118

DERIVATIVE FINANCIAL MARKETS (Part 1)

Y 4. EN 2/3: 103-118

Derivative Financial Markets, (Part...

HEARINGS

BEFORE THE

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

OF THE

COMMITTEE ON ENERGY AND COMMERCE HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

MAY 10, 19, AND 25, 1994

Serial No. 103–118

Printed for the use of the Committee on Energy and Commerce

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DERIVATIVE FINANCIAL MARKETS

TUESDAY, MAY 10, 1994

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:37 a.m., in room 2123, Rayburn House Office Building, Hon. Edward J. Markey (chairman) presiding.

Mr. MARKEY. Good morning and welcome to the Subcommittee on Telecommunications and Finance.

This morning the subcommittee is holding the first in a series of hearings focusing on the growth of derivative financial markets and their impact on the U.S. and global financial system. Derivatives are financial products whose value is dependent on or derived from the value of some underlying financial asset, such as a stock, bond, or a foreign currency, commodity, or an index representing the values of such assets.

Some derivatives have been around for many years, such as the exchange-traded futures and options used by investors and dealers seeking to hedge positions taken in the stock or bond markets, or to speculate on future market movements.

Within the last few years, however, exchange-traded futures and options have been supplemented by a vast and dizzying array of over-the-counter derivatives. These include forwards, swaps, options swaptions, caps, floors, and collars, that may be linked to the performance of the Japanese stock market, the dollar-Deutschemark exchange rate, the S&P 500, or virtually any other assets. Today, the total outstanding value of the principle underlying such over-the-counter derivatives is estimated to be over $12 trillion.

The dynamic growth of the over-the-counter derivatives market is the direct result of developments in computer and telecommunications technology and breakthroughs in modern portfolio management theory. Using these tools, Wall Street's new generation of "quants" and rocket scientists have sought to turn the art of trading into a science. By breaking down price movements into individual "deltas," "gammas," "thetas" and "vegas," dancing across the computer screen, the quants literally have created a new world of cyber-finance, that is reshaping U.S. and global financial markets.

While these innovations offer great promise, there may also be a dark side to the world of cyber-finance. The concentration of market-making functions in a small number of large banks and securities firms, the close financial inter-linkage derivatives have created

between each of these firms, and the sheer complexity of the products being traded raise serious concerns about the potential for disruptions in the fabric of our financial system.

Nearly 2 years ago, senior investment banker and Wall Street guru Felix Rohatyn warned that "26-year olds with computers are creating financial hydrogen bombs." Today, we must ask ourselves whether Wall Street's young rocket scientists, like the old Tom Lehrer song, have concluded that "I just shot them up, I don't care where they come down, that is not my department, says Wernher von Braun."

If we are to prevent misuse or mismanagement of derivatives from igniting a chain reaction of losses or defaults that drain liquidity from our financial markets, we must see to it that those whose department it is to worry about such matters, the regulators, have the tools needed to detect and to respond to crises. We must have reasonable confidence that they will be able to avert or contain any damage to the operation of the financial system that might result from the use of derivatives, including any damage resulting from the activities of the largely unregulated derivatives dealers owned by securities firms, nonbank financial firms, or insurance companies.

Moreover, recent derivatives-related losses have raised concerns about the adequacy of internal controls and risk management at both dealers and users. We must ask senior management and the dealers if they really understand what the 26-year-old rocket scientists are doing with the firm's money. And what about the management boards and audit committees of the public companies, pension plans and mutual funds and other institutional investors in these markets, are they adequately monitoring their derivative activities?

And finally, derivative losses by Proctor & Gamble, by Marion Merrill Dow, by Gibson Greetings and Dell Computer have focused renewed attention on the disclosure and accounting treatment of derivatives. Investors and creditors rely on companies, SEC filings, to provide disclosure of all material investment information, including financial reporting that adheres to Generally Accepted Accounting Principles. Unfortunately, when it comes to derivatives, there are big gaps in GAAP. As a result, investors who thought they were buying stock in a consumer product company like Procter & Gamble, may not have fully understood the extent to which the company was also speculating heavily in derivatives.

Today, the subcommittee will be receiving testimony from three extremely distinguished witnesses from the financial services industry who have had extensive experience in this field. This hearing represents an important step in assisting the subcommittee in determining whether changes in regulation or the adoption of remedial legislation is necessary. Later this month, we will receive the General Accounting Office report on the findings and recommendations of its investigation—conducted at the request of this subcommittee nearly 2 years ago—into the growth and regulation of the derivatives markets. The following week, we will be hearing from each of the Nation's top financial regulators.

I want to thank each of the witnesses for appearing here today. That concludes the opening statement of the Chair.

I now turn and recognize the gentleman from Ohio, Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

I want to commend you for calling these hearings on the important subject at hand.

In 1993, a study of derivative practices and principles was conducted by a distinguished collection of the world's financial executives and academicians, the global derivative study group of the "Group of 30." One of our witnesses today, Dennis Weatherstone, chaired the study group at the request of Paul Volcker, chairman of the "Group of 30."

The study reported that over 44 percent of the private sector corporations consider controlling risk with derivatives imperative, and 37 percent consider it important. Roughly, 87 percent of the corporations surveyed used interest rate swaps, while 64 percent used currency swaps, and 78 percent used forward foreign exchange contracts.

The study makes it clear that to survive in business today, most companies recognize the need to develop expertise in using these important risk management products.

At times, Mr. Chairman, the media attention given the arcane and technical subject of derivatives reminds me of the coverage given the circus coming to town when I was a boy. When examining the press reports of instances in which derivatives have led to some earnings losses, I find myself harkening back to that campaign question of a few years ago, "Where's the beef?"

Managers of American corporations receive information every day about the markets in which they do business. Whether it is in the market for the commodities which they fashion into finished products or interest rates for the money they borrow, the receipt and the application of this information is an important part of their jobs.

It does them no good, for example, to see the profits from the sale of their products disappear as a result of adverse interest rate or foreign currency fluctuations. As the G-30 study clearly shows, it is a regular practice for management to position some investments to hedge against adverse interest rates or currency movements. At times there will actually be opportunities to profit in anticipation of expected interest rate or currency movements, and as management becomes aware of these business opportunities, they may decide to weight their investments and take a speculative position.

If the investment decisions ultimately prove to be unsuccessful and the company loses money in some trades, that is an ordinary and inevitable consequence of accepting business risk. No one makes money on every business transaction. Judging from the size of the market and the relative infrequency of reports of any sizeable losses, for the most part the risk assumed and losses and gains sustained appear to be within acceptable ranges.

The issue of management accountability in these cases must turn around, whether the size of the speculative position was too large to be responsible, and whether the capital and profitability of the company was large enough to afford a loss if it occurred. In one well-reported case, Procter & Gamble, headquartered in my home State, lost $150 million or $102 million after taxes in a derivatives transaction.

The company had $584 million in earnings for the quarter, in which the money was lost, and $1.9 billion in earnings for the three-quarters of the current year that have been reported. I do not believe that a loss by a well-capitalized company that was profitable both before and after the transaction, should be any more concern to Congress than losses the business might have suffered from any other type of transaction in which it might engage. There is nothing unique about derivatives.

While I am sorry to see any American businesses lose money, I do wonder what Congress can be expected to do. Are the securities markets for American corporations so inefficient that those companies cannot be allowed to decide how they want to put their capital at risk, and in so doing accept responsibility and answer to their shareholders if the strategy does not perform?

In the name of protecting shareholders, should Congress micromanage American business and actually get involved in day-to-day business decisions concerning the costs of hedging raw materials, adjusting interest rate exposure on borrowings, or deciding the most efficient and least costly methods of securing foreign exchange to carry on international trade?

I think not. Even our traditional favoring of regulatory disclosure must be approached cautiously. If shareholders are entitled to disclosure of their derivatives activities of their company, at what level are the amounts material?

Will we turn the SEC into the invisible member of every board of directors in this country? Will we involve the government in every business decision under the rubric of disclosure of risk, when in reality we have required disclosure of a management decision-making process?

Change makes some uncomfortable because it involves the exploration of new frontiers. Derivatives are meeting the important need of American corporations and financial institutions to manage the risk of the worldwide marketplace.

They also provide these companies with new opportunities for trading revenues earned by accepting additional risk in the hope of earning additional returns. Without risk, there is not profit. We must not let the inevitable losses that appear in all evolving financial markets lead us to interfere with that evolution.

I thank the Chair. And before I yield back the balance of my time, I ask unanimous consent that the opening statements of the gentleman from California, Mr. Moorhead, and the gentleman from Texas, Mr. Fields, be made part of the record at this point.

Mr. MARKEY. Without objection, so ordered. The gentleman's time is expired.

[The prepared statements of Mr. Moorhead and Mr. Fields follow:]

STATEMENT OF HON. CARLOS J. MOORHEAD

Thank you, Mr. Chairman. I too commend you for holding this timely hearing on the issues surrounding over-the-counter derivative financial products. Recent fundamental changes in the global marketplace—for example, the increased volatility of interest and currency exchange rates—have sparked the development and rapid growth of the derivatives business.

Today, by any measure, derivatives are a major financial activity. The derivatives market already is a multi-billion dollar business and it is still growing. Clearly, a

business that has grown so quickly must be providing the marketplace with desirable products and valuable benefits.

Through derivatives, U.S. and foreign corporations, governments, financial firms and other institutions have been able to reduce exposure to fluctuations in interest rates, currency exchange rates and equities and commodities prices. Derivatives also have enabled end-users to reduce their costs of funding.

This is a market that is meeting a demonstrated need and it is one that is here to stay. The continued globalization and complexity of the commercial and financial markets mean that more and more corporate treasurers and fund managers will realize the need for some hedging and learn how to go about it.

The rapid growth and increasing sophistication of derivative products reflect not only the creative methods end-users are utilizing to understand and manage financial risk.

More importantly, they also reflect the innovative capacity and entrepreneurial spirit of the financial firms, in particular the U.S. investment and commercial bankers, who are responding to customer demand.

Congress would be less than prudent if it did not take a long and hard look at the issues surrounding the burgeoning market for over-the-counter derivative products.

Nevertheless, there is one overriding principle that we must remember throughout the process of these hearings and in the development of any new regulations. That is, that the appropriate role of Congress in the derivatives industry, as in the securities industry generally, is one of oversight, not micromanagement.

We must be very careful to ensure that the benefits of this developing and complex industry are not lost in a zeal to regulate.

Statement of Hon. Jack Fields

Thank you Mr. Chairman. When the cause of savings and loan failures in the 1970's was examined, and the frauds and mismanagement were taken into account, it was clear that a fundamental business problem contributed to their demise.

Savings and loans borrowed short term to lend long term. This placed them at the risk of adverse movements in interest rates, and indeed many institutions found themselves slowly being choked to death when rates rose dramatically during the Carter administration.

Thrift managers with portfolios of 30-year fixed mortgages earning 7 percent were paying interest of 10, 12 percent and more to depositors and certificates holders. Many felt forced to stop acting like savings and loans, and instead ran their institutions like real estate developers or high yield bond traders. The rest, as they say, is history.

In the late 1980's the financial community developed revolutionary new products to supplement exchange traded options and futures. The new Over-The-Counter derivatives, instruments that could be tailored to the needs of the investor, permitted lenders to break out of the interest rate trap.

Using OTC derivatives, it became possible to swap some amount of long-term fixed rate obligations, for short term or variable interest rate income streams. For the first time, it became possible for a lender whose portfolio was overexposed to long-term interest rate risk, to adjust its risk without selling off its assets. Having lived through the financial inflexibility that led to the savings and loan crisis, is it any wonder debt managers embraced derivatives, and in a few short years hedged billions of dollars of their assets with them?

The market for derivatives developed because it provides a way to lower borrowing costs for financial institutions. This translates into lower charges and more availability of credit to homeowners and businesses. OTC derivatives are also a key element in expanding exports because they provide a way for manufacturers to hedge against adverse movements in foreign exchange markets. More exports mean more jobs for American workers.

Non-traditional products create non-traditional challenges for Congressional oversight. One issue that must be addressed by this subcommittee is what is the appropriate regulatory scheme for derivative product companies formed as affiliates of SEC registered broker-dealers. Although not currently subject to SEC regulation, a supervisory regime, perhaps even a voluntary regime, based upon reporting information to the SEC to allow it to evaluate risks undertaken by these firms and how they are controlled, might be appropriate.

Similarly, the development of industry standards for investor protection, and development of a process for assessing capital adequacy based upon risk evaluation models used by the firms themselves should be considered. Finally, enhancing finan-

cial statement disclosure to accurately reveal the risk profile of derivative dealers should be explored.

I particularly encourage members of the subcommittee to support industry voluntary or self regulatory initiatives that make the heavy hands of legislation and government regulation unnecessary. Above all, we must avoid imposing regulation on financial institutions under our jurisdiction that will place them at a competitive disadvantage to entities, both foreign and domestic, that are not subject to our oversight.

As the experience of the Eurobond market shows, it is possible for Congressional errors to move financial markets overseas. I, for one, do not want to build markets in London and Frankfurt with business that could have been done in the United States.

We must ask ourselves what is unique about these instruments that requires a regulatory structure outside of the one that exists today. Bank, commodities, and securities regulators are actively considering adopting guidelines and possible regulations concerning derivative trading. That process should be allowed to run its course without interference.

Certainly, there have been losses in derivative transactions, some of them large enough to attract the attention of the press. It is inevitable, however, that in billions of dollars of transactions some will result in millions of dollars of losses. As a ship's captain cannot protect the safety of the crew by refusing to leave port, acceptance of some losses to business risk is an unavoidable part of commerce. Dealing with that risk is a ordinary part of corporate management.

Unlike the earlier examinations by this subcommittee that led to market reform and banking reform legislation, and investigations that occurred because of record numbers of bank failures or the historic drop in the stock market in 1987, in the case of derivatives, we are examining a market that seems to be functioning well.

We must be careful not to see only risk and be blind to the opportunities that exist in effectively managing and in, some instances, accepting risk. The development of the derivatives market is an American success story, and we must do everything possible not to interfere with its natural evolution.

I look forward to the testimony of our distinguished panel today, and yield back the balance of my time.

Mr. MARKEY. The Chair recognizes the gentleman from Oklahoma, Mr. Synar.

Mr. SYNAR. Thank you, Mr. Chairman.

Let me also join with my colleague from Ohio and commend you for this very timely and important hearing. I think it is appropriate at this moment that Congress exercise its constitutional responsibility to do oversight in a clearly growth industry that is having a tremendous impact not only here but around the world through the financial derivatives.

It is only appropriate that Congress ask the question: Should we be regulating this industry, and what is appropriate regulations for these types of derivatives? Should they be market wide? Should they be focused towards dealers or users?

And, obviously, as we have this discussion and investigate these financial derivatives, our goal must be to try to represent the shareholder and the consumers and to give them the most adequate protection by making sure that data is available on a timely basis that they can make a good decision and requiring disclosure that is usable, both in nature and adequacy, so that they know exactly the risk that they are taking on.

So these two hearings are important, as we develop this issue. And I commend you for your interest in this and thank you very much.

Mr. MARKEY. The gentleman's time has expired.

The Chair recognizes the gentleman from North Carolina, Mr. McMillan.

Mr. MCMILLAN. I thank the Chair.

The derivatives market has undergone a dramatic evolution since its birth in the early 1970's, when the Chicago Mercantile Exchange launched the International Monetary Market to develop trading in financial futures. Since that time, advances in finance technology and global markets have transformed the simple tools of complex derivatives that can deal with the fundamental components of financial risk.

Today, it is my understanding there are over $14 trillion of those derivatives outstanding. They allow businesses to hedge against fluctuations in revenues and cost, resulting from changes in exchange rates and interest rates, commodity prices and so forth.

Given their importance in value to U.S. business and financial markets, we must be careful before we rush to regulate and respond to the questionable charges that these derivatives are so complex and risky that they threaten our entire financial system and the stockholders of that system. The fact of the matter is that derivatives were created to do just the opposite. That is, manage the risk that already exists in our business world.

We tend to focus on losses that are reported. No one talks about the avoidance of loss or profits. And one's loss is another's profit. To put it in perspective, compared with the foreign exchange market, the swap market is minuscule. While daily global turnover in foreign exchange markets exceeds 800 billion, the daily cash flow for interest rate and currency swaps is about 2.6 billion.

Those using derivatives are becoming increasingly adept at pricing these instruments and assessing credit risk, thereby reducing the systemic risks that some fear. In addition, internal control systems are evolving to accommodate the increased volume of derivative activity. These internal controls need to be strengthened, to avoid the kinds of losses sustained by Kidder, Peabody and Procter & Gamble.

To say that the over-the-counter derivatives market is underregulated is not entirely true.

While the instruments themselves are not regulated, most derivatives dealers are. In fact, of the top 50 institutions doing interest rate swaps, more than 90 percent of banks and large investment firms are already regulated.

The Controller of the Currency has issued guidelines for national banks dealing in derivatives and is in the process of issuing more. The SEC is modifying its rules that govern security broker-dealers and the Commodities Future Trading Commission is reexamining the regulations that govern its futures commission merchants.

So in conclusion, I would simply caution my colleagues that we not seek to overregulate this critically important market. To do so will only drive business overseas, making the job of regulating derivatives all the more difficult.

I thank the Chair again, and yield back the balance of my time.

Mr. MARKEY. The gentleman's time has expired.

All time for opening statements by members has expired.

We will now turn to our distinguished panel.

Our first witness, Gerald Corrigan, was the chairman of International Advisers at Goldman, Sachs & Company in January of this year.

Mr. Corrigan began his distinguished career at the New York Federal Reserve Bank 25 years ago, in 1968, as a staff member and was named its President and CEO in 1985. He has also served as the first American chairman of the Basil Committee on Banking Supervision. Mr. Corrigan has spoken widely about the subject of derivative financial markets.

It is a pleasure to welcome you here today.

STATEMENTS OF E. GERALD CORRIGAN, CHAIRMAN, INTERNATIONAL ADVISERS, GOLDMAN, SACHS & CO.; RICHARD C. BREEDEN, CHAIRMAN, FINANCIAL SERVICES GROUP, COOPERS & LYBRAND; AND DENNIS WEATHERSTONE, CHAIRMAN, J.P. MORGAN & CO.

Mr. CORRIGAN. Thank you, Mr. Chairman. And let me begin by saying, I am pleased——

Mr. MARKEY. If you could turn on the microphone, please.

Mr. CORRIGAN. There we go.

Again, thank you very much, Mr. Chairman. And as I said, I want to begin by saying how pleased I am to be with you and your fellow committee members again, to offer my views and observations on the impact of derivative financial instruments on our Nation's financial system.

In the interest of keeping my opening statement brief, Mr. Chairman, I have attached to this statement the text of formalized remarks I made a few weeks ago at a conference on risk management sponsored by Goldman Sachs in Frankfurt, Germany. And I would like those remarks to be included in the record, please.

Mr. MARKEY. Without objection.

