes that England has a well-developed system of commercial law; that English law is used very widely by derivatives dealers; and that our jurisdiction gives rise to very little concern in the market. Nevertheless the UK system is not free from legal risk. We have decided, therefore, to determine whether greater certainty can be achieved for our legal and regulatory arrangements without going through the time-consuming and sometimes inflexible route of legislation. The establishment of the Financial Law Panel, chaired by Lord Donaldson, former Master of the Rolls, aims to provide an authoritative opinion, drawing on the expertise of distinguished legal and market practitioners whose doubt may exist about the state of the law on particular commercial classes of transactions. Two of its early subjects are iron, and the enforceability of bilateral close-out netting in the UK, two of the issues identified in Recommendation 22. Netting is taking highest priority, and we hope that the FLP will be able to make a statement on this subject very soon. Such a statement will not have the force of law but,
given the process of consultation that is involved and the very high reputation and standing of its members, there is every reason to think that the Courts would weigh very heavily the views of the Panel in any case coming before them. Indeed it might be argued that statements from such a body might, in the case of certain subjects, be preferable to legislation the wording of which may defeat or delay the Parliamentary draftsman.

I do not have a great deal to say on Recommendation 23 which deals with the tax treatment of derivatives. I do not suppose I would be believed if I said the word "sympathetic" in describing the attitude of the tax authorities anywhere to requests for accommodation on such things, but I do not believe that they are mindless of the risk that derivative products are highly mobile and potentially migratory and that the existing fiscal yield could actually be reduced if the climate were to become relatively unhelpful.

So far as the UK is concerned, I can report that there is a regular and constructive dialogue between the regulators, supervisors, and those responsible for setting accounting techniques and standards. The Accounting Standards Board is already working hard to bring greater consistency to the treatment of all financial instruments and activities. The institutional arrangements for improving accounting practices and accounting standards in the UK have undergone considerable change recently, and it is evident that among the issues occupying the attention of the Board the evaluation of financial transactions figures high on their agenda. Getting cohesion internationally is a more difficult problem.

Nevertheless, as the Report notes, the IASC is already well advanced in finalising accounting standards on financial instruments. But the accounting bodies have a great deal on their plate, and it would be unrealistic to look for definitive results too soon on the treatment of derivative products.

**Derivatives and System Risk**

The Group of Thirty Report suggests that because derivatives do not introduce risks of a fundamentally different kind and greater scale than those already present, systemic risks are therefore not appreciably aggravated, and that supervisory concerns can be addressed within the present supervisory framework. I have to say this strikes me as somewhat complacent. On a general point, there seems to me to be a sense in Part V of the Overview that experience so far, and the related research, do not appear to throw up any serious problems. I would myself lay heavy emphasis on the words "so far." These are early days for derivatives and it is not yet clear whether they will follow what I will call the LDC path or the LBO path. In the former case, the favourable risk/reward
ratio in the early phase attracted many new entrants, on both the
borrowing and lending sides, in a great rush. That rapid expansion did
two things. First, it moved both the numerator and the denominator in
the ratio sharply against the banks. Secondly, it took place over a period
when the availability of data to track this development and its means
of transmission were not available. In particular, data on the role of the
interbank market in the expansion of LDC lending ran well behind the
expansion on the ground.

By the time the full dimensions of the problem became apparent it
was almost too late. It was a close run thing and only the efforts of your
Chairman today, together with a few of his closest associates, avoided
a real catastrophe. In the case of LBOs, by contrast, the rapid growth in
the use of the instruments was matched by an early awareness of their
risks, by accurate and timely reporting of the exposures and by clear
regulatory guidelines for the main participants. Perhaps most important,
the risks were diffused and the involvement of individual institutions
did not outrun the supply of skills required to conduct the business
with prudence. This latter point is, I think, important. Expertise in
derivatives trading is limited. If the demand for this new source of
profit should expand more quickly than the supply of people capable
of doing the business there can only be trouble ahead. Derivatives
trading is for grown-ups.

Let me now turn to some of the particular potential causes of
systemic risk taken up in the Group of Thirty report about which I
would like to make some observations.