Mr. CORRIGAN. While I believe those remarks address the essence of the questions raised in your letter of invitation, allow me to take just a few minutes to provide a little further perspective on this very complex and very important subject.

For starters, we should recognize that the term "financial derivative" has taken on a life of its own in which there are widespread disparities as to its meaning and application. For example, by some definitions, the "plain vanilla" floating rate home mortgage could be considered a financial derivative.

Further, while it is true that the choice of a floating rate mortgage can entail costs to the user due to interest rate changes over the life of the mortgage, there can be no denying that the floating rate mortgage has been a distinctly beneficial financial innovation. The same can be said of countless other financial innovations including the family of financial instruments that are generally associated with the term "financial derivatives."

The point I am driving at, of course, is that financial innovations, including the more exotic derivatives, are both inevitable, and welcome. They are inevitable because the human mind knows no limit and they are welcome because they serve the legitimate needs of households, businesses and governments while at the same time promoting the larger goal of greater market efficiency and effectiveness. On the other hand, financial innovations, like all innovations, entail some learning and adjustment on the part of both suppliers and users.

In the case of the newer financial derivatives, the learning curve is steep because, by any standard, many of these transactions are highly complex. Indeed, it is the complexity factor, with its elements of speed and interconnection on a global basis, which accounts for so much of the unease or concern that we see with regard to financial derivatives. To a very important degree, the complexity factor is also what makes it so difficult for both top managers and regulatory authorities to design and implement appropriate safeguards with regard to the use of derivatives. While the task is indeed difficult, the fact remains that great progress has been, and is being made, on both the private and official sides. But, as outlined in my Frankfurt address, I believe that further efforts are needed on a variety of fronts.

In the context of that Frankfurt address, Mr. Chairman, I made the observation that I thought that derivatives had little in common with NFL quarterbacks, in that they get more credit and more blame than they deserve and at the end of the day, what almost always matters is defense. And the thrust of the suggestions in that Frankfurt address are, of course, viewed by me as steps that I think can be taken with a view toward buttressing the defenses, which I think again extending the analogy of football, is the name of the game.

Now, while I do not take lightly the risks in this overall area, and while I certainly do not take lightly the agenda of initiatives that are spelled out in that Frankfurt address, I am not in favor of new legislation at this time. Now this position may seem at odds with my long-standing concerns about derivatives and the very low probability contingency that derivatives could play a role in transmitting a localized financial shock to markets and institutions more generally. As I see it, however, there is no contradiction for the following reasons:

First, while I am not in favor of legislation, I am strongly in favor of moving ahead promptly with a series of initiatives that, building on efforts already underway, can and will further strengthen institutions and markets.

Second, in looking at the agenda of initiatives spelled out in that Frankfurt address, including their implied chronological priority, legislation, or the lack thereof, is not a barrier to the steps that need to be taken. Moreover, certain items on that agenda, such as improvements in payments, clearance, and settlement systems, do not, at least in the first instance, lend themselves to legislative solutions.

Finally, while I am not an expert in this field, my impression is that existing legislation provides more than adequate flexibility to provide a higher measure of disclosure and protection for small and unsophisticated investors, if the appropriate authorities deem such steps as necessary.

Third, and this I do want to emphasize, I am fearful that legislation in the United States could work to the detriment of U.S. markets and institutions by shifting activity to institutions and locations that could easily increase, not decrease, the risk to U.S. institutions and markets. If the demand for these services is there, if profits are to be made, U.S. financial institutions and U.S. corporate end users will be there, whether there is New York or Chi-

cago, London, or any number of other financial centers, including so-called "offshore" financial centers. And if something badly were to go wrong at such a center, it would be folly to assume that U.S. institutions and markets would be insulated from such an event or to fail to recognize that U.S. authorities would be less able to anticipate, contain and control such a problem.

Finally, Mr. Chairman, I believe that U.S. authorities, especially the Federal Reserve as the Nation's central bank, already possess the essential tools needed to cope with a major financial problem should it arise. That is not to say it would be easy, for it never has been. But, assuming we continue to make progress on the fronts outlined in my Frankfurt address, I am hard-pressed to think of sensible things that might be done through legislation that would better equip the Fed or other official bodies to deal with a financial disruption of consequence.

Indeed, based on my experience, what is most essential in times of stress are institutional credibility, flexibility, sophisticated intelligence gathering, interagency cooperation and above all, a supportive and cooperative private sector. None of these things can be legislated, but they can be legislated away.

In closing, Mr. Chairman, let me add one further point. In discussing this subject, I and others place great emphasis on systems, controls, procedures, standards and, yes, regulations. In one sense that is entirely appropriate, but in another it misses the point because achieving the dual goals of greater safety and greater efficiency very much comes down to people and culture.

It is literally impossible to design a perfect fail-safe system of controls at the level of the individual firm. Because of this, the time and effort that is going into the development of better systems and controls must be matched with parallel efforts aimed at better training, better supervision and, above all, endowing workers at all levels with greater sensitivity not just to the technicalities of risk management but also to sound and disciplined business practice.

Thank you, Mr. Chairman.

Mr. MARKEY. Thank you, Mr. Corrigan, very much.

[The attachment to the prepared statement of Mr. Corrigan follows:]

Derivatives: A Framework for Greater Stability and Greater Efficiency

E. Gerald Corrigan
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Over the past several years there has been a continuous flow of commentary in trading rooms, executive offices, legislative and regulatory chambers, and the press about financial derivatives. In the wake of the period of extreme volatility in financial markets in recent weeks, that flow of commentary has taken on extraordinary proportions.

In those circumstances, I am often asked about the well-known sentence contained in an address I gave in January, 1992 concerning derivatives. The sentence in question was both deliberate and straightforward. I said, "I hope this [the preceding discussion about derivatives] sounds like a warning, because it is."

With the passage of almost two and one-half years, I am pleased with the significant progress that has been made in learning more about derivatives in both private and official circles. For example, in the private sector truly great progress has been, and is being made, in developing the risk management, information and control systems that are so crucial for individual firms and the marketplace more generally. At the same time, supervisory authorities are also making important gains in adapting prudential standards to the widespread use of derivatives.

Notwithstanding these constructive developments, there are several reasons why the central thrust of my warning of January 1992 should not be forgotten. Among those reasons are the following; first, the constructive steps mentioned above are hardly complete; second, the markets have continued to grow and are evolving very rapidly; and third, derivatives seem to me to entail an acute, if not ironic, dilemma. Namely, while derivatives unmistakably work to reduce risk, including the risk of a systemic financial breakdown, they also work in the direction of making the

implications of an admittedly very low probability systemic financial event more difficult to contain and control. Thus, as I have said on other occasions, we are left with the vexing question of how to deal with a very low probability contingency in a manner which remains sensible and constructive in a broader and longer term perspective.

As a part of that broader and longer term perspective, several things seem to me to be of particular importance. Some of those things are institutional, some are behavioral, but all are important. On the behavioral side, it is very clear that financial institutions and end users of derivatives, both view risk reduction or control as the driving force behind their use of derivatives. For example, in the recently published and highly informative G-30 Appendix III "Survey of Industry Practices" (hereafter referred to as the G-30 III survey) 78 percent and 82 percent, respectively, of dealers and end users of derivatives consider these instruments as either "imperative" or "very important" in controlling risk in their respective institutions. It is also clear that in this age of instant information and analysis, even the most conservative financial practitioners must react -- at least in part-- to "events" in a manner that takes account of the manner they believe others will react to the same "events". This reality tends to amplify market movements once they gain some initial momentum.

These behavioral tendencies take on increased importance when they are coupled with certain institutional developments. One such development is the increasing application of high technology, information processing, and telecommunications to finance. Another related development is the increasing extent to which financial assets are being managed for all segments of society by professional institutional managers. Indeed, in certain respects the emergence of so-called "hedge" funds is but another form of institutional management of financial assets.

Given (1) the growing and large scale institutionalization of asset management; (2) increases in processing and information technology; (3) that asset managers will act in part based on the way they think other asset managers will act; (4) the long and steep run-up in financial asset prices that preceded the market developments of recent

weeks and (5) the string of economic and political "events" during recent weeks, an intriguing question is whether derivatives amplified the volatility and/or fall in financial asset prices. All things considered, the answer to that question is by no means clear.

In one sense, however, the answer to that question is irrelevant since we will never know. At another level, however, the issue is quite relevant because even if derivatives were a passive or a positive factor with regard to recent price volatility or price declines, there is no escaping the fact that while these instruments and practices promote market efficiency, they also have the potential to create new and different elements of risk to individual market participants and to markets more generally.

At the most general level, the way in which derivatives bring new elements of risk is through the sheer magnitude of the speed, complexity and inter-connection they foster across markets, across institutions, and across the globe. Also, while major financial institutions are quite accustomed to coping with counterparty credit risk and market risk, the measurement and control of these elements of risk in the high speed and complex world of derivatives presents new and different challenges. For example, in the G-30 III survey, only 48 percent of the dealer respondents said that counterparty credit risk measurement and control was fully consolidated across all product and all business units; similarly 75 percent said that derivatives exposure to counterparties was monitored either intra-day or overnight. As still another example, 39 percent of the G-30 III survey dealer respondents indicated that crash scenarios were not used, or rarely used, to test the market risk associated with derivative portfolios. However, it is most encouraging to see that many of the respondents indicated that they were planning major enhancements in monitoring and controls, some of which may have been implemented since the survey was conducted a year ago.

Derivatives also bring new or different elements of risk into the once seemingly benign areas of clearance, settlements, payments, and operational activities. Indeed, the likelihood is great that if a serious, but initially localized, financial problem were to take on more generalized or systemic proportions, the modality through which that

would occur is likely to be the clearance, settlement or payments systems that are the equivalent of the global financial system's central nervous system. To its credit, the G-30 III survey focuses a great deal of attention on these issues.

All of that having been said, derivatives, like NFL quarterbacks, probably receive more credit and more blame than they deserve. But to extend the football analogy, defense is almost always the name of the game.

Consistent with that, the issue at hand in the arena of financial derivatives is clear; namely, how can we best strengthen the defenses of individual institutions and the marketplace in general against those elements of risk that may disrupt institutions and markets in a manner that entails potential systemic consequences. In seeking to address that question, several things stand out in my mind. They include:

First: of necessity, the process of shoring up these defenses will entail a step-by-step approach over time. There is no quick fix.

Second: ill conceived efforts to "solve" the problem by regulation or legislation entail the clear danger of making things worse by stifling the evolution and efficiency of markets and/or by shifting the risks to geographic locations or to institutions that will leave the system at greater risk.

Third: effective solutions will require a blend of private actions and public policies.

Fourth: effective solutions will require a high degree of international coordination on the regulatory side.

Fifth: under the best of circumstances we will probably continue to see isolated instances in which market participants incur losses of consequence associated with derivatives. While such episodes are sure to capture headlines and while authorities and practitioners can ill afford to ignore the lessons from such episodes, we must guard against overreaction especially when the episode in question entails obvious miscalculation or excess on the part of the party incurring loss.

With those qualifications in mind, there are several steps which I believe can be taken with a view toward better containing the risks associated with financial derivatives in a manner that will not materially impair the ability of these instruments and markets to perform their necessary role.

First: All major market participants, including non-financial firms that are significant end users of derivatives, need to redouble their efforts to insure that risk management, information, and control systems are up to state-of-the-art standards. As a part of this effort, boards of directors and top managers should insist that all such firms undertake a rigorous self-analysis relative to the original G-30 recommendations and relative to the findings of the G-30 III survey of industry practices. Among others, the objective of this exercise should be to achieve accurate and timely consolidated credit and market risk monitoring on the part of all major institutions in these markets. Over a longer time frame, the goal should be to push these monitoring efforts to the limits of technology and practicalities in order to achieve intra-day monitoring capabilities on a broad scale.

Second: Working together, individual firms, exchanges, clearinghouses and central banks should be even more aggressively pursuing ways to strengthen clearance, settlement and payment systems. These efforts should focus on programs aimed at (1) shortening and standardizing the timing gaps between trade date (and time) and final payment; (2) the more widespread use of same day delivery against payment systems for securities transactions; (3) moving toward same day final payment in clearing houses and exchanges; and (4) further strengthening the operational reliability of major processing systems. While it may not be obvious to all, such improvements in the "plumbing" of the financial system can work in the direction of enhancing market liquidity across a wide spectrum of financial instruments. This is important because greater market

liquidity should work in the direction of strengthening the capacity of markets to absorb more smoothly sudden shifts in market psychology.

Third: We must move more aggressively to establish a standard set of definitions applicable to financial disclosure and reporting requirements for widely traded derivative instruments. This may sound like a narrow and technical issue, but it is not. It is at the heart of the ability of firms and regulators to make consistent judgements as to the risks associated with given portfolios of derivatives. As things now stand, the gaps in uniform definitions and disclosure standards are a major factor in explaining the considerable variation in the manner in which firms responded to the G-30 III questions that are relevant to these issues. While it would be unfair not to acknowledge the progress that has been made in this area, the fact remains that much remains to be done.

Fourth: Major market participants need to work with regulators and supervisors to assure the legal enforceability of derivative transactions, both within and across jurisdictions. Particular attention should be paid to removing any legal uncertainty with respect to the enforceability of netting arrangements both nationally and internationally. Dealers and end users also should work together to establish greater standardization in documentation to further promote liquidity and stability in these markets throughout the world. All of these steps, which are included in the G-30's list of recommendations, are critical to reducing risk and promoting certainty in the international derivatives markets. Here, too, I recognize that while significant progress has been made, more can and should be done.

Fifth: I believe that consideration should be given to the possibility of seeking to establish voluntary minimum standards for disclosure, credit and market risk controls, and customer suitability that could

apply broadly to all major market participants in derivatives. In practice this will be very difficult, especially if applied nationally and internationally, and to both regulated and non-regulated entities. However, one way some progress might be made in this direction entails the development of such minimum standards by a private sector group, such as the G-30. While standards developed in this fashion would have no binding authority, they could serve a very useful purpose. For example, to the extent prominent individual firms were to voluntarily and publicly commit to comply with such standards, their actions would put great pressure on others to do so. Indeed, if some firms -- acting on their own and in their own best interest -- refused to do business with firms that did not voluntarily comply with such standards, the pressures could be very great. The obstacles to such a workable framework of voluntary minimum standards are formidable, but the concept should not be rejected out of hand.

Sixth: While the steps outlined above constitute a building block approach to the dual goals of greater safety and greater efficiency, it remains true that the international community of banking and securities regulators-- together with the appropriate officials of the European community-- still are faced with the enormous challenge of achieving greater cohesion and consistency as it applies to minimum capital standards. Under any circumstances, this will take time. And, based on my experience as Chairman of the Basle Committee, I know it will not be easy. Yet, in the fullness of time, I am hard pressed to believe that the legitimate interests of individual firms or groups of firms or individual regulators or groups of regulators cannot be accommodated in ways that permit significant movement in the direction of greater consistency in prudential standards and greater harmony in market practices.

The agenda of initiatives spelled out above is formidable but it is not insurmountable although it will be both time consuming and expensive. However, it is an agenda that is compatible with the goals of safer, more efficient, and more effective financial markets and institutions. It is also an agenda that can be achieved without new legislation, new regulatory structures and without the threat of regulatory overkill. Having said all of that, it should also be stressed that no framework of private sector initiatives, regulation or legislation is fail-safe. That is why there can be no substitute for the time honored dictates of discipline, conservatism and knowing your counterparty. In the current environment, those dictates should take on a special premium of attention because neither the markets nor the regulatory and political communities will react kindly to any large scale surprises. To coin a phrase: I hope this sounds like a warning, because it is. Much has been accomplished in a setting in which, the difficulties notwithstanding, both markets and institutions have demonstrated considerable resiliency. But, more needs to be done.

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Mr. MARKEY. Our next witness, Richard Breeden, serves as the chairman of the Financial Services Group of Coopers & Lybrand in the United States, and is chairman of the Global Capital Markets Group of Coopers & Lybrand International.

Prior to joining the firm, Mr. Breeden served as chairman of the Securities and Exchange Commission from 1989 to 1993. During his tenure at the SEC, he handled the failure of Drexel Burnham Lambert, the investigation of Salomon Brothers, and other participants in the U.S. Government bond markets' settlement of the SEC's case against Michael Milken, market disturbances in 1989, and more than 1,200 enforcement proceedings.

A many time guest before this subcommittee, and it is a great pleasure to have you become before us again, Richard.

Whenever you are ready, please begin.

STATEMENT OF RICHARD C. BREEDEN

Mr. BREEDEN. Thank you very much, Mr. Chairman.

It is a very great pleasure to have a chance to be here with you today and to join you and the committee in discussion of what is unquestionably a very important topic. The overall market for derivative instruments, particularly so-called OTC derivatives, over-the-counter derivatives, has, as you noted, been growing enormously in recent years.

OTC derivatives are traded in a dealer market that is conducted largely by telephone. The market is generically similar to dealer markets for other types of instruments around the world. Compared with the cash market for securities in the United States, the OTC derivatives market is characterized by lower levels of overall liquidity, and little or no transparency concerning individual transactions.

Most liquidity in the market comes from the market-making activities of the major derivatives dealers. Their capacity and willingness to provide liquidity to the market is in turn affected by the liquidity of cash markets and exchange-traded derivatives markets, as well as the willingness of other customers to enter into new OTC transaction, all of which contribute to a dealer's ability to hedge its own positions.

Derivative instruments vary widely in that their size, duration, complexity and purpose of the some instruments are referred to as "plain vanilla" instruments, such as simple currency swaps. Other instruments are highly complicated allocations of cash flows based on different variables, sometimes for periods of 20 years or more.

OTC derivatives are also structured to give varying degrees of leverage to transactions, with some instruments requiring the payments of amounts that may be many times the movement of a reference rate or asset. Some of these complex and highly levered derivatives are attached to or embedded in other types of financial instruments.

Particularly the highly levered embedded instruments represent what can be characterized as live ammunition. The hallmark of this market and one of the reasons for its success is that it is a market for customized transactions that allow customers to determine the risks that they wish to bear and those risks that they want to shift to others.

It is important to recognize that the derivatives market in the aggregate is engaged in the shifting, not the creating, of risks, that already exist somewhere from one party to another. Whether derivatives enhance a particular company's safety or increase its risk depends entirely on how the instruments are used and of course on what happens in the real world during the term of the contract.

Some of the recent press articles on derivatives tend to ascribe—use a highly apocalyptic tone to the overall market. Some descriptions of the market tend to imply that all derivative transactions are highly speculative or risky, when in fact some are and some are not.

Whatever else is true, and there are certainly real issues that should be addressed, the sky is not falling. By allowing a company to control its maximum exposure to currency values or interest rates, derivatives help many companies operate more efficiently and more safely. Indeed, hedging some types of market risks is a quite prudent and relatively inexpensive method of enhancing long-term corporate shareholder values.

Of course, it is also true that derivatives can be used in a manner that increases risks for an end user. Substantial sums can be lost through ill-considered, poorly executed or uncontrolled use of derivative contracts, but the same would be true through ill-considered or poorly controlled business activities of any type.

Here, however, the problems have been preponderately among the end users of derivatives, rather than among the derivative dealers. Despite the publicity surrounding the Procter & Gamble case in particular, it is not apparent that there will be any significant long-lasting harm to that company as a result of its experience with derivatives.

Indeed, the longer-run effect on both P&G and the general corporate community of some of the recent cases, may turn out to be quite positive if the incidents serve as a reminder for directors and senior managers who are entrusted with the duty of protecting and enhancing shareholder value, of the importance of proceeding carefully. In general, many users of derivatives would benefit from far closer attention to internal corporate practices by their CEO and their board members.

Here directors have a responsibility to know and to control the manner and the degree to which the shareholders' net worth is being put at risk in significant amounts, whether through the use of derivatives or whether through the company's normal operations. In this regard, directors and senior managers should know what the company's maximum exposure of its balance sheet and its income statement is, how that exposure is created, on what it is dependent, and how it is managed over time.

Issues like decision-making authority, maximum risk limits, reporting and approval requirements and other questions of internal controls should be carefully considered and decided in advance, not after the fact. In this respect, however, derivatives, like other human inventions, can be both good or bad.

For example, an automobile can provide its owner with efficient, convenient, and sometimes even very pleasant transportation. However, the same model auto that is driven at 90 miles an hour down a curvy and wet mountain road, may be a mortal danger to

its driver and others on the road at the same time. That difference isn't the result of the car itself, but of how it is used.

The same phenomenon is true with the use of derivatives. If a CFO or a treasurer of a corporation plans to take the company's financial condition out for a drive in the markets, the CEO and the board should have a clear understanding of the plans for the journey.

You have posed a number of important questions for our consideration this morning. First and foremost of which is the issue of systemic risks in the market. In thinking about the issue of systemic risks, one must start with the fact that the basic risks in derivatives trading, credit, market, operational, legal and others, are generically the same types of risk that arise from the other activities of banks and broker-dealers. Thus, the activities in derivatives do not create any new types of financial risk, though in some corporations, the proportions of the risks that they are undertaking may be modified from traditional patterns.

Ultimately, however, the different elements of risk that have to be monitored both by the company and with its regulators are largely the same. An important factor in evaluating systemic risk is the size of cash flows that could potentially be interrupted due to an unexpected problem, and capacity of the system to provide alternate sources of liquidity.

Here, however, the daily cash flow requirements in derivative markets notwithstanding, the immense numbers that are cited for notional amounts, but the actual daily cash flows that are going back and forth between participants in the market, are far less than those resulting from spot foreign exchange transactions, settlements in government securities, and settlements in many other types of instruments. In all these markets, there are higher daily settlement requirements.

Since new types of risk are not being created, the remaining systemic issue, I suppose, is whether the magnitude of derivative transactions and cash flows creates a risk that the overall system will be strained past some breaking point. Happily, high rates of growth in trading activity in derivatives have also coincided with very high rates of investment by major dealers in communications and data processing capacity.

The major related cash and exchange-traded derivative markets have also generally been investing substantially in enhancements to their capacity and reliability. Therefore, while eternal vigilance is called for by both banking and securities regulators, there is not today to me any apparent serious capacity constraint on market or communication systems that would suggest the imminence of any type of systemic problem.

In dealing with systemic risk, the extremes of both "Pollyanna" and "Chicken Little" must be avoided. Instead, we need to pay constant attention to enhancing the speed, reliability and capacity of systems in all our major markets, the blocking and tackling of maintaining a good and efficient capital market.

For the future, in my opinion, the best way to prevent the development of systemic risks is to maximize the transparency of financial reporting by both U.S. and foreign derivatives dealers and users, and in every way possible to preclude the extension of de-

posit insurance or other government backing for derivatives dealers. Market disciplines should be allowed to curb speculative abuses where they arise, without attempts to shield firms through governmental intervention.

In the area of risk management and internal controls, it is important for regulators to set standards for minimum practices by the major financial dealers. But I believe it is also important that regulators not seek to codify a particular form or approach to risk management.

Practices in the private sector are improving daily. There is substantial investment going on in risk management practices, and that process is not time to freeze that process. Nobody has a crystal ball, including the regulators, and therefore it would be counterproductive for regulators to mandate specific risk methodologies, for example. While improvements can always be made, this is an area in which significant investment and improvements are going on in the private sector.

In the area of internal controls, this is probably the biggest problem for both dealers and end users. While investments in risk management systems tend to be perceived as contributing to profitability, internal controls and similar compliance functions are not always seen in the same light. Breakdowns or patent inadequacy of internal controls have been a factor in many of our previous financial market scandals, as well as with some of the worst financial losses that have occurred.

Time and again, internal controls prove to be a point of major vulnerability to a firm's ability to carry out policies designed to control risk or to ensure compliance with the law. But as important as internal controls are, and I believe they are extraordinarily important to every company, the most important group to address internal controls is the board of directors and the senior management of a company.

Controls can't be purchased at the software store, they can't be brought home in a box and plugged in. They have to be designed carefully to mesh and integrate with the basic fabric and structure of a company, and no one knows how to do that better than the company's own management and directors.

In the area of suitability standards, and other abusive practices, the question really in response to the committee's request question, the issue really is what is abusive?

How should that be determined? What kinds of transactions are outside the norms of accepted ethical principles and practices of trade?

Suitability standards are certainly an important tool for supervision of, among other things, the conduct of broker dealers in securities with respect to solicited transactions in a retail context. Suitability embraces issues of customer understanding of risk and the customer's ability to absorb risk. But since the earliest days of Federal securities regulation, there have been exceptions for normal regulation, for large and sophisticated market participants.

An obvious example is the fact that a issuer may sell securities to a large institutional purchaser in a private placement, without registering the securities with the SEC. This is done because at some point we believe that the buyer is big enough to take care of

itself, and the resources of public bodies, such as the SEC, should not be diverted from the task of protecting less sophisticated market participants.

The traditional, and in my view, still appropriate answer to whether a dealer should have a duty to make a suitability determination with respect to a major multinational corporation, is simply no. There has not been a category of "widow and orphan multinational corporation" in the past, and I don't believe we should create one now.

If a major corporation loses significant sums in inappropriate speculation in any type of financial instrument, the remedy is for the management or the board to take action with respect to the responsible individuals and to install better controls. It is, however, always important for a dealer in derivatives or other securities to understand the client's level of sophistication and the client's motives for entering the transaction, particularly if it involves disproportionately large or particularly unusual risk characteristics. This should be done, however, as a matter of good corporate practice, good business practice, and doesn't need to be codified in the law at the present time.

In the area of disclosure, I believe that improved transparency of practices in this entire area would be the most beneficial action of all that can be taken. The nature of derivatives activity, the exposure to risk, are important disclosure issues.

For firms with significant levels of exposure, management discussion and analysis should include commentary on the company's practices, controls and strategies. It shouldn't be possible for losses of an enormous magnitude to occur, without there having been disclosure that risks of such potential magnitude are being incurred by the company.

In addition to all the other benefits it brings, greater disclosure to shareholders concerning derivative activities has the additional benefit of helping make sure that the board of directors appreciates the scale of the company's activities in this area. It is important with greater disclosure, however, to emphasize that a great deal of improvement is going on in the market today, and it is highly desirable for individual companies and their auditors to be able to design the best form of disclosure to suit its own specific conditions.

Companies need the flexibility to structure the most helpful and informative presentation, and codification of requirements in this area could actually have the counterproductive result of holding back new forms of disclosure.

Mr. Chairman, I would like to conclude by simply agreeing with the assessment that legislation at the present time, is not something that would be warranted and that the many important issues that you have posed can and should be addressed by individual companies in the market and by regulatory agencies.

Thank you.

Mr. MARKEY. Thank you, Mr. Breeden.

[Testimony resumes on p. 60.]

[The prepared statement of Mr. Breeden follows:]

Testimony of

Richard C. Breeden

Chairman,
Financial Services Group
Coopers & Lybrand

Concerning Supervision of Derivatives Markets

Before the Subcommittee on Telecommunications and Finance
United States House of Representatives

May 10, 1994

Chairman Markey and Members of the Subcommittee:

It is a special privilege to have the opportunity to join you today for the Subcommittee's consideration of derivative markets. Mr. Chairman, during my nearly four years as Chairman of the U.S. Securities and Exchange Commission, this committee convened to consider many important issues affecting the integrity, efficiency and stability of the nation's capital markets. The subject this morning is as important as any of the topics that you have examined during the past few years.

At present I am the Chairman of the Financial Services Group of Coopers & Lybrand in the United States, and also Chairman of Global Capital Markets for Coopers & Lybrand (International), our worldwide firm. In these positions I work with both domestic and foreign financial institutions of all types, as well as with industrial and other nonfinancial firms that are users of capital markets for raising capital or for managing their risks. Coopers

& Lybrand has an extensive global practice in the techniques and systems of financial risk management, and in the structuring and operation of effective internal controls for firms dealing in or purchasing securities and derivatives. We are also among the largest firms in the provision of traditional accounting, auditing and tax services for some of the world's most innovative dealers in securities and derivatives, as well as for many large end-users or other purchasers of these instruments including mutual funds.

I mention these facts, Mr. Chairman, so that you and the members of the Subcommittee will understand that my firm has an active and extensive involvement with many clients that are directly interested in developments in derivatives markets. My testimony today represents my personal views, based on my experience as a regulator and as a market participant, and not the views of Coopers & Lybrand, or its personnel.

During my tenure at the SEC, the agency spent a significant amount of time considering issues relating to the regulation and supervision of exchange-traded and over-the-counter derivative instruments of various types. During that time I worked with you, Mr. Chairman, to help pass the Market Reform Act of 1990 (the "MRA"), which gave the SEC its first authority to review the activities of affiliates of broker-dealers.1/ We utilized this authority to establish the first reporting requirements for

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1/In addition, the MRA gave the SEC enhanced authority to harmonize inconsistent state laws relating to clearance and settlement of securities transactions.

significant exposures of broker-dealer affiliates involving derivatives and other financial instruments. In addition, the SEC was also quite active in visiting the major firms to begin evaluating their risk management systems.2/

It is said by some that one of the greatest areas of concern with safety in our current system is the supposedly "unregulated" derivatives affiliates of U.S. broker-dealers. With the passage of the MRA, the completely "unregulated" status of U.S. broker-dealer affiliates was ended, at least where any such affiliate has a material level of financial market exposure. These entities are unquestionably "less regulated" than banks or broker-dealers, but a lesser degree of regulation is also appropriate because these entities are not engaged in a public client business and their liabilities are not backed by the federal government or the SIPC. In my view, the creation of "AAA" rated derivative affiliates as a vehicle for institutional derivatives business has been a healthy development.3/

2/Legislation to establish oversight by the Federal Reserve for margins on stock index futures--though strongly opposed by the CFTC--was another positive step taken by Congress in part as a result of expressions of concern during this time by the Federal Reserve and the SEC, as well as by this Committee.

3/One of the purposes of the holding company risk assessment provisions of the MRA was to determine whether there was a need for enhanced oversight in any particular areas. It may now be appropriate to examine whether there are any unintended gaps or other problems with the holding company risk assessment provisions of the MRA. However, any such review should not be based on a mistaken understanding of the current system or exaggerated fears of a systemic crisis. Furthermore, the first priority if action is needed would presumably be SEC rulemaking actions to utilize fully existing authority, rather than new legislation.

Creditors of such entities would not have any direct claim on the net worth of a broker-dealer supporting its obligations to its public customers.

The holding company risk assessment provisions of the MRA are, in effect, a smoke alarm for problems brewing in the affiliates (or parent) of a broker-dealer. The SEC can monitor the financial condition of affiliates of broker-dealers so that, in the event a holding company has a serious risk of failure, the SEC will have sufficient advance warning to enable it (i) to sell the firm's broker-dealer to a healthier organization, or to transfer all the public customer accounts out of the firm's broker-dealer to another firm; and (ii) to heighten the SEC's monitoring of any attempts to withdraw capital from the broker-dealer subsidiary. The statute was not designed to "prevent" failures from occurring, but rather to minimize the cost and potential spillover effects from the periodic failures that inevitably will and should happen in an open and competitive marketplace.

Direct SEC supervision of broker-dealer affiliates was not created for several reasons. First, many of the broker-dealer affiliates are financial institutions such as banks and insurance companies that are already regulated. Second, unlike the limited businesses authorized for bank holding company affiliates, the parent corporations of broker-dealers may include large industrial corporations with a wide range of activities. Consolidated holding company supervision of such companies would

be well beyond any conceivable supervisory purposes. Finally, direct regulation might create a suggestion to some of an implicit federal backing for the obligations of such an entity, thereby undercutting market disciplines.

Thus, the MRA was designed to give the SEC improved tools to address problems, but also to avoid the overregulation that has resulted from the Bank Holding Company Act of 1956. Enhancing oversight without overriding market disciplines remains in my judgment both the most cost-effective and efficacious approach to the issue of affiliates.

In addition to working to secure enactment and implementation of the MRA, the SEC also gave considerable internal consideration to the adequacy of our net capital rule and other supervisory standards relating to the activities of broker-dealers and their affiliates in the market for OTC derivatives. One result of these inquiries was a wide-ranging "Concept Release" published by the SEC a year ago just prior to my departure.4/ The Concept Release sought to lay the groundwork for new approaches to capital requirements and other supervisory standards relating to OTC derivative activities.

In the course of supervisory activities, the SEC staff performed stress simulations on the derivative and other portfolios of broker-dealers to evaluate changes in capital position in the event of substantial movements in various U.S. and international markets. In addition to beginning the process

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4/SEC Release 32256 May 4, 1993, 58FR27486 on May 10, 1993.

of revising the SEC's own capital rules applicable to OTC derivatives, we also conducted virtually nonstop discussions with domestic and foreign bank and securities regulators concerning capital rules, netting agreements and clearance and settlement systems.5/

During my tenure the SEC also spent large amounts of time working with the Financial Accounting Standards Board (the "FASB") to seek to drag the accounting and disclosure rules for traded financial instruments such as stocks, bonds and derivatives out of the 19th century, where they had been languishing in a fairy tale world of "cost accounting." Indeed, after listening to impassioned rhetoric against mark to market accounting for financial instruments from bank trade associations, I was very happy to see that the recent report of the Group of 30 on derivatives recommended mark to market

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5/Many people believe that establishing uniform worldwide capital rules for banks and securities firms engaged in securities and derivatives businesses would improve the stability of the overall market. In practice, the opposite result would be more likely, since the "lowest common denominator" always seems to be proposed for such a uniform global standard. A mistake in judgment does not become better by virtue of being repeated by more people. In addition, uniform global standards gloss over very important differences between different types of institutions and between substantially different markets. Finally, the overall process is so difficult and involves so many tradeoffs that a common standard will tend not to be updated even when new developments make marginal changes desirable.

In any event, as Chairman of the IOSCO Technical Committee, I had to endure endless discussions in which some European regulators sought to have the SEC slash its capital requirements. Aside from being utterly fruitless, these discussions tended to monopolize the staff and divert it from more important issues such as designing the best possible approach to a capital rule for derivative activities of U.S. broker-dealers.

accounting for internal risk management purposes and, at least in some areas, for the public financial reports of derivatives dealers, including banks. In its excellent report, the Group of 30, which is largely composed of bankers and former bank regulators, correctly noted that market values are the only relevant and effective measure of cash flows, financial market exposures and hedging activities. Hopefully more and more firms now acknowledge that cash market positions in traded instruments, often related to derivative positions, should also be marked to their market values.6/

During my tenure at the SEC we were successful in encouraging the FASB to adopt SFAS No. 107, Disclosures about Fair Value of Financial Instruments, and SFAS No. 115, Accounting

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6/While it is relatively simple to mark most cash market positions to their market values (thinly traded or closely-held stocks being examples of difficulties), this is often not possible with OTC derivative instruments. Because of the highly customized, "one-off" nature of many instruments, there is not any "market" of fungible instruments. In addition, the lack of liquidity for some types of instruments, such as long-dated swaps, makes finding comparable transactions impossible. Even where transactions do exist, the non-transparency of trading also makes it difficult to determine a "market" value. Thus, though market participants speak of "mark to market" and "market value" accounting for derivatives, in many cases valuations reflect "mark to model" valuations. In essence the present value of the projected cash flows of the instruments is produced from mathematical models. The resulting profit or loss on a position is based on the initial accrual of expected cash flows and then ongoing adjustments to reflect mark to model. Both the model's underlying methodologies and the data fed into the model, such as interest rate or foreign exchange curves and volatilities, must be accurate in order for the "mark to model" value to reflect synthetic "market" conditions reliably. That is another way of saying that it is very difficult to derive the exact value of highly complex, one-of-a-kind instruments, and that there are risks firm's must be vigilant to guard against that mark to model earnings will be distorted.

for Certain Investments in Debt and Equity Securities. Nonetheless, the accounting literature for derivatives and other traded financial instruments is still riddled with ambiguities and allows excessively opaque accounting for exposures to, and income from, a wide range of activities (market making, trading, sales and distribution, etc.) pertaining to derivative instruments and other forms of securities. However, these two standards have at least begun the process of bringing greater transparency to the portfolio values and trading results of major financial institutions. They have also made it harder for institutions to use the selective timing of recognition of securities or derivatives trades to manage their income reported to creditors and shareholders.

While the FASB has at least made modest progress in updating the accounting treatment of financial instruments, much more remains to be done to improve the accounting and disclosure requirements for derivatives and other types of complex financial instruments. For the future, further progress in substantially enhancing the transparency of risk exposures and related financial results for institutions utilizing all types of financial instruments is the most important tool available to deter and to discipline excessive risktaking. Sharply enhanced transparency for the derivatives market is also probably the best means for preventing the development of excessive systemic risks.

By far the toughest "regulatory program" to deter excessive risktaking is strong market discipline. When a firm's credit

rating is downgraded, it will incur substantial increases in its funding costs, and at least a somewhat reduced availability of funds. In addition, a firm that is not thought to have an extremely strong financial position will experience a tightening in the terms available to it from counterparties. As a firm's credit quality erodes, an increasing number of potential counterparties will decline to enter into transactions, or will do so only with higher levels of collateral and perhaps under other limitations such as shortened maturities. All of these market disciplines get the attention of senior management of a company, as well as that of the general marketplace, because they have a direct and substantial limiting effect on a firm's capacity for growth, on the availability and cost of its funding, and ultimately on its future profitability.

Although strong market discipline represents our best protection against systemic risk and excessive speculation, market discipline does not work well unless the market has access to timely, accurate, detailed and relevant financial data. This year's annual reports of the major institutions active as dealers in derivatives contain far more disclosure than in previous years, much of it provided on a voluntary basis. The major firms are also working actively with the FASB and others to promote better transparency and sensible accounting rules. However, there is still a long way to go to make sure that the market has all the information that it needs in order to be able to fully evaluate the major risks facing institutions in this market.