Concentration, Illiquidity, and Regulated Entities

In support of the argument that concentration is not a problem, the
Report quotes a survey indicating that the top eight dealers accounted
for only 58 percent of the interest rate and currency swap markets at the
end of 1991; and that no firm had over a 10 percent share of the market.
It goes on to state that there are three times as many ISDA dealers as
there are primary dealers in US Government bonds. I am not altogether
sure how much comfort these statements give. First I have some
questions about the scope of the survey. Secondly the market in
Government bonds is, of course, carefully regulated by the Federal
Reserve and is a centralised market. A better comparison might have
been between the markets in derivatives and those in foreign exchange
which are both OTC. The 1992 London Forex market survey concluded
that the 10 most active principals have a combined overall share of 43
percent, while the top 20 account for 63 percent. These figures suggest
a materially higher level of concentration in the derivatives markets,
which are much newer. In the Bank of England study we found a
diversity of opinion over whether counterparty concentration was a
concern. We were also told that the limited number of counterparties was bringing firms fairly quickly against their individual credit limits, suggesting that an expansion in the number of market participants would be both welcome and healthy. But of course I recognise a tension here with my earlier remark about the necessary skill base.

I also find myself unpersuaded by the statement in the Report that the liquidity of derivatives transactions has been successfully tested by several situations of failure by large participants. I believe that this statement rests on a piece of research which looked at the cases of DFC New Zealand, Bank of New England, British and Commonwealth Bank, and Drexel Burnham Lambert; I hope I will not offend anyone by suggesting that the derivatives portfolios of DFC and BCB fall some way short of what I would expect of a large participant. The portfolios of swaps and similar transactions at each of the other two institutions amounted to around $30bn notional principal. I accept that this would qualify them as large-ish, but would also point out that the regulators were heavily involved either as managers or facilitators in ensuring that the demise of both institutions caused as little disruption as possible to the market. In a word, I am not at all sure the market has been faced with a surprise in the form of an unexpected failure of a large participant in derivatives trading.

It would be nice to think that test may never arise, and it is reasonable to ask the question whether the system should be designed and regulated to cope with events which occur once every couple of decades? I would contend that it would be reasonable to answer “yes.”

I suppose the sentence which struck me most forcibly in this section of the Report was the one which states that participants can evaluate for themselves the risks and benefits of trading with unregulated entities. As a robust statement of the efficient markets hypothesis this is unexceptionable; but to those charged with the responsibility of ensuring the safety of the system and providing some protection to investors and depositors, it certainly makes one stop and think. A good deal of the work of the banking and securities regulators in the last decade has been devoted to what we have called mapping exercises: identifying institutions which carry or communicate such risks and trying to ensure that they are subject either to adequate supervision on a consolidated basis or, at least, to close surveillance. The damage limitation which marked the Drexel affair was, as I have already indicated, partly explainable by the fact that the market itself could see what was coming, but also because of the vital efforts of the Federal Reserve to ensure that the fall out was contained. I myself can see no justification for the failure to include in consolidated supervision the
activities of wholly-owned unregulated subsidiaries of banks, securities, or other financial companies conducting derivatives trading.

There is, then, the question of market linkages. It is not difficult, given the characteristics of derivatives, to see that failures and shocks could in principle be transmitted faster and further than hitherto. The Report draws comfort from academic research indicating that derivatives trading does not increase volatility in underlying markets. I do not disagree with this statement as it stands, but I would be more comfortable if the evidence on which it was based was more widely drawn.

Let me therefore repeat two of the recommendations from the Bank of England study:

- that research into the relative price volatility and liquidity of cash and derivatives markets should be conducted, with a view to improving our understanding of the increasing links between financial markets, and their potential systemic implications;
- that the Bank, in consultation with the FSA and the market participants, considers which data on exchange-traded and OTC derivative markets it is desirable to collect for the purposes of examining market size and the degree of concentration, and subsequently considers establishing a survey of the derivative markets comparable to that already conducted for forex activity.

Finally, if one were to put these three or four observations together a rather frightening picture could emerge: the unexpected failure of a large, unregulated derivatives specialist operating on a significant scale in a number of markets. That to do this would be to exaggerate my concerns. This is partly because problems seldom come at you in the way in which you expect and partly because of my earlier observation that both participants and regulators are fully awake to the possible sources of disturbance. So I do not offer this vision either as forecast or as an attempt to foreshadow a heavy-handed treatment of derivatives activities by the regulators. I say only that there is further work to be done on several aspects of the new section of the Group of Thirty Report, and I am quite sure that Sir Dennis Weatherstone and his colleagues would find themselves in agreement with that.
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