On April 14 of this year, the FASB published a new exposure draft (the "ED") for enhanced disclosures regarding derivatives activities. The FASB is planning to make a final standard effective for 1994 financial statements. If adopted in its current form, the ED would require both derivatives dealers and end-users to disclose more detailed information than is required under current authoritative accounting guidelines.7/

While the ED would be a step forward in improving transparency in derivatives, in many respects it is a stopgap measure, with further changes anticipated as part of the FASB's long running and apparently neverending financial instruments project. One serious defect is that the ED by its terms is limited to "stand-alone" derivatives, and it apparently would not apply to various important products including structured products

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7/For companies using derivatives, the ED requires disclosure concerning (i) why the end-user holds or issues derivative transactions, including the strategies employed to achieve its objective; (ii) how the end-user reports its derivative transactions including the accounting policies for recognizing or not recognizing its activities and how they ultimately would be reported in its financial statements; and (iii) whether derivatives are used to hedge anticipatory transactions and, if so, the type of transaction hedged, when it is expected to occur, the amount of hedging gain or loss deferred and, when and how the deferred amounts will be recognized. For companies trading derivatives, the ED requires disclosure concerning (i) the average, maximum and minimum aggregate fair values during the reporting period of each class of derivatives held, distinguishing between contracts in an asset position and those in a liability position and (ii) its net trading revenues for the reporting period. The ED also encourages companies to disclose quantitative information about interest rate and market risks, including more detailed information about current derivative positions, the hypothetical effects of changes in market prices, and details of an institution's gap analysis, duration and value at risk concepts.

such as levered structured notes. When a swap or derivative is embedded in a note, certificate of deposit, or other type of instrument, such instruments are among those needing more (not less) disclosure, yet they are exempt from the disclosures mandated by the ED. This could encourage even more transactions to be constructed in this manner in the future.

In this entire area the FASB has been far behind the curve of developments in the market. The FASB seems to have been slow to realize the importance of updating promptly U.S. accounting rules for financial instruments (for assets and liabilities, and for both cash and derivative positions) in the face of explosive growth in the size and velocity of capital markets of all types. The slowness of the FASB's efforts in this area runs the risk of prejudicing shareholders, creditors, and overall public confidence in our markets.8/

Regulatory Issues Relating to the Derivatives Market

It is well known that the overall market in "derivative" instruments, particularly "over-the-counter" or OTC derivatives, has grown enormously in recent years and continues to do so. Broadly speaking, derivative instruments are contracts whose

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8/In fairness to the FASB, its own attempts to improve the accounting and disclosure rules for financial instruments have often run into extremely stiff opposition from market participants, bank regulators, and others. While speed is important, it is also vital that the FASB fully consider all serious points of view and proceed with the accounting version of due process.

value depends on or results from the value (or a change in value) of something else. The "something else" may be an interest rate, currency value, index of asset values (such as a stock or commodity index) or any other asset value or reference rate.

Many derivatives are traded on stock and futures exchanges, such as options on stocks or currencies, or futures on stock indexes, foreign currencies or interest rates. Exchange trading of derivatives involves varying degrees of order exposure, trade transparency, audit trails, clearing houses and other attributes of an exchange-trading environment.

OTC derivatives are traded in a dealer market conducted largely by telephone. This market is generically similar to dealer markets for other types of instruments around the world, including the OTC market for equities trading in the United States. However, unlike the OTC equities market where there is a self-regulatory organization, the National Association of Securities Dealers, and an electronic system for public order transparency, NASDAQ, the OTC derivatives market functions without any formal SRO and does not have any overall trade reporting systems.

Compared with the cash market for securities in the United States, the OTC market is characterized by lower levels of liquidity and little or no transparency concerning transactions. Most liquidity in the market comes from the market making activities of the major derivative dealers. Their capacity and willingness to provide liquidity to the OTC derivative market is

in turn affected by the liquidity of cash markets and exchange-traded derivatives markets, as well as the willingness of other customers to enter into new OTC transactions -- all of which contribute to a dealer's ability to hedge its own positions. The relative illiquidity of at least longer-dated and more customized instruments, and the difficulty of obtaining information concerning market transactions, create risks that both dealers and end users must plan for and manage.

Based on overall activity, currency and interest rate swaps represent the largest portion of the OTC market in terms of volume. However, there is a steady and unquantified growth in the number and value of "structured" transactions which incorporate derivative features that enhance yield and may involve substantial risk to principal value.

Derivative instruments vary widely in their size, duration, complexity and purpose. Some instruments are referred to as "plain vanilla" instruments, such as simple currency swaps. Other instruments are highly complicated allocations of cash flows based on different variables, sometimes for periods of 20 years or more. OTC derivatives are also structured to give varying degrees of leverage to transactions, with some instruments requiring the payment of amounts that may be many times the movement of a reference rate or asset. Some of these complex derivatives are attached to or imbedded in other

financial instruments. These instruments in particular are aptly characterized as live ammunition.9/

The hallmark of this market, and one of the reasons for its success, is that it is a market for customized transactions that allow customers to determine the risks that they wish to bear, and those risks that they wish to shift to others. It is important to recognize that the derivatives market in the aggregate is engaged in the shifting (not the creating) of risks that already exist somewhere from one party to another. Whether derivatives enhance a particular company's safety or increase its risks depends entirely on how the instruments are used, and of course on what happens in the real world during the term of the contract to affect the value of the various assets or cash flows that may be embodied in the instrument.

Several of the recent lengthy press articles on derivatives have tended to apply a highly artificial and quite unrealistic apocalyptic tone to the overall derivatives market. Some descriptions of the market seem to imply that all derivative transactions are highly speculative or risky, when in fact some are, and some are not. Whatever else is true -- and there are real issues that should be addressed -- the sky is <u>not</u> falling.

In fact, a derivative contract is a tool with which a company can alter its risk in certain areas either by paying a

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9/The fact that someone can lose money holding a structured note, for example, in the event of adverse interest rate changes is not different in kind from what happens if one holds a 30-year U.S. Treasury bond and long term interest rates rise.

fee, or agreeing to incur some other offsetting risk, or both. A derivative can be a highly valuable aid to a company seeking to achieve greater certainty in its operations, such as by locking in the cost of foreign exchange for a set period of time. Both exporters and importers use derivatives to curtail the risk of unexpected currency fluctuations, and companies and government entities also use derivatives to control the cost to them of fluctuations in interest rates.

One simple reason for the growth in use of derivatives is that the total volume of world trade has risen sharply over the past decade. As a result, more and more companies have exposures in foreign currencies that they must manage. The relatively high levels of volatility of currency values and interest rates makes the "option" of not taking any steps to limit a firm's currency or interest rate exposures more risky, which also leads to an increase in the use of derivatives.

For a company that considers itself expert in making airplanes, automobiles or telephone systems, but not in trading currencies, derivatives can give the company the ability to focus its management attention on the businesses it knows best, and where it can create the greatest value added from its management and capitalization, and to shift the job of managing other types of risks to the market.

By allowing a company to control its maximum exposure to currency values or interest rates, derivatives help many companies operate more efficiently and more safely. Indeed,

hedging some types of market risks can be seen as a prudent and relatively inexpensive method of enhancing long term corporate shareholder values.

Of course it is also true that derivatives can be used in a manner that increases risks for an end-user. Recent public disclosures of problems at Metallgesellschaft, Proctor & Gamble and other companies have shown that companies can lose substantial sums through ill-considered, poorly executed or uncontrolled use of derivative contracts. Here the problems have been preponderantly among the end-users of derivatives, rather than among the dealers in these products.10/

Relatively greater losses among end-users of derivatives rather than dealers is not surprising given the great disparity in expertise and market knowledge between the largest dealers and even very large corporations that purchase derivative contracts for various purposes. Indeed, the same phenomenon frequently occurs in cash markets as well. During 1987, the large broker-dealers lost fairly little in the collapse of stock market prices, while individuals and institutions lost immense sums.

Of course any "losses" from derivatives for end-users must be kept in perspective. The business news on almost any day will report companies that have incurred far larger operating losses or "restructuring charges" -- often measured in the billions of

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10/Indeed, the entire debate over derivatives activities would benefit considerably from a more precise differentiation of issues that pertain to dealers and those that pertain to end-users, as the risks and problems are often sharply different.

dollars -- flowing out of their basic operations. While one should not take losses of tens of millions of dollars lightly, it is worth remembering as a matter of perspective that if Proctor & Gamble had reported the same $157 million pretax loss from discontinuing a line of products that it manufactured, the news would have received scant attention due to the strong financial condition of the company.

Despite the publicity surrounding the Proctor & Gamble case in particular, it is not apparent that there will be any significant longlasting harm to the company as a result of this experience. What probably generated a greater degree of interest in the business community was that a company with a relatively conservative business reputation had evidently been engaged in very aggressive proprietary trading quite unrelated to its basic business through its corporate treasurer's office. The longer run effect on both P&G and the general corporate community may turn out to be quite positive if the incident serves as a wakeup call for directors and senior managers who are entrusted with the duty of protecting and enhancing shareholder value.

In general, most users of derivatives would benefit from far closer attention to internal corporate practices by their CEO and their board members. Here directors (especially members of audit committees, but also others) have a responsibility to know -- and to control -- the manner and the degree to which the shareholders' net worth is being put at risk in significant amounts -- whether through the use of derivatives or in normal

operations. In this regard directors and senior managers should know what the company's maximum exposure of its balance sheet and its income statement is, how that exposure is created, on what it is dependent and how it is managed over time. Critical assumptions about markets and the potential magnitude and timing of changes in markets must not simply be ascribed to a risk model or formula, but should be evaluated by senior management if a company plans to incur significant exposures.11/ Issues like decision-making authority, maximum risk limits, reporting and approval requirements and other questions should be considered and decided in advance.

An example of this issue is the parameters that may be built into a company's risk management program. Many companies (including some dealers) set a standard of managing or controlling the risk of price moves with a magnitude of two standard deviations over a defined period of a market's history. While that standard may be sufficient to cover expected or periodically recurring levels of price movements, it may not cover much larger and more damaging price moves due to an unusual or unexpected event. Thus, a company also has to consider the risk of unexpected events and the occurrence of price moves that, statistically speaking, shouldn't happen but nonetheless might (statisticians sometimes refer to these situations as "outliers"). While using the highly valuable tools of modern

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11/Of course one important threshold question for directors is the degree, if any, to which the company is using stockholder funds simply to speculate on the timing or direction of markets.

markets for analyzing risk, there is still not any substitute for judgment and a bit of healthy skepticism.

In this respect, derivatives, like other human inventions, can be both good and bad. For example, an automobile can provide its owner with efficient, convenient and sometimes even very pleasant transportation. However, the same model auto that is driven at 90 miles per hour down a curvy and wet mountain road may be a mortal danger to its driver and others on the road at the same time. That difference isn't the result of the car, but of how it is used. The same phenomenon is true with the use of derivatives. If the CFO or Treasurer of a corporation plans to take the company's financial condition out for a drive in the markets, the CEO and the board should have a clear understanding of the plans for the journey.

With these general observations in mind, I would like to turn to the specific questions on which you have asked my views.

1. THE POTENTIAL FOR DERIVATIVES TO CONTRIBUTE TO INCREASED SYSTEMIC RISK IN THE FINANCIAL SYSTEM (INCLUDING THE POTENTIAL FOR SUCH FINANCIAL INSTRUMENTS TO CONTRIBUTE TO INCREASED LEVELS OF VOLATILITY OR EXCESSIVE SPECULATION IN THE STOCK AND BOND MARKETS.

Banks have always been exposed to credit risk through their loan portfolios. Many banks are now also heavily exposed to market risks through the management of enormous portfolios of securities. Their foreign currency business creates significant trading as well as settlement risks. The same is also true for broker-dealers.

These credit, market, operational, legal and other risks in nonderivative activities are generically the same as the types of risk arising from derivative activities. Thus, the activity of banks and broker-dealers in derivatives does not really create any new type of financial risk, though the proportions of different types of risk may be modified from traditional patterns. Ultimately, the different elements of risk that must be monitored both by the company and by its supervisors are largely the same.12/

One factor making people fear systemic risk is the derivative industry's practice of announcing its statistics in terms of "notional amounts." The notional amount is a reference standard for calculating cash flow obligations, not the obligation itself. Indeed, actual credit exposure to swap contracts, for example, is typically less than 5% of the "notional amount."13/ Notional amounts are a convenient and by now accepted measure for positions, but it must be understood

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12/This is why the only agency that can effectively evaluate the riskiness of a firm's derivatives activities is the agency that is also responsible for evaluating its non-derivative exposures of the same type. If the evaluation of a bank's credit risks in loans is done by one agency, and its derivatives by another, there would be a significant likelihood that the full supervisory picture would be lost. The same is of course true of broker-dealers, where the SEC is the only agency that could perform a meaningful evaluation of the overall financial condition of a broker-dealer.

13/In its Annual Report for 1993, for example, J.P. Morgan & Co. Incorporated reported that it had approximately $1.6 trillion in "notional amount" of swaps, options and other derivatives. However, the firm's reported total credit exposure to such instruments was $20.7 billion (only $6.3 billion of which was reported on the balance sheet).

that the reported notional amounts vastly overstate the actual credit exposure or expected cash flows associated with derivatives.14/

An important element in evaluating systemic risk is the size of cash flows that could potentially be interrupted due to an unexpected problem, and the capacity of the system to provide alternate sources of liquidity to replace the interrupted cash flow in order to prevent defaults from following a chain reaction. Here, the daily cash flow requirements in derivative markets are far less than those resulting from spot foreign exchange transactions, settlements in government securities, mortgage backed securities and many other instruments. In all of these markets there are higher daily settlement requirements.

Of course rapidly growing markets do pose special supervisory risks. They tend to attract new participants who will not always make the necessary personnel and systems investments and may encounter problems as a result. The very newness of many individual products may mean that legal or regulatory issues have not been fully explored. Here the industry has made extensive and quite important efforts to codify master agreement documentation, and to remove legal issues as to

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14/It is worth noting that derivatives transactions have not been responsible for the failure of any significant depositary institution in the U.S., although thousands of banks and thrifts have failed due to poor lending practices or insider transactions. That is certainly not a guarantee for the future, but it should provide some helpful perspective.

the enforceability of netting arrangements that can reduce potential system risks profoundly.

Since new types of risk are not being created, the remaining systemic issue is whether the magnitude of derivatives transactions and resulting cash flows creates a risk that the overall system will be strained past some breaking point. The back office crisis of the U.S. securities industry in the 1970s, and the capacity limits of the equity trading systems in 1987, are examples of potential systemic risks resulting from the sheer volume of transactions or the ability of the system to supply sufficient liquidity under both extraordinary volume and severe price stress.

This is a very difficult issue because it involves the supervisory equivalent of unexpected event risks. Happily, high rates of growth in trading activity in derivatives have also coincided with very high rates of investment by dealers in communications and data processing capacity. The major related cash and exchange-traded derivatives markets have also generally been investing substantially in enhancements to the capacity and reliability of their systems. Therefore, while eternal vigilance is called for by both banking and securities regulators, there is not today any apparent serious capacity constraint on market or communications systems. In dealing with systemic risk, the extremes of both Pollyanna and Chicken Little must be avoided in favor of constant attention to enhancing the speed, reliability and capacity of systems in all our major markets.

For the future, the best way to prevent the development of systemic risks is to maximize the transparency of financial reporting by both U.S. and foreign derivative dealers and users, and in every way possible to preclude the extension of public credit, deposit insurance or other explicit or implicit government backing for derivative dealers. Market disciplines should be allowed to curb speculative abuses where they arise without attempts to shield firms through governmental intervention that has historically proven to create moral hazard problems of a substantial order.15/

2. THE NEED FOR IMPROVEMENTS IN INTERNAL CONTROLS AND RISK MANAGEMENT SYSTEMS OF BOTH THE FINANCIAL INTERMEDIARIES AND CORPORATE OR OTHER END-USERS OF DERIVATIVE FINANCIAL INSTRUMENTS (e.g.,MUTUAL FUNDS, MUNICIPALITIES, PENSION PLANS OR OTHER INSTITUTIONAL INVESTORS).

Risk Management by Dealers. This is a critical area for both dealers and end-users. As to dealers in derivatives, both the federal banking agencies and the SEC have programs designed to test and to evaluate the risk management systems of firms under their respective supervision and oversight. By testing and

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15/Firms engaged in derivatives trading for their own account should be risking their own shareholder's capital, and only that -- not taxpayer dollars or publicly insured funds. If that limit is observed, then boards of directors can appropriately serve as the primary oversight and review mechanism for these activities, and public authorities can avoid the need for interventions that would erode market discipline for risk-taking. Of course there should also be effective supervision of financial institutions engaged in derivative activities. However, that supervision should be carried out by the same agencies, and to no greater or lesser extent, that would supervise a firm's exposures in the cash market for bonds, currencies or other instruments.

evaluating a firm's risk management and controls system, the regulator seeks to develop an understanding of the firm's ability to control overall risk patterns in any given situation.

In the area of financial institutions' risk management systems, it is important for regulators to seek to establish standards for minimum practices, but not to codify a particular form or approach to risk management. Nobody has a crystal ball, including the regulators. Therefore, it would be counterproductive for regulators to mandate specific risk methodologies, for example. Instead, regulators should encourage constant enhancements to, and review of, risk management systems, with final responsibility and accountability resting with management and the board of directors. Those firms whose systems are not adequate to support a firm's type and level of activity can be required to curtail new activity until adequate internal controls are present.

While improvements can always be made, this area is one where virtually all the major players in the market have been making relatively significant investments. Happily, many of the investments necessary to enable firms to operate and trade profitably also enable the firm to model and structure its own risk profile in a manner that will not exceed its tolerance for risk to the balance sheet or the income statement.

In contrast to the situation of the largest derivatives dealers, where overall risk management systems tend to be fairly high, new market entrants, second or third tier dealers, firms

with limited scope and others may have failed to make the generally high level of investment in people, analytics and data systems that are required to manage risk effectively.

Internal Controls of Dealers. For derivatives dealers, the biggest problem tends to be internal controls rather than risk management systems. While investments in risk management systems tend to be perceived as contributing to profitability, internal controls and similar "compliance" functions are not always seen in the same light. Thus even some very large institutions may have serious deficiencies in their ability to operate effective internal controls. Breakdowns or patent inadequacies of internal controls have been a factor in most of our largest bank and securities firm "scandals," as well as with many of the worst financial losses that have occurred. Time and again, internal controls prove to be a point of major vulnerability to a firm's ability to carry out policies designed to control risk, or to insure compliance with the law.

Risk Management by End-Users. By far the greatest need for improvement in risk management systems is with the end-users of the products, including corporations, governmental entities, mutual funds, pension funds and other institutional investors. Here the seeming torrent of companies that have experienced losses when interest rates began to reverse their previous long period of decline provides a fresh stream of examples of companies that had not put in place adequate systems for understanding and managing risk.

One basic distinction in the corporate world is whether the company allows (or encourages) its treasury operation to take positions in derivatives that are not related to hedging the company's normal business risks. Some companies look to the treasurer's office as an independent "profit center," rather than viewing it as a "cost center" that simply provides service to operating divisions of the company.

Where a company determines to seek to build on its own financing experience and to seek to generate profits from derivative trading, that company has entered into a far different arena from that involved in managing its own operating costs and exposures. Essentially, such companies have made an election to go into the business of proprietary trading. There is not any per se reason why such a decision would be inappropriate if the goals and limits of such a policy had been approved by the board, and fully disclosed to shareholders. However, any such decision would mean that the user corporation had decided to become at least in part a de facto dealer in these instruments.

The first corollary of any such decision is that if it hopes to be successful, the company must be prepared to invest in analytical systems competitive with the major financial institutions, rather than with other end-users in the market. While corporate officers may get caught up in the mystique of dealing in this market, in most cases an end-user corporation simply does not have the systems for risk modeling and risk control that would be present in a major dealer. An end-user

also does not have nearly as many inputs of market information as does a major dealer involved in large numbers of transactions. These differences would seem to make it difficult for a typical end-user corporation to be successful in proprietary trading activities over time.

Internal Controls of End-Users. The inadequacy of internal controls at many end-users of derivatives is another closely related but separate problem. Many companies have invested in a top quality internal audit department, and management has devoted significant attention to the development and use of an effective and efficient system of internal controls. However, there is certainly quite a bit of variation in the quality of these programs in different companies.

Establishing effective and efficient systems of internal corporate controls is a difficult task requiring a careful blending of incentives, corporate culture, regulatory and compliance systems (if any). It also requires senior management to articulate goals clearly, and to establish procedures for communicating important policies and procedures and management's commitment to them throughout the firm.

While there may need to be considerable enhancements to the internal controls of many end-users of derivatives, the best way to accomplish this would be through internal action by the directors or the most senior management of the company. Effective controls cannot simply be purchased in the software store, or taken off the regulatory shelf. Effective controls

must be closely tied to the individual company's operating structure, its own particular control risks and its experiences to date. Good controls must be related to the overall management structure for operations, yet also responsive to the dynamics of the controls objectives.

Throughout our history, members of the board of directors of a public company have had extensive fiduciary duties to shareholders, and they have been held accountable for establishing a system of internal controls that is satisfactory for the specific company. Boards are ultimately responsible to the shareholders for the protection and enhancement of their shareholder values. Thus, directors must be certain that a company is able to control unacceptable risks of financial statement fraud, unethical or illegal business practices, and many other issues. While some boards have clearly been more vigilant than others, the enhancement of internal controls is a matter best left for the shareholders and the board to decide.

Any attempt to superimpose the SEC or another agency with the power to direct end-user corporations on how to use these instruments, or how to control risktaking, would be a highly serious interference with the role of the board, and the delicate balance of corporate governance that has been built painstakingly for many years. It would also be well beyond the capacity of the SEC or any federal agency to achieve across the enormous diversity and complexity of America's roughly 12,000 publicly traded companies. What is needed are high standards for

management established by informed and active boards of directors, with good disclosure to shareholders and the market concerning a company's exposure and also its policies and practices regarding risk management and internal controls.

3. THE NEED TO PROVIDE INCREASED PROTECTION TO CORPORATE OR OTHER END-USERS OF DERIVATIVES AGAINST ABUSIVE PRACTICES IN CONNECTION WITH SALES OF SUCH FINANCIAL INSTRUMENTS (e.g.,THE SALE OF UNSUITABLE INVESTMENTS TO CUSTOMERS, INADEQUATE DISCLOSURES REGARDING THE RISKS ASSOCIATED WITH THESE PRODUCTS).

It is relatively easy to agree that "abusive" practices should be curtailed. However, the more difficult issue is defining what is, in fact, "abusive," or outside the norms of accepted ethical principles and practices of trade. This is an issue that depends very much on the context that one is considering.

"Suitability" standards are an important tool for the supervision of, among other things, the conduct of broker-dealers in securities with respect to solicited transactions in a retail context. Because of the inherent relationship of broker and customer, the SROs and the SEC have long required the broker to know his or her customer and to make a reasonable judgment as to the appropriateness of a particular type and size of transaction to the customer's ability to absorb risk. Suitability embraces issues of customer understanding of risk and the customer's ability to absorb risk.

Since the earliest days of federal securities regulation, however, there have been exceptions from normal regulation for

large and sophisticated market participants. An obvious example is the fact that an issuer may sell securities to a large institutional purchaser in a private placement without registering the securities with the SEC or delivering a statutory prospectus to the buyer. This is done because, at some point, we believe that the buyer is big enough to take care of itself, and that the resources of public bodies such as the SEC should not be diverted from the task of protecting less sophisticated market participants.

The traditional (and still appropriate) answer as to whether a dealer should have a duty to make a suitability determination with respect to a major multinational corporation is simply "NO." There has not been a category of "widow and orphan multinational corporation," and I do not believe that we should create one now. If a major corporation loses significant sums in inappropriate speculation in any type of financial instrument, the remedy is for the management or the board to terminate the responsible individuals and to install better internal controls.

The issue of suitability standards is more difficult with respect to pension funds and other "institutional" purchasers of securities. While there may be no such thing as a widow and orphan multinational, all pension funds deal with widows and orphans, and some pension plans are not nearly as sophisticated as their asset size might imply. Here the issue is whether limitations are more appropriate through standards of conduct for the dealer selling the instrument, or for the trustee allowing

the purchase of the instrument. Traditionally we have governed the actions of pension fiduciaries through ERISA, life insurance statutory investment standards and similar devices.

While I am very cautious about the desirability of diverting SEC resources into policing transactions among people who are capable of protecting themselves, it is always important for a dealer in derivatives or other securities to understand the client's level of sophistication and the client's motivations for entering into any transaction that involves disproportionately large or particularly unusual risk characteristics.16/ If the level of potential exposure of a governmental entity, pension fund or other institutional purchaser becomes utterly disproportionate to its resources, then special steps are called for by the dealer.

At a minimum these steps would include determining the level of client approval of the transaction, and the rationale for its unusual nature. However, the dealer should also consider refusing to enter into a transaction involving client exposures that are substantially disproportionate to the client's resources. Competitive pressures sometimes make this difficult, but it is one way of avoiding far more serious potential problems.

16/This has reasons that go beyond suitability concerns. Such inquiries would also help detect any situation where the counterparty is seeking to use a derivative transaction to conceal unlawful conduct of some type.

Government entities, pension plans, mutual funds and similar entities should not be precluded from utilizing OTC derivative instruments, as this would prejudice their ability to seek the best results for their taxpayers, beneficiaries or shareholders. Those who manage such institutions acting on behalf of others should of course exercise skill and care in managing their activities, including limiting their ultimate risk exposure in a thoroughly prudent manner. The managers of such institutions should also be accountable in an appropriate manner to the beneficiaries, shareholders or voters.

Dealers who may be selling instruments to such entities should apply the highest standards of business ethics that they would apply to other types of customers as a matter of good business practice, irrespective of legal requirements. This should include being certain that the customer's motivation and goals for the transaction are understood and seem to be within a realm of reason, and full and extensive disclosure to, and even discussion of risks with, the customer in such an institutional setting.

The foregoing discussion seeks to answer what factors ought to be considered in determining whether a particular act or practice should be considered "abusive." Certainly misleading disclosures, such as deliberately inaccurate or incomplete scenario projections, should be considered to be "abusive." The industry itself should be at the forefront of promoting standards of healthy conduct and codes of business ethics and practice. If

the derivatives arena is seen as simply a "free fire zone" in ethical terms, then the long term growth of the market could be impaired. As with other securities markets, public confidence in the integrity of the market and its major participants is an essential ingredient in building liquidity and efficiency.

4. THE NEED TO IMPROVE THE PUBLIC DISCLOSURES PROVIDED TO INVESTORS REGARDING THE DERIVATIVES HOLDINGS OF PUBLIC COMPANIES, MUTUAL FUNDS, MUNICIPAL GOVERNMENTS, AND OTHER END-USERS OF DERIVATIVE FINANCIAL PRODUCTS.

I strongly believe that improved transparency of practices in this entire area would be the most beneficial action that can be taken. Shareholders and others can usually tolerate bad news far better than they can bad news that comes as a complete surprise. The nature and level of a company's derivative activity, and the level of exposure of both its earnings and its net worth, are very important disclosure issues. For firms with significant levels of such exposure, management's discussion and analysis should also include commentary on the company's practices, controls and strategies. It should not be possible for losses of a significant magnitude to occur without there having been disclosure that risks of such a potential magnitude are being incurred by the company.

In addition to all the other benefits it brings, greater disclosure to shareholders concerning the nature and magnitude of derivative activities has the added benefit of helping to make sure that the board of directors has appreciated the scale and

magnitude of a company's activities and its exposure even under the most unexpected circumstances.

Though the question was addressed to improved disclosures by end-users of derivatives, it is also relevant to dealers as well. As discussed earlier, far greater transparency of disclosure by the financial institution participants in the market can provide better market disciplines against excessive levels of speculation or abusive practices. There is still work to be done to improve the quality of disclosure concerning the risks embedded in financial institutions. However, any enhancements to disclosure should not be targeted solely at derivatives as some type of suspect transaction, but should be designed to permit the analysis of earnings and risk across the spectrum of different types of financial instruments. Finally, it is desirable if such enhanced disclosures and improved transparency can be developed by management and a company's outside auditors. A company should work diligently to design the best form of disclosure to suit its own specific conditions, and it needs the flexibility to structure the most helpful and informative presentation. Codification of requirements too soon could prevent healthy experimentation.

[illegible]. THE NEED FOR ANY CHANGES IN THE REGULATORY TREATMENT OF DERIVATIVE FINANCIAL INSTRUMENTS OR THE ADOPTION OF REMEDIAL LEGISLATION RELATING TO SUCH INSTRUMENTS.

The growing size and importance of the OTC derivatives market makes it important for Congress to understand the

practices in this marketplace, but it must approach <u>any</u> legislative actions with great caution. There is already a substantial volume of contractual commitments in place, and we must be certain that any potential legislative actions enhance certainty in the marketplace rather than detract from it. Furthermore, this market is a global market that can easily shift transactions from one jurisdiction to another. Where a nation puts in place unilateral and ill-considered actions such as transaction or other taxes, market participants will swiftly move transactions to other venues and thereby render the action meaningless except as a jobs export program.

One area for inquiry, though not necessarily for any legislation, is the issue of whether the SEC has done enough to make it possible for shareholders and potential investors to understand the practices and exposures of institutions dealing in or purchasing significant quantities of derivative instruments. Here there are issues of whether the traditional materiality test based on aggregate corporate net worth and earnings is an adequate threshold for disclosure. There may also be certain specific activities, such as corporate use of highly levered instruments, that are indicative of trends that would be important to shareholders to appreciate. Sunlight is the most powerful disinfectant in the market, and there may be areas where stronger doses of that traditional medicine may help prevent the development of abuses.

The maximum permissible level of leverage is another issue for future consideration. Supervision of dealers extending credit may be sufficient to prevent excessive leverage, but the area is one of classic concern.

While I am not an expert in the nuances of enforceability of netting agreements under the bankruptcy code, the uniform commercial codes of the states, and the laws of foreign jurisdictions, any and all actions to strengthen legal certainty as to the enforceability of obligations, including netting agreements, will powerfully contribute to systemic stability by significantly reducing potential liquidity demands.

Finally, there is the issue of whether most OTC derivative contracts are in fact securities as a legal matter. If they are, then many traditional protections of the securities laws such as prohibitions on fraudulent acts are applicable to the behavior of dealers and others in this market. If some or all OTC derivatives are not securities, then one must consider whether any analogous prohibitions against fraudulent conduct would be appropriate. Certainly there should be some consequence for practices that involve outright deceit or distortion, for example.

On balance, I believe that recent publicity surrounding this market has been considerably overstated and overly alarmist. On the other hand, I firmly believe that the public scrutiny that is taking place can also have a salutary impact on practices in the marketplace. Hearings such as this should help to put both dealers and end-users of these important products on notice that high standards of legal and ethical behavior are definitely in order.

Mr. MARKEY. And our final witness, Dennis Weatherstone, is the chairman of the Board and CEO of J.P. Morgan & Company and has served in those capacities since January of 1990.

Mr. Weatherstone also serves as chairman of the Group of 30 Global Derivatives Study Group, and under his leadership the industry's oft quoted review and analysis of how best to control and manage the risks associated with derivatives trading, the G-30 report, was published.

He testifies before us today as both an observer and practitioner in this area, as he began his career with hands-on experience as a foreign exchange trader in London.

We welcome you to our subcommittee, Mr. Weatherstone. We look forward to your testimony.

STATEMENT OF DENNIS WEATHERSTONE

Mr. WEATHERSTONE. Thank you very much, Mr. Chairman. I will be as brief as I can and there is a more detailed written testimony.

First, the use of derivatives has grown dramatically because they serve a good purpose which is managing risk. Managing risk is nothing new. It is a basic function of finance and a basic need of business. But it is a task that has become more challenging.

Markets are opening, trade closed more freely, so business and institutions of all kinds have more dimensions of risk to deal with around the world than ever before. Markets respond to such needs through innovation. Derivatives are a product of that healthy process, one that has taken place, I should stress, over many decades, not just the past few years.

Of course, derivatives cover a range of products, some long in standard use, like foreign exchange forward contracts, going back maybe 150 years; others relatively new, but rarely controversial, like swaps and some rather rare and complex.

The point is, risks would exist whether derivatives did or not. The point is, risks would exist whether derivatives did or not, but without derivatives we would be less well able to manage those risks than in fact we are.

The second key point is that there is nothing fundamentally new, unique or threatening about the risks involved in derivatives activity. They are the same old risks, credit, market and liquidity risks, legal and operational risks. The major risks to which participants in the derivatives markets are exposed is actually credit risk, the same one involved in traditional financial transactions including making loans.

This is the risk that most derivatives dealers have the most experience managing, and the evidence suggests that concentration of credit risk among dealers does not pose a problem either, thanks in part to the growing use of master netting agreements.

Major derivatives market participants are characterized by high credit ratings and strong capital positions. When the primary exposure is to credit risk, this is no more than the market equivalent of natural selection. Links among derivatives dealers are of essentially the same kind of links as in other markets so there is no reason to believe that these dealers are uniquely prone to topple like dominoes.

World financial markets in general are more interdependent than ever before, but that is because of the rise of cross-border capital flows in deregulation of national markets. Derivatives have been found to have a beneficial effect if anything on the behavior of underlying capital markets in times of stress.

My third point is that risk-management practices by those who deal in or use derivatives continue to improve steadily. The Group of 30 study of derivatives this last year had one main goal, to raise the standards of practice among dealers and, importantly, among end users of derivatives.

The G-30 report, which was begun at the initiative of market participants 2 years ago, constituted perhaps the most extensive sharing of knowledge and state-of-the-art techniques ever published in the financial industry. The good news is that we are seeing its effect. Participants are clearly improving their risk management practices and disclosure.

Derivatives activity is getting plenty of attention by regulators, my fourth point. More important, that attention is increasingly informed and constructive. It covers the major dealers thoroughly and it is backed by the authority and skill to make sure supervisory initiatives have teeth. Because derivatives activity is global, there is also active attention in other countries and by the supernational international settlements.

The only regulatory community, just about all interested parties from industry groups to the FASB to rating agencies, are actively at work on proposals or possible improvements in practice.

My last point is the conclusion that so far the normal channels are working. It is hard to make a case that separate regulation or additional legislation is required to make up for a deficiency elsewhere. That is not to say everything is perfect and no sensible person is complacent about the potential for destabilizing risk to the financial system. But are we at the point where unusual steps are needed?

Such measures would themselves carry risks, the possible risk of limiting the use of effective risk management tools and the risk of placing American institutions at a disadvantage vis-a-vis their powerful international competitors, to name just two.

Again, derivatives activity, like virtually all financial activity today, knows no borders. I hope that Washington will not regulate discretion out of existence. Legislation takes supervisory discretion away from regulators and regulations take discretion away from managers. Market circumstances are always changing and the market's mechanism for adapting to change is innovation. So far the system for coping with the remarkable innovation we call derivatives is working remarkably well.

Thank you.

[The prepared statement of Mr. Weatherstone follows:]

Testimony of Dennis Weatherstone

Chairman

J.P. Morgan & Co. Incorporated

Chairman Markey and members of the Subcommittee, thank you for the opportunity to be here. You've asked for my views on the impact of derivative transactions on the United States financial system, and specifically for perspective on five key issues. I'll try to be as brief and informative as I can.

To set the stage, bear in mind the forces that are reshaping the political and economic environment globally. The increasingly free and efficient flow of capital across borders, in the wake of far-reaching social, political, and technological changes in every corner of the globe, generates recognized economic benefits. It also means a rise in the complexity of risks that companies, governments, and institutions of all kinds encounter, as their sphere of activity encompasses more markets. The risks themselves are not new, but the challenge of managing them is greater.

Innovation - in finance as in any business - is a response to change, and highly constructive when it fills a genuine need. Derivatives meet this test. They are useful tools for managing risk in a complex, volatile world that is here to stay. That's why derivatives transactions have grown so dramatically.

Whenever change occurs on such a scale, legitimate questions arise about its consequences and the proper public policy response. In this context, let me address the first and most serious issue you have raised: systemic risk. Do derivatives by their nature increase the probability of contagious failure or pervasive malfunction in the financial system?

Basically, fears about systemic risk fall into two categories: one, that if a derivatives dealer is unable to meet its obligations, other dealers will collapse like dominoes; and two, that derivatives contribute to greater volatility or excessive speculation in the stock and bond markets.

The risk that a dealer cannot meet its obligations is a credit risk - the same risk involved in many financial transactions, including making a loan or participating in the interbank payments system. Credit risk is probably the oldest and most familiar kind of financial risk, the one that most derivatives dealers - certainly banks - have the most experience managing. So the major risk to which derivatives dealers are exposed - credit risk - is not new.

Does concentration of credit risk among major dealers pose a unique problem? What this amounts to is a concern that counterparties are not prudently managing their exposure to one another. Judging from experience, this is not the case, thanks to the increasingly consistent application of tested risk management practices and to the growing international use of legally binding netting agreements. The variety of exposures between two major derivatives dealers tends to reduce their *net* credit exposure to each other. Congress served the market and the public well in acting three times in the past few years to clarify the legal status of master netting agreements. They are proving a powerful tool for reducing systemic risk, and we expect their use to become standard.

As for the domino effect, it is simply not true that the interdependence of dealers in derivatives is different in kind from that of participants in the payments system, the foreign exchange market, or other traditional markets. Links among dealers are essentially the same as in other markets. The risk is no more than this: that one market participant won't make payments that others expect - a classic credit risk.

What about the fear that derivatives tie markets together so effectively that shocks in one place can spread to other markets with such speed that regulators do not have time to manage the situation? Global markets have become more closely linked primarily because of the rise of cross-border capital flows and efforts by governments to open national markets, in the hope of attracting mobile capital. Derivatives are part of this larger phenomenon but not its cause, and there is no

reason to believe that they transmit shocks which would otherwise be contained. Evidence about the effect of derivatives on underlying markets actually suggests a beneficial effect. A January 1993 joint study by the Federal Reserve, FDIC, and OCC concluded that, during the 1992 European currency crisis, "It is unlikely that the underlying markets would have performed as well as they did in September without the existence of related derivatives markets."

The risk of contagion exists in all financial markets. Regulators and participants are well aware of it, and the challenge of guarding against threats to the system rightly gets plenty of attention. But derivatives present no special or intensified threat.

Now, do derivatives contribute to excessive volatility or speculation in the capital markets?

This fear harks back to the role of portfolio insurance during the 1987 stock market crash, and to the self-reinforcing momentum that so-called delta or dynamic hedging theoretically might generate in falling markets. Last year's report by the Group of 30, produced by a cooperative effort of derivatives dealers, end users, and academics, stated that "the academic research on the effects of derivatives on market volatility is increasingly consistent in its findings, and particularly voluminous after the 1987 crash. The research strongly indicates that derivatives trading either has no effect on, or reduces, volatility in underlying markets." The theory that dynamic hedging could produce overwhelming pressures in the cash or exchange-traded derivatives markets is also based on a questionable assumption: that those who write options do not understand options pricing theory and do not prudently limit their short options positions.

It is relevant in this context that the stresses and volatility in the stock and bond markets during the early months of this year had relatively little to do with derivatives. And while the question about derivatives' effect on market volatility remains controversial, we frankly do not have the facts today to settle the matter. We are eager to cooperate with regulators to help everyone

understand how pressures actually build up in the markets, and how they can be managed with the least effect on the markets' ability to absorb and cope with change.

Generally, I think it is important to dispel the notion that derivatives are inherently more speculative in nature than more traditional instruments. They are not. They simply provide a way - one of the most efficient ways - to alter or change exposure to market prices.

Finally, studies conducted to date by supervisory authorities on the systemic implications of derivatives have concluded that derivatives do not significantly increase systemic risk. Far from being complacent about such risk, however, U.S. and other supervisory entities have been actively improving their understanding and supervision of derivatives activity. We are encouraged by and actively support these efforts. I would also stress the fundamental conclusion of the Group of 30's study, which urged strengthening management practices on the part of both dealers and end users as an essential first line of defense against systemic problems.

This leads me to your second question, about the adequacy of internal controls and risk management systems of dealers and end users of derivatives. Again, the thrust of the Group of 30 recommendations was to improve risk management practice throughout the market, and the G-30 study represented a major effort to transfer knowledge and advanced techniques for managing risk to all market participants. The good news is that we are seeing the intended effect: Participants are improving their practices.

I would also point out that good risk management systems are essential to conduct business in the financial markets generally - not just to manage derivatives - and, again, that the risks managed throughout are the same: credit, market, and liquidity risks, as well as operational and legal risks. Derivatives simply make it possible to manage the same risks in new, more flexible ways.

The third issue arises from recent concerns about the use of derivatives by public companies, pension funds, municipal governments and a host of others. Do they need to be protected from abusive practices in the sale of derivatives?

Let's remember that this is almost entirely an institutional activity. The level of sophistication among participants, end users as well as dealers, is assumed to be high, just as in other markets dominated by institutions. There is no evidence that the healthy and long-established distinction, in law and public policy, between such sophisticated players and retail consumers of financial services should be abandoned.

On the other hand, I think the dealer community should step up to the challenge of making sure its practices hold to a high standard - that they are consistently based on clear communication of the risks and benefits of the product or strategy being proposed to the end user. And it is essential that end-users, for their part, assume appropriate responsibility for understanding, authorizing, and managing their use of derivatives. We've worked increasingly with clients over the past year to review and improve their risk management approach and capabilities, and expect to do more. And let's not forget the axiom that any business which doesn't deal honestly with its customers is not going to have them for long. With powerful incentives for both dealers and end users to understand and use derivatives properly, legislated tests of suitability or other restrictions on sophisticated institutions are at odds with the constructive operation of market discipline.

Disclosure is the fourth issue of concern. I fully agree that improvements in disclosure of derivatives activity are needed, and I'm encouraged to see that both voluntary and official progress is being made. Many recently published annual reports, especially of dealers (including J.P. Morgan), provide more useful information. Just about all interested parties, from industry groups to the FASB, rating agencies, and regulators at the national and supranational levels, are actively at work studying possible improvements, issuing proposals for comment, and preparing new

standards. In other words, normal, constructive adaptation to change is proceeding - not least because the market itself, embodied by investors, is demanding better information. There's no apparent deficiency of attention in the right places that calls for legislative intervention.

The final question is whether there is need for any change in regulatory treatment or for remedial legislation on derivatives. On this, I would repeat the point made a moment ago: There is every sign of progress in addressing the challenges posed by derivatives through existing channels, from initiatives on capital treatment of market risks by the Bank for International Settlements to voluntary improvements in risk management practice at individual institutions. In particular, supervisors of banking institutions that are derivatives dealers are vigorously examining dealers' activities and controls, with increasing knowledge and with all the authority and tools needed for the job.

As to whether separate regulation of derivatives is warranted, I believe such a system would be at cross-purposes with the existing framework of regulation, with its emphasis on the risks common to all financial activity. The risks involved in derivatives, again, are not new or different; only the techniques for managing the risks are new. Able, active, flexible supervision does more to limit risk, in my experience, than any set of rules.

It is also critical to recognize that, like most financial markets today, the derivatives market is global. Any regime of regulation that applied only to U.S. institutions would have little impact on the key concern - systemic risk - and would certainly place U.S. institutions - including corporate end users - at a disadvantage vis-a-vis their powerful international competitors. There is also a significant risk that the over-the-counter derivatives activity - the largest segment - could be driven offshore if the burden of regulation or legislation became too great, with negative economic consequences for our country. The Euromarket grew up in just this way a quarter century ago.

Perhaps most important, unnecessary regulation could deprive end users of efficient risk management tools that prove their value daily to American businesses operating in a volatile, complex global financial environment. I would be happy to provide the Committee with case studies of the many useful purposes to which derivatives are put by American companies, as time does not permit giving examples now.

I am aware of concerns about unregulated entities in the derivatives market. While I have not seen compelling evidence of dangers that require bringing such entities under some scheme of regulation, I think we need to consider the merits of any proposal with an open mind, provided there is a clear focus on the public purpose to be served. Essentially, the test should be the risk to the financial system posed by the presence of unregulated or differently regulated entities. Absent a clear, significant risk, I believe a mix of regulated and unregulated service providers can be beneficial.

In conclusion, I think Washington should take care not to regulate discretion out of existence. Legislation takes supervisory discretion away from regulators, and regulations take discretion away from managers. Market circumstances are always changing. As I said at the outset, the market's mechanism for adapting to change is innovation.

The debate about derivatives is, at heart, a debate about coping with change. Derivatives do involve risk, but their value is genuine, and the risks are neither new nor impossible to manage. And so far, the system for coping with this remarkable adaptation to change is working well.

Mr. MARKEY. Thank you very much.

The Chair will now recognize himself for a round of questions.

Mr. Corrigan, 2 years ago the New York Bankers Association sounded a warning on derivatives, and there are a number of scenarios that we could go through here, but let's just list some of them that would be of concern to this subcommittee and to regulators. A large dealer or user making a big, wrong bet on the market's direction and then panics. A large counter party defaults and triggers a cascade of other losses. A liquidity drought occurs, as in October of 1987, so that the ability to dynamically hedge a derivatives position suddenly disappears. A flawed hedging model is relied upon by a dealer or user whose projections of market volatility or pricing turn out to be wildly inaccurate. Some of these affect only the firms, some of these affect the whole system.

Does the rapid growth, Mr. Corrigan, of derivatives markets suggest that formerly cautious and conservative firms are taking speculative positions in markets where they have limited experience and expertise?

Mr. CORRIGAN. Let me, Mr. Chairman, try to briefly put your question in perspective. First of all, as I have said on many, many occasions, there is no question in my mind that derivatives broadly defined do work in the direction of reducing risk overall.

The issue that I think is also relevant, however, is that while derivatives work in the direction of risk reduction, I do think that we have to allow for the possibility that while the probabilities of something genuinely bad occurring may be a lot lower because of derivatives, I think that we also must be sensitive to the fact that controlling a situation can be made more complicated by virtue of derivatives.

Mr. MARKEY. Of the disastrous scenarios that I laid out, which of those do you think that we should be most concerned about?

Mr. CORRIGAN. I think that Mr. Weatherstone made a crucial point. At the end of the day it is almost always going to be a credit problem of one kind or another that triggers something else. And in that sense I think that is the key.

However—and again, I think that there maybe slightly different views on this—but I think that when you ask yourself the question, Given a shock to the system, what is the modality, the instrumentality that can cause that shock to move across institutions, across markets, my own view has always been that the place we have to look is at clearance settlement and payment systems, the plumbing of the financial system, as I like to call it. And that is one of the reasons why I have always tried to stress the need to do all we can to further strengthen those systems.

Mr. MARKEY. Would it be——

Mr. CORRIGAN. I think one of the key recommendations throughout the G-30 report is precisely aimed in those areas. But I have never—to answer your question—I have never been able to answer what is a likely flash point. I don't know. But I do know the things that are likely to make that flash point a matter of greater or lesser concern.

Mr. MARKEY. When you were head of the New York Fed you dealt with both the failure of Drexel Burnham and the collapse of the Bank of New England, both of which had derivatives holdings

that were much smaller than those held by banks derivatives dealers.

In light of the extraordinary efforts that went into responding to those events, what do you think would happen if a large dealer like Chemical Bank or Bankers Trust or Goldman Sachs got into serious trouble? Isn't there a far greater risk today of a cascade effect of losses at other firms and of increased market volatility?

Mr. CORRIGAN. I think there is a far lesser risk today than in the past of any of those types of things happening because all major institutions have substantially improved their financial strength and muscle over the past few years. All major financial institutions have dramatically increased their internal control systems, information systems, risk management systems, and indeed I would stipulate that we are better off in terms of the underlying strength and vitality of our financial system today than we were in the past.

Mr. MARKEY. Mr. Breeden?

Mr. BREEDEN. I would agree to most of what Gerry has said. I do see every day in the marketplace immense investments going on in both the area of internal controls and in the area of very sophisticated risk management.

Of course, none of us can say that in the rest of human history no financial institution will get itself into trouble, and maybe they will do so with derivatives or maybe they will do so with something else none of us has thought of yet or a product yet to be invented. There is no way anybody can give you a guarantee that that won't happen.

As long as we have vibrant and competitive markets, I think the benefits of those competitive markets far exceed the costs when firms are not, occasionally, not successful. I believe that these tools help companies limit risk and for the most part by the major financial institutions are effectively used to do that, and that we have therefore less risk than we would have, given the same aggregate size of markets if we didn't have these tools available.

Mr. MARKEY. Mr. Weatherstone, in your prepared statement you walk through some of the concerns about systemic risks and essentially argue that each is either misplaced or manageable. This subcommittee over the past decade has been witness to many impressive pieces of testimony back in the late 1970's about how safe Third World bank loans were, the argument in the 1980's about banks' speculative real estate lending or LBO loans, and how there would be no problem there.

We were assured in the summer of 1987 that there was absolutely no problem with program trading. Distinguished and nationally known witnesses sat here in July of 1987 and told us, Don't worry, it is all under control. And we heard the same thing about junk bond default rates back in the mid-1980's. We were assured about that as well.

Why shouldn't we cast an arched eyebrow towards this as well, Mr. Weatherstone? I think that too many of these corporate CEO's don't have a clue as to what is involved in these transactions. I am afraid that too many of the CEO's of financial firms don't understand what their 27-year-old nuclear scientists are doing in the lab with there tailor-made, custom-designed derivaties that have their personal imprint on them.

Why shouldn't we be concerned at a much higher level than the relative calm that you bring to this witness table today?

Mr. WEATHERSTONE. I might say the participants in the market 2 years ago decided that there was a concern about a market which was growing rapidly, was global in its nature, was not necessarily well understood, and was profitable in these things that make you look at what is going on very carefully. That was the reason for the Group 30 study by the participants: to get a better understanding of the market. If you know what the risks are, you can manage them better. That was principle, number one.

In deciding what the risks are, we came to the conclusion that there were no particularly new risks in derivatives. They were the same old risks of credit, market risk, legal, operational and so on, and that what we had to do was manage those risks properly. Now you can always lose money through inappropriate decisions in connection with those risks, but it is not to lay the blame on the derivatives as such. You can make a faulty credit judgment or a faulty market risk analysis.

Mr. MARKEY. We wouldn't lay the blame per se on Third World loans or on junk bonds or on real estate investment. The problem is the lack of understanding on the part of the institutions that are investing in these products or the inability of regulators to minimize any negative impact these investments could have upon the financial system as a whole. That is the problem.

I do agree with you in terms of how you view it. My question is, do too many of these people not have a proper understanding of the risk that they are undertaking?

Mr. WEATHERSTONE. There would be a few I imagine who don't understand some of the more complex products, but I think these numbers that are quoted, $12 trillion, $14 trillion notional principal amount as we know overstate the amounts at risk, which are much smaller than that.

And also many so-called derivatives are not that complicated. Foreign exchange hedges are now included in this grand term, derivatives. They have been around for 150 years, not difficult to understand, very useful, interest rate swaps, swapping the obligation to pay a fixed rate instead of a floating rate is not difficult to understand and I think those kinds of transactions in foreign currency swaps probably make up by far the majority of the so-called derivatives transactions.

There are some, however, which are complex, highly leveraged and should only be undertaken by corporations and participants who really understand them. So we have to zero in on a rather narrow area, and I think we have done our best to do that through the control systems in the banks working with the supervisors.

And very importantly, what was mentioned earlier, advising our clients when there is a somewhat more complicated derivative, we regard it as our responsibility to see that the risks are understood by the client. If you don't, sooner or later you won't have any clients. So we think there is a market discipline to that as well.

I agree there is a problem. It does come around to credit. In the end, I think the derivatives business is largely a credit intermediation business and if we focus on good credit practices, we are more likely to avoid problems.

Mr. MARKEY. I would agree with that, but what we have in this arena, as in all arenas, are people who are not engaging in good practices, and we have innocents or ignorant potential victims combined with the potential for systemic risk as well. Although Mr. Breeden and others minimize that potential, I think it is still difficult to evaluate it and finalize it, because, as you know, notional principal is used by the industry itself as a market measure, because there is no data on capital flows at risk; it just doesn't exist.

What we are trying to say here is that we need to give better vision to the regulators and to others who are out in this marketplace so they can understand where they are at any point in time. Otherwise, we could be creating a class of victims who could, in turn, include the financial system of the country as well, if only for a short period of time. While it corrects itself eventually, and I guess you would say that there would be a certain discipline, the question is how do we avoid going through that learning period.

My time has expired. Let me recognize the gentleman from Ohio.

Mr. OXLEY. Thank you, Mr. Chairman.

Let me ask each one of the panelists—in the cases of Procter & Gamble and J.P. Morgan or Meade, are we dealing with anything except ordinary business deals that went sour? If we take the position that these risks have to be disclosed, where do we draw the line? Are we in danger of requiring every management decision to be disclosed and is that our goal, and if it is our goal, is that a proper goal to have?

Mr. Breeden?

Mr. BREEDEN. I do not believe that disclosure of a management decision would be constructive. Indeed, that would be highly damaging to the overall disclosure system.

One of the things that people who really wanted to hide things at the SEC, you have two choices. One is you don't put something in at all and you are very likely to get chased. The other option is you prepare a 4,000-page document and somewhere on page 2,206 you put in that fact that you want to be sure no one will ever find. So too much disclosure can obscure what is really significant.

So I agree that it is very important to focus on disclosure of material events. It is also very important, and in recent years the SEC has focused very strongly on the importance of what is referred to as management's discussion and analysis, to have the management of the company set forth what management believes are the most important factors that shareholders ought to be bearing in mind.

Mr. WEATHERSTONE. We believe with regard to the participants in disclosure of as much relevant information as possible on a voluntary basis and we have at J.P. Morgan tried to be at the forefront of doing that, not only disclosing the notional principle amount of derivatives but also the credit risk, which is a much smaller sum, a much smaller percentage. For us, it is just over $20 billion, which is still a lot of money, but the balance sheet is nearer $170 billion, so there is some relativity there.

We also very much believe in the understanding by management of the issues and the proper corporate risk management system, and as I remarked earlier in regard to dealings with clients, we regard it as our responsibility to make sure that the clients are fully

informed of any product, not just derivatives of what the advantages are and what the problems are.

To disclose, however, every transaction, there is a loss on this and there is a profit on the other, I think may just be involving information but not understanding. So I would be wary of overdisclosure.

Mr. CORRIGAN. I agree with the spirit of both Richard and Dennis's comments. The only thing I would add is a point of emphasis. I think it would be a colossal mistake, colossal mistake, to even consider the extension of a formal regulatory framework or apparatus to corporate end users of derivatives. I think that would be just a horrible mistake.

Mr. OXLEY. How would we even go about crafting that?

Mr. CORRIGAN. Beats me. There are disclosure issues; again, I think the spirit of the two sets of comments that you have just heard I think are on the money. My point is just beyond that. I think it would be, as I said, a colossal mistake to try to do a de facto extension of a regulatory apparatus and regime to the corporate end users.

Mr. OXLEY. You heard my opening remarks regarding Procter & Gamble, under $2 million losses after taxes in a quarter in which they actually had $584 million in earnings, and yet my perception is that the media accounts only focused in on the loss figure, which is obviously a big number, and ignored the earnings.

To what extent do these kinds of media reports drive these kinds of hearings, the kind of attention paid to it by legislators and regulators?

Mr. Corrigan?

Mr. CORRIGAN. That is a tough one. I think you should ask the people behind you instead of the people in front of you.

Again, generally speaking, I think we can get into some areas of sensationalism here that I think get a bit overdone. On the other hand, I would also say that episodes like the one that you refer to probably—and the way they have been reported in the press—probably have served a very, very useful purpose of getting CEO's and treasurers and CFO's of corporations to ask themselves some hard, new, fresh questions.

One of the specific suggestions that is contained in that Frankfurt address of mine, which I think is quite consistent with that, I still think that to the extent it has not already been done, whether it is a dealer or a corporate end user, the boards of directors should take Mr. Weatherstone's report and hand it to the line operators and make them go down item by item, Where do we stand with regard to these recommendations.

I would also add that while it hasn't gotten as much attention as the initial report, I think the recently published Survey of Industry Practices, which covers both dealers and end users, I frankly found this to be more useful than even the first report. There again I think a chairman of a board of directors, a CEO or CFO should take this and give it to those line operating people and say, How do we shape up vis-a-vis industry practices.

So I think the raw materials are there, particularly in these two reports, that can provide a vehicle to get at these questions in a reasonable way.

Again, I think Richard Breeden made this point in somewhat different terms, but I think the P&G example may have done more to tee up the ball for evaluation at the level of the individual firms than any regulation or legislation that any of us could write. So I think that is a constructive development.

Mr. OXLEY. So your sense is that the entire marketplace that is taking in press accounts and real world reaction is very constructive in working these things out and that we shouldn't be in a position of, nor should the boards, or the SEC say to some people, Well, don't lose money. My little league coach used to say, Don't strike out. Occasionally it happened, as much as I tried to make contact. Is that your sense?

Mr. CORRIGAN. Yes. Not to sound self-serving, but that famous sentence of mine back in 1982, If this sounds like a warning it should, because it has I think probably played a useful role in the same process of focusing attention.

Again, Mr. Congressman, that any of us are saying that we think we are home free, not at all. I think we are all saying that there are avenues that need further attention, there are efforts that need to be reinforced. But again, as I heard the testimony of my fellow panel members, I think what we are also saying is that we don't see the case for legislation.

Mr. BREEDEN. Mr. Oxley, I think you have put your finger on something that is very important for people to remember. In a lot of these press articles, I must say people seem to be getting carried away with individual occurrences in which people have had a bad experience. People don't write about the occasions when risks that would otherwise have happened or costs that would otherwise have occurred were avoided.

If you were really able to tote up both sides of the ledger, I think what you would find these products do is to give companies, as I tried to say earlier, a very prudent means of shaping their own risk, deciding which risks they are really good at managing and keeping those, and shifting risks that they are not as good at managing.

So the losses that occur have to be kept in proportion not only to a company's ongoing business profitability and over a longer period of time that these instruments occasionally result in losses but they often result in very favorable results for the companies using them.

Mr. WEATHERSTONE. I just first of all wanted to thank Gerry. I want to hire him as a salesman for publicity for the G-30 reports.

I would mention as part of that, when the question was asked about users in this country and abroad, this was put together by 26 people from about a dozen countries all over the world. So it has application, was intended to have, in its recommendations for participants and end users on a global basis.

I would certainly share in this kind of concern and one of the reasons for publication of that was the focus that there seemed to be on the occasional problem that there was in the derivatives market and to the neglect of all the useful risk management results that were achieved by use of derivatives.

Mr. MARKEY. The gentleman's time has expired.

The gentleman from Oklahoma, Mr. Synar.

Mr. SYNAR. On the last two comments I think the congressional concern, which is the public concern, was best said by you, Mr. Weatherstone, when on page 3 of your testimony, you say about the derivatives effect on market volatility remains controversial.

We frankly do not have the facts today to settle the matter. That is why we are here today, trying to accumulate facts to find out exactly what is the problem.

Mr. Corrigan, I see from this morning's Wall Street Journal that the Comptroller of the Currency is going to develop some new suitability rules for banks involved in derivatives. Do you support that?

Mr. CORRIGAN. I haven't seen the specific proposal you are referring to.

Mr. SYNAR. But do you support the concept that the Comptroller General would set some suitability rules?

Mr. CORRIGAN. Again, suitability is—I find a difficult concept to get your arms around.

Mr. SYNAR. Let me ask you this. Two years ago according to Fortune magazine, you addressed a number of bankers and you were quoted as saying that derivatives might be introducing new elements of risk and distortion into the financial system. To bank managements you said, I hope this sounds like a warning because it is.

Isn't the Comptroller just basically carrying out what you warned bankers of 2 years ago?

Mr. CORRIGAN. Again, there have been and continue to be a series of what I would consider very constructive initiatives by the bank regulatory authorities not just in this country but around the world in this area, and I certainly do support the notion of continued effective evolution of sound supervisory and prudential practices on the part of the authorities.

The specific thing you are referring to——

Mr. SYNAR. Do you agree with the concept that the Comptroller General should come in? Just the concept, not the specifics.

Mr. CORRIGAN. I don't know what the concept means.

Mr. SYNAR. The concept is to set some suitability rules for banks that are involved in derivatives.

Mr. CORRIGAN. I am not trying to be evasive. I would have to see this.

Mr. SYNAR. You are being evasive because the next question is that if the Comptroller General is going to do that for banks, isn't the natural extension of that that the SEC has to look at its securities firms involved with the market, because if they don't, there will be a gap in regulation between banks and security firms?

Mr. CORRIGAN. This is an issue—and Richard Breeden and I in our former official capacity have been around this track several times.

Mr. SYNAR. I will ask him the same question.

Mr. CORRIGAN. I made this point very explicitly in that address in Frankfurt that you have, that we have got to move in the direction of greater consistency nationally and internationally as between banking and securities regulators. I think a lot has been achieved there too.

Mr. SYNAR. Mr. Breeden, do you support the Comptroller of the Currency developing new suitability rules for banks involved with derivatives?

Mr. BREEDEN. Mr. Synar, in the presence of talent like Gerry Corrigan on bank regulation, I always defer to him on subjects of bank regulation.

Mr. SYNAR. I am asking about the concept.

Mr. BREEDEN. As I tried to address in my remarks, suitability is a basic concept that is often used in securities markets. It is one that the NAST and SEC since 1933 have required people to adhere to in dealing with retail customers, for example. But when you have something that a little bit of it is a good thing, it doesn't always mean that more of it is even better. You have to look at the specific situation without knowing how that rule is structured, whether it would apply to——

Mr. SYNAR. If the Comptroller General of the Currency does set suitability rules for banks, wouldn't it be imperative that the SEC authorities do the same thing over security firms so there is not a regulation gap?

Mr. BREEDEN. There have been suitability standards in the SEC world for 60 years. In most of these trading market issues——

Mr. SYNAR. But not for derivatives.

Mr. BREEDEN. Many derivatives are in fact securities and treated as such.

Mr. SYNAR. Mr. Breeden, this is not a hard question.

Mr. BREEDEN. And I am not trying to complicate it, Mr. Synar. I agree that the major problems if it is sales practices or if it is capital standards or whatever have to be addressed by both the bank regulators and securities regulators and there has to be a certain level of consistency, although there doesn't have to be congruity.

Mr. SYNAR. Mr. Weatherstone, on page 5 of your testimony, you say, "I think that the dealer community should step up to the challenge of making sure its practices hold to a high standard; that they are consistently based on clear communication of the risk and benefits of the product or strategy being proposed to end user."

I think in your testimony you testified that your firm does provide for your clients a variety of disclosures, is that correct?

Mr. WEATHERSTONE. That is correct.

Mr. SYNAR. Should dealers who are involved in these products, should they have a standard set for them on what that kind of disclosure should be given the fact that you are voluntarily doing that, but that doesn't necessarily protect those who do not choose that path.

Mr. WEATHERSTONE. I would kind of like to answer this question and the previous one. I would not choose a formal suitability rule for bankers on derivatives, frankly. I think the better system is to have it clearly understood by participants in the market that they have a responsibility to make sure that the clients understand the risks and issues, but I would not advocate frankly the formalization in some way through the regulatory authorities of a suitability test or whatever the specifics are.

So you asked conceptually, I think was the question. Conceptually I would not go down that route.

Mr. SYNAR. Basically when we talk about suitability, we talk about that a bank should make sure that its counterparty understands the general market-risk profile of the derivative transaction and should explain how, particularly if the counterparty lacks sophistication to derivatives, the transaction will achieve the counterparty's objective. You don't think that ought to be an official or a normal standard?

Mr. WEATHERSTONE. That is correct. I think the difficulty, and I might add when we wrote the G-30 proposals generally for good practices, we didn't know whether to call them benchmarks or recommendation standards. We ended up by calling them recommendations. There are so many different kinds of derivatives, complicated ones, simple ones, different participants, different end users——

Mr. SYNAR. How do you enforce a bank making sure they do it on a voluntary basis?

Mr. WEATHERSTONE. I think you can by exactly what you said earlier, having it understood that it was good practice for banks to make sure that their clients——

Mr. SYNAR. So we are supposed to leave the enforcement up to the goodwill and good practice of the banks?

Mr. WEATHERSTONE. No. I think good management is important in all institutions, and I think what we have said in our recommendations is that it is very important that each bank has a proper risk management system. I don't think that we would want to say what that specific risk management should be in detail.

Mr. SYNAR. Let's say you fail in your recommendation and that the Comptroller General sets an official standard for banks. What about the regulation gap that the SEC might be faced with then? Will there be a recollection gap and should it be closed?

Mr. WEATHERSTONE. I have to let Mr. Breeden answer that, frankly.

Mr. SYNAR. What about the second question I asked you? You all provide public disclosure, you have disclosure. Obviously that is one of the things we are looking at is seeing whether or not the kind of things you are doing for your clients should be more formalized.

Should they be more formalized through standards, or how would we ensure all players at your level are providing that kind of disclosure?

Mr. WEATHERSTONE. It should be looked at to see whether a suitable standard would be applicable to all the people in the market. If one can be constructed that makes sense, then one should proceed with it. But I am not sure we have got to that status yet. We are trying to set an example by disclosing what we think is relevant and I think that if that gives us a competitive advantage or is useful, that practice will be followed.

Mr. SYNAR. Would you provide for the subcommittee the kind of disclosure you give your clients?

Mr. WEATHERSTONE. I was talking about in our annual report. The additional information that we gave over and above that that was required by the accounting regulations and the bank regulators was in the maturity breakdown of derivatives book and the split between our trading and our asset liability derivatives.

Mr. SYNAR. Thank you, Mr. Chairman.

Mr. MARKEY. The gentleman's time has expired.

The gentleman from North Carolina.

Mr. MCMILLAN. Business is clearly at risk and I think anyone running a portfolio of assets is going to have to manage those assets. Are derivatives more risky than other assets that might be under management?

I figure if we looked at a range of financial institutions, bad loans and losses may have occurred to a far greater extent—things that we don't tend to sit around here and question in this manner.

Pursuing in a little different way what the chairman addressed initially, I'd like to focus on something, like the Bank of New England, which apparently was heavily engaged in derivatives. In going back and looking at it, did their exposure in that way increase or decrease the risks to other people doing business with the bank, whether a stockholder or depositor? In other words, were derivatives the cause of the problem? Or to carry it a step further, did in that case their engagement in derivatives actually reduce the risks to others as opposed to increase it?

I think that is the key question. I think perhaps Mr. Weatherstone should be the first to address that.

Mr. WEATHERSTONE. I am not too sure of the actual facts of the case, but I will tell you my impression about the Bank of New England, that its problems were really credit problems in real estate. I think those were the fundamental reasons that gave it a problem.

As far as I know, its activities in derivatives were simply part of its foreign exchange and interest rate management, and I would suspect that net they probably reduced their exposure to loss in interest rates and in foreign exchange. But I haven't the facts on that. That would be my guess. So I would not have thought that was a contributing factor to their problems. As I understand it, the derivatives that they had outstanding were unwound without any great problem.

Mr. MCMILLAN. Are there other cases that we should be looking at that address the same question? In other words, if we are so concerned about derivatives, are there other cases in which it has resulted in an extraordinary extension of loss to others indirectly because of the institution's engagement in the practice? Can we cite any others that——

Mr. WEATHERSTONE. I am always nervous at citing cases because then we zero in on a problem and we forget all the cases where there have been so many pluses. But I suppose one example would be the recent problems of Metallgesellschaft in the old futures market where it looks as though the hedging techniques that they used were not properly understood, or from what I have read, not properly communicated to management. So that would be I think a most recent example of problems that came from what we think are the fundamentals of lack of understanding.

I hate to keep going back to the Group of 30 recommendations, but we did quite a lot of work there and the essence of managing derivatives is management understanding and controls, and it would seem from what we have heard about Matallgesellschaft there was a failure there. So that is one example.

One can't help thinking going backwards that if interest rate swaps had been used to a greater extent, perhaps some elements of the S&L problems might not have been severe because they would have had the opportunity to hedge out some of their interest rate exposure. I would like to make that point as well. They are a very, very useful tool on the plus side.

Mr. MCMILLAN. I have seen individual institutions in which the reverse was true, but they probably made greater mistakes on their real estate loan portfolio than they made on efforts to hedge their risks.

In the final analysis, we have to rely upon management to perform. Otherwise, we are back to the other situation where nobody strikes out, in which case nobody goes to the game.

To get at a question that I think you raised in responding to the ast one, and perhaps Mr. Breeden would be in the best position o address this, should we do some other things in terms of corporate reporting to illustrate not just citing a loss from derivatives, out rather citing profits as well, or perhaps even go the next step—s the purpose of derivatives to cite the avoidance of loss or at least nake some reference to it so that we get this thing in perspective. think that is part of our problem here.

Mr. BREEDEN. I do think that the issue of disclosure is very important. I can't resist noting that I think when you talk about the Bank of New England, I think their fundamental problem was that hey really didn't understand the business of hedging. They hought that they could hedge construction loans in downtown Boson with construction loans on Cape Cod, and I am not sure, if that s your level of sophistication, whether there is anything that can elp you even derivatives. Perhaps they would have been better off edging in some other way.

Mr. MCMILLAN. That was the least risky part of its portfolio.

Mr. BREEDEN. Perhaps.

The issue of disclosure is very important. It is true that there are ffsetting risks that you have avoided, costs that you might have ncurred. To put those kinds of things in an annual report or 10K s difficult because of course you have strict legal liability of the acuracy of statements and it is oftentimes difficult to know for sure hat you avoided.

That is why in something like MD&A, it is very important for ne management to try and give shareholders an understanding, Here is what our objectives are, here is what kind of strategies we re following and why, so that the shareholder can look inside the orporation and understand what the management's policies and ntent are, not that they can micromanage the decisions or understand dollars and cents of every single action that was taken, but hat they can at least understand the objectives that the corporaon is following and contrast those to what other companies might e doing.

Mr. CORRIGAN. Can I pick up for a minute on this Bank of New ngland question, because it is like an old shoe; it keeps eappearing. The fact of the matter is that to the best of my knowldge, derivative activities had nothing whatsoever to do with the emise of the Bank of New England, that their derivative positions ere as Mr. Weatherstone's hunches told him they were, and that

in fact by the time of the actual demise of the institutions, those derivative positions were really quite small.

I think the point should also be made as in the Drexel case that their problems, which were legion in number, were not problems, again, that had anything to do directly or indirectly with derivatives. But I do think the Drexel case does tell us something that we need to remember, and that is that while the derivatives were not in any sense the cause of the problem, they do complicate the unwinding process because of this interconnection problem. And the interconnection problem can be within the firm and external to the firm.

That, I think, is the key issue in the context of the kind of thing that I and I think others think can and should be done to try to bolster those defenses that I spoke about earlier. But the impression again in both of those cases, the Bank of New England and Drexel, that derivatives where somehow the cause of the problem is just entirely misplaced.

Mr. McMillan. In 1993, 31 percent of the bank's trust earnings came from selling risk management products and 56 percent came from trading for its own account. In the first quarter of 1994, profit from the sale of derivatives to clients climbed to $114 million, accounting for 70 percent of earnings.

Does this indicate a concentration in and dependence on derivative sale income that is inappropriate for a commercial bank? Because we seem to have focused on exposure here and particularly the banking system, and I would be interested in your perspective on that. Anyone.

Mr. Weatherstone. I think what you should do is not look at quotas, earnings in isolation. I think you would get a better idea if you look at earnings over the period of a year. It certainly would look as you notice somewhat disproportionate in a quarter but it was a rather unusual quarter in market activity and I think that rather distorted the results.

So I would say if that were to occur over a year, I am not sure that it is necessarily wrong, because after all, the derivatives business is a credit intermediation business and it may be the decision of a particular institution that it can be more useful to its clients in credit intermediation in derivatives rather than using up its capital in other areas.

But I think that this should be looked at over a longer period, and I believe that diversification is probably the answer here and it would look at though one particular area was a bigger contributor in one quarter. On the other hand, I think it is too short a period to come to a judgment about it.

Mr. McMillan. Would it be fair to say that you would characterize that as simply exposure by choice of the bank, the way it runs its business in terms of where it puts its emphasis, where it is trying to get a return on investment, and it is to be evaluated like any other exposure, with perhaps no greater concern?

Mr. Weatherstone. I am not sure that the bank chose to have that particular division of its profitability. I think very unusual market circumstances produced that. I think the interesting thing is that the derivatives earnings which have been looked upon by many as somewhat unstable and worrisome in a very, very difficult

time, actually were a major contributor to the earnings. So I think that is just an interesting result of what happened in the quarter.

Mr. MCMILLAN. Would anyone else care to continue on that question?

Mr. BREEDEN. I would suggest that your analysis about choice, while Dennis's focus on the longer term is appropriate, is an irrelevant consideration. Certainly in the broker-dealer industry, you have some firms that choose to specialize in trading and only trading, and other firms that choose to pursue a broad spectrum of products.

That is true of other industries as well. Some companies choose to make only one product. Others want to diversify into every possible business, and that is a decision that is best made in the boardroom by the senior management of the company and they take that decision out into the marketplace and they compete with it. The market will penalize people who don't do well over a long period of time and will reward those who do.

So from the standpoint of public policy, should the American public be concerned that even a large bank in a particular period has a high proportion of its earnings from trading? My answer is no. As long as whatever it is that they are doing they do carefully and do it well, then that is the key consideration. And investors have to choose then which institutions following which strategies they want to invest in, and they just have to know enough about the strategy of each particular firm so that they can make an intelligent and informed choice.

Mr. MCMILLAN. That is distinctly different than what we had in the S&L situation where government-insured deposits were an issue and I don't think we are demonstrating here that derivative activity is necessarily a threat to that.

Mr. BREEDEN. I think what is the most important lesson from the S&L crisis and what I take away as the most important lesson from the failure of Drexel Burnham as well is that the public shouldn't be asked to pay for other people's mistakes, that market disciplines will work very, very well.

If the creditors in Drexel's case chose to lend it vast sums of money that it was not really capable of repaying, that was a bad credit judgment for their part and there was no reason for the government to come in and bail them out from that decision, and people ever after will be more careful in lending money to broker dealers and their holding companies. And that market discipline is very, very important.

The S&L crisis became as large as it was by almost every analysis subsequent in large part because deposit insurance allowed firms that were weakly capitalized and badly run nonetheless began to grow very rapidly, and that is what we don't want to repeat.

Mr. MCMILLAN. I thank the chairman.

Mr. MARKEY. The gentleman's time has expired.

First we will put that old shoe of the Bank of New England back out on the table just to say that the point isn't that derivatives caused the problems of the Bank of New England but that the derivatives which were held by the Bank of New England had to be unwound. And you, Mr. Corrigan amongst others, worked very furi-

ously to accomplish the goal of unwinding those positions so that there was no problem, and it is to your credit that no problem in fact developed. But it is only through your skill and that of others that this resulted at the end of your efforts.

But the truth is that it is a harbinger potentially of things to come. If an institution held 10 times the derivatives that the Bank of New England held and the potential risk was not properly anticipated, it could cause greater problems. We are just lucky in the case of the Bank of New England it didn't.

I am taking the Bank of New England as a warning to all of us that it could resurface in much greater magnitude in ways that we haven't anticipated or thought through yet.

Mr. Breeden, in your prepared testimony you state that we don't need suitability standards for multinational corporations, but you seem to leave things open for less sophisticated institutions such as pension funds or State and local governments.

As you know, one of the principal reasons why we authorized the NASD was to develop sales practice rules for the government securities markets. In last year's Government Securities Act, there was concern over losses by such institutions in Treasury and government agency IO's and PO's and other structured bonds. Should we consider similar sales practice rules for derivatives?

Mr. BREEDEN. Mr. Chairman, as you know from the many discussions we had of sales practices in the government securities area, I am a believer that whether or not the law formally requires it, that you shouldn't take the opportunity to use abusive sales practices because there is some exception in the law that would otherwise prevent you from doing so.

In this area, some of these instruments—there is an implicit assumption that OTC derivatives are not securities. And while I have foresworn the practice of law, I am not sure that is a very good assumption. And so to the extent that OTC derivatives are securities, many of the duties that are put on people who sell, are selling securities, such as the basic anti-fraud protections, would apply.

If we conclude that there is something different and that they are not securities, then to that extent I think that we should consider whether some basic elements of the existing system such as it being prohibited to engage in fraud in the sale or distribution of the instruments, should be considered. I don't see it as a problem in the marketplace today, because I think the major institutions are providing fair disclosure.

Mr. MARKEY. I appreciate it, but we are talking about a town treasurer, you know, that is being sold a bill of goods in the same way that a S&L president was being sold a bill of goods as the junk bond salesman shows up or whomever. And that was a sophisticated investor, the S&L president.

We are talking here about the town treasurers and there are thousands of them across the country, and people are coming in plying their wares. And there is a certain, you know, sales attraction that certain derivative products, if they are marketed properly, could have for some of these people although such an investment would be completely inappropriate for the objectives or purposes of that community.

Can we definitionally, in other words, ensure that these communities, these treasurers, these pension fund managers, are protected so that they are not risking the taxpayer's or the pensioner's money—under the guise of protecting them—because of the misrepresentations of any of these firms? It is too late then to take care of those individuals.

Mr. BREEDEN. Well, traditionally State laws do govern the permissible investments of State officers or municipal officers. There are traditionally limitations on what life insurance companies can invest in. So, in many cases, there are investment restrictions on some types of entities.

There are, in almost all cases, limits on what a municipality can invest its temporary surpluses in.

Mr. MARKEY. We have the same problem over in government securities as well. It is the same set of issues. It just gets to the question whether or not we want to work wholesale here just to make sure those protections are out there, rather than waiting for a patch quilt of "60 Minutes" exposes to finally drive us to it.

I mean, is there some sense for us acting in an anticipatory fashion rather than waiting for the horror stories to come in out of the cities and towns of the country?

Mr. BREEDEN. I want to be very clear to distinguish between two different situations. One is fraud, and the other is suitability. My comments were direct——

Mr. MARKEY. With fraud, that requires a determination of scienter.

Mr. BREEDEN. Right.

Mr. MARKEY. With sales practice requirements, it doesn't require scienter, but it does offer the protection to these people in terms of what the obligations of the sales person are. So we crossed that bridge with the government securities, and we made a determination that it would make some sense.

And again, we are separating this from the treasurers of Fortune 500 companies. This is a different category of people altogether, much more vulnerable and targeted by, unfortunately, the worst elements, not the best elements.

We don't have to worry about the best people from J.P. Morgan heading after these people and trying to misrepresent; we have to worry about others who are also going to be moving in that direction. So how do we protect those people?

Does it make sense that we extend the formula we put together for government securities over to derivatives as well?

Mr. BREEDEN. Well, I think among the regulators, and this is an issue both for bank and securities regulators, I think one of the—Jerry was talking earlier about consistency. And one of the principles that should in general apply is that if you have a certain type of protection involved for buying the cash market instrument, a government bond, for example, then if somebody is buying the synthetic equivalent of that cash market instrument through a derivative, you ought to consider having similar types of protections against basic things like lying.

If you walk in and give the client a scenario of cash flows and it turns out that the numbers are all false and you knew it, well, that is a fraud and there ought to be some consequence for that.

Where I think the problem is, is how far down the road you can go in this suitability area. We were discussing it earlier.

There, I think, as long as the information is available and institutions are large enough, at some point you can drag the horse to water but you can't make him drink.

Mr. MARKEY. I understand. We are talking about communities which would be pretty good targets. For example, a community that has only got 20,000 people in it, but has got a pretty nice flow of capital that could come out of it, would not remotely meet the standards of sophistication that would be required in order to deal with products of this complexity. How do we deal with that?

Mr. BREEDEN. Mr. Chairman, you have put your finger on a really good question. Perhaps the largest loss the derivatives dealers have ever taken was as a result of the Hammersmith Fillum case in the United Kingdom. And there, almost exactly what you are talking about, was one of the situations.

I mean, not only was a municipal government buying derivatives, but it bought them in quantities that were quite disproportionate to the entire tax revenues available to them.

So my concern is not that we try and have statutes or regulations governing extensive disclosure or suitability for every single trade with a State government with a pension plan, but it is very important that dealers observe a sense of proportionality. If you push too much, if you get people whose exposure is too great, then they have a problem and ultimately you will have a problem.

Mr. MARKEY. I agree with that.

But even if some of these derivatives, though, are securities that are covered by the SEC anti-fraud rules, by the 10(b)(5), wouldn't it still be advisable to supplement them so that there are prophylactic protections which have been put on the books to guarantee that the sales practice rules that require dealers to know their product and to know their customers apply, especially in these areas where the level of customer sophistication is, I think, palpably inadequate to deal with the complexity of the products that are being marketed to them?

I suppose you could convince town treasurers, a certain percentage of them across the country, to get into it, but they just aren't in the same league as the salespeople who would be walking in the door.

Mr. BREEDEN. Unlike the cash market where any broker-dealer can go out and buy on the market these instruments of some kind and then try and sell them with large markups or other problems to a city, the OTC derivatives market is—you can draw a distinction because the number of firms that are creating the product is a very, very small group of major financial institutions that look very hard at controlling their own behavior.

So I haven't seen in the market yet a crying need for legislation to govern sales practices in this area. I think of the major firms——

Mr. MARKEY. Even for the relatively unsophisticated purchaser?

Mr. BREEDEN. Even for the relatively unsophisticated large pension plans.

Mr. MARKEY. Well, no, we are talking about—let's just talk about the towns.

Mr. BREEDEN. All right, municipalities. I haven't seen it yet.

Mr. MARKEY. I haven't given you the toughest case.

Mr. BREEDEN. You are giving me the toughest case.

Mr. MARKEY. You have got to say, no, small towns don't need protection in this area. You can say yes, or say no, but I appreciate the big pension plans, I appreciate. I am talking here about the tough case. We are here to protect against the 10 percent bad people who are going to prey upon the 10 percent most vulnerable.

We don't need any laws for the 90 percent and the 90 percent. We don't pass laws for the 90 percent. We pass laws for the 10 percent and 10 percent, OK, the 10 percent bad and the 10 percent vulnerable.

And my question to you is are they vulnerable? And could a nefarious derivatives dealer, take advantage of that, and do we need suitability protections that are built into the law that would give sufficient disincentives to those dealers to stay away from these towns?

Mr. BREEDEN. No dealers wanted here.

Well, I think that small towns like small companies could be——

Mr. MARKEY. I know you don't want to come out for any legislation at all, there is a pact down here, I understand that, OK. But we are going to give you tough cases from here on, for the next half hour, we are going to give you tough cases. And you are going to have to say, no, we don't need it for any of these.

But just understand, OK, you are afraid that we get the foot in the door and we will be regulating everything. So how can we get around saying that we need any protections for anybody, you know, for fear that the pact has been broken. So how do we deal with these poor, vulnerable town treasurers that were the cause celebre of our government, you know, securities area, ensuring that they are given some more protections here? And, by the way, in products that are arguably much more dangerous and much more complex.

Mr. BREEDEN. Well, I think that the best protection for Peterborough, New Hampshire, or Manhattan Beach, California, is if the corporate treasurer loses a bunch of the taxpayers' money doing dumb things, is the people ought to vote him out of office. And there is a market discipline, as I know, Mr. Chairman, you are a better practitioner and more knowledgeable than I, but there certainly is a market discipline, having been——

Mr. MARKEY. Again, I don't have any problem with, you know, Acme Toilet Seat Manufacturer going out of business. I do have a problem with Manhattan Beach, California, going out of business, all right. And that is possible if they are put into the wrong products in this particular area.

And there is a certain market discipline, if you have to rebuild your community out of the debt that it is now saddled with, your financial obligations. But I just don't think we want to reach that point with 15 or 20 communities across the country—as the market discipline. It is a different test.

In other words corporate executives, they can come and go, but cities and towns affect tens, hundreds of thousands of people, their lives, their police, their fire, the services, the schools in their community—different test altogether.

Mr. BREEDEN. Having been staunchly in favor of sales practice controls in the government securities area, I can't tell you that is an unimportant area. I have not seen a problem yet in the real world in the derivatives instruments with municipal governments.

I think if there were to be a problem, it would be certainly an appropriate subject for this committee and others to consider. But I think because the community of dealers is much smaller than it is with many of the cash market instruments, it is easier for self-control to work in this area than it has proven in other areas.

But it is certainly one of the areas that is going forward if the industry doesn't understand that it has to live to very high ethical standards, including very high standards of their sales practices and suitable, I——

Mr. MARKEY. Again, I don't think we are going to have a problem with Mr. Weatherstone here, but they don't send in the bad people to testify—we can't get bad people to come in. We couldn't get any CEO of any company that lost a bundle in the last 6 months to come in and testify and to concede that they were completely ignorant and were bilked by whoever it was that put them in these products.

I can't get anyone who was either stupid or venal to come and to testify. So they send you in, and you are good people.

Now the question is, while we stipulate that you are good people, are you willing to help us with the bad people? All right?

And we will try to promise that we will work with you to make sure it doesn't affect the good people, OK? That is you; all right?

Or are you so concerned that we are going to affect good people, too, that you don't want to protect the stupid or the vulnerable from market practices which we know occur. I think all the evidence we need to know is that major companies in the country are reporting losses related to it; OK?

So that is all the evidence we need to know, that municipalities could be vulnerable as well. And again, they are in a separate and, in my opinion, you know, different public policy posture in terms of how we would have to respond. So—we are not going to get an answer; OK?

Let's move on, we will keep going. I appreciate it, you know.

Mr. BREEDEN. I agree with that.

Mr. MARKEY. The similarity of the final line of each of your opening statements, no legislation needed, is obviously a bar at this point to eliciting any affirmative responses to my questions. But exceptions are going to continue to rear their head.

Mr. Weatherstone, in your prepared statement you say that you are aware of concerns about unregulated entities in the derivatives market. And that you think that we need to consider the merits of bringing unregulated entities under some scheme of regulation, quote, "with an open mind."

Don't you think it would be a good idea if some Federal regulator were setting capital standards for such institutions or regularly examining them, to assure the integrity of their internal controls and risk management systems?

Mr. WEATHERSTONE. Well, the reason for the comment I made there was that when we did our original work on the Group of 30, we tried to look at the participants in the market and the end

users. And then we made brief reference to the unregulated entities, because we realized there was some concern about whether they should be regulated or unregulated and how they should be regulated.

The reason for, I guess, making the statement there, that we didn't think that anything special should be done, was partly because of the difficulty of who were the unregulated entities. It is a strange phrase. It could be someone who has nonbank, nonsecurities house, set up particularly to trade in derivatives. It could be someone outside the United States.

And I wasn't quite sure exactly who would—who one would want to include in this new extension of regulation. It would seem to me that a good number of the nonbanks, if you like, have their own supervisors. And if their own supervisors wanted to look at industry practice and do, perhaps, as I believe the Federal Reserve have done, taken the Group of 30 recommendations and not used them as standards, but simply said as part of the examination process—do you comply with these regulations and if not, why not? That seemed to us a very useful way to use this.

I would think as a first step with what we loosely call "the unregulated entities," something like that could be done. Some useful work would be achieved to see whether they were complying with those. And then if there were a supervising agency, they could then decide what their next step would be.

So I would rather—that is what I called "the open mind," instead of just saying, yes, let's regulate them all, why not see whether they were complying with good practices and there was need to do anything else. And if they were, continue to supervise that activity. If they were not, then make some kind of judgment.

Mr. MARKEY. So each of the Federal regulators should make a determination as to the adequacy of the capital standards.

Mr. WEATHERSTONE. I think that would be sensible. It is one the reasons that we split up our recommendations, which we were careful to call exactly that, into 24 participants, and then four, or what we loosely determined to be nonparticipants. And also made it clear that if nonparticipants wanted to follow all the 24 rules, that was fine as well.

Mr. MARKEY. How big of a problem is leverage in this derivatives marketplace?

Mr. WEATHERSTONE. Is what, sir?

Mr. MARKEY. How big of a problem is leverage in this, in the derivatives marketplace?

Mr. WEATHERSTONE. I don't quite know how to answer that. Let me answer it by saying that I think it is important when leverage is used that both sides are very well aware of it and examine when—when examining the credit, take into account that it is a leveraged transaction and, therefore, there will be a greater degree of risk with it.

Now, how important that is, if measured the number of leverage transactions as compared with all the transactions, I would say not too important. But having said that, in the area of actually leveraged transactions, very important, make sure that the credit risk is examined extra carefully.

Mr. MARKEY. Well, I appreciate that.

In your opinion, is it being managed extra carefully in the marketplace right now?

Mr. WEATHERSTONE. Again, this would be a generality. As a generality, I would have said yes.

Mr. MARKEY. You would say yes?

Mr. WEATHERSTONE. Yes. We have not had, considering this huge number that is bantered around of 14 trillion, we had related to that relatively little loss experience. That doesn't mean we should be complacent about it, I realize that.

Mr. MARKEY. Mr. Breeden, your testimony suggests that it may be appropriate to examine whether the holding company risk assessment provisions of the Market Reform Act of 1990 should be enhanced or augmented to increase the SEC's oversight of affiliates, of broker-dealers.

Just how would you recommend we go about augmenting the risk assessment provisions to cover the derivative subsidiaries of broker-dealers?

Mr. BREEDEN. Mr. Chairman, my comment in my testimony was, first, to disagree with the reports I have read of the forthcoming GAO study, which I haven't seen but have read accounts of, talking about concerns about these so-called unregulated securities, unregulated affiliates in the securities industry, and my comment was that there is no such thing as an unregulated affiliate in the securities world. There hasn't been since the Market Reform Act was passed, which gave oversight authority, though in a different form, from direct regulation, to the SEC over all the affiliates of a broker-dealer that would be engaged in significant derivative activities. So it is there now.

What I tried to say was if there is a problem, and I am not aware that that statute is not adequate, but if it isn't, then certainly the SEC would, I suspect, would not be bashful in coming before you and recommending areas where it should be improved. But I think there is this general rhetoric about there being this great gap in the regulatory system, and I think it just doesn't exist.

Mr. MARKEY. So should we just focus on the derivative subsidiary and put it under SEC supervision?

Mr. BREEDEN. Well, Mr. Chairman, I was not—I didn't have any recommendations for changes or enhancements that ought to be made, but simply tried to leave the door open to say if there is a problem, and I am not aware of a problem, but if there is one, that the appropriate way to address it would be to go back to those provisions where this committee has already addressed several years ago this particular issue in a generalized framework and the best approach would be to go back to that and look and see, well, if that statute hasn't worked as it was intended to, why not, and how to fix it.

Mr. MARKEY. In your prepared statement, you discussed the role that the risk assessment provisions of the Market Reform Act play in allowing the SEC to monitor the activities of the derivative subsidiaries of broker-dealers. Some have suggested that the risk assessment data doesn't contain sufficient information on the type and amount of derivatives earnings and the extent to which the firm's trade may be concentrated with a few counterparties. Is there a need to improve the data?

Mr. BREEDEN. There is—if the data that is being collected is not currently adequate, there would be no legal reason that the SEC could not expand the data that is required. I believe the statute gives the commission all the authority it needs to collect the significant—what it believes is the significant data.

In trying to do—and I was—during my tenure, we put those regulations in place for the first time and we were very concerned to try and not have so much data that the staff would be swamped in it and couldn't try and focus on the bigger trends and the bigger risks.

As they go forward, obviously, and get more experience with that program, I would expect that on an ongoing basis, they will fine-tune it to make sure they are getting the most important information. That is the purpose of the statute, and I would expect that is what they would go after.

Mr. MARKEY. OK. The head of derivatives modeling for a major dealer acknowledged recently that there were holes in some of the hedging models used by the dealers, but that any good trader knows where the holes are in the models and how to put on other hedges to adjust. If that is the case, what happens if we get into another Kidder, Peabody-type situation where profits are artificially inflated or losses hidden by a trader, only this time with a product that is even more difficult for management to price accurately?

Mr. BREEDEN. Mr. Chairman, is that question directed to me?

Mr. MARKEY. That is right. The question is what happens when the traders start gaming these instruments in a way that could be criminal in nature?

What kind of responsibilities does the regulator have? What kind of additional supervisory responsibilities should we give over to the managers of these firms?

Mr. BREEDEN. Well, companies sure need a good auditor in dealing with problems like that. No, I think you put your finger on——

Mr. MARKEY. In your opinion, in the typical firm, if there was a 27-year-old, 800 in his math boards, a quant, playing games, is there a reasonable chance that he will be caught under the existing supervisory schemes that have been constructed at firms of your knowledge?

Mr. BREEDEN. Caught at what? Caught at insider trading, caught at taking too much risk? I think you have put your finger on. If I could go back just for a second to the big picture, I think you put your finger on one of the most important issues in this marketplace. People talk about—and you listed yourself earlier on, Mr. Chairman, some of the problem scenarios that were problem. You didn't list one of the things that I think is the greatest risk of a problem. And that is fraud and illegality in a major dealer.

In Drexel and in Salomon, two of the biggest cases we have ever had that began to raise some of these questions, the problems didn't come about because there were some flaw in their mathematical trading models. The problems came about because people down in the organization, high or low, decided that the laws didn't apply to them, that they were smarter and tougher and faster and than these silly old laws were designed to catch, and that they would do whatever they pleased. And when an institution has a

breakdown in its internal controls and it needs to have good, tough external auditors, good, tough internal auditors, a good compliance program, a lot of safeguards against this, but if those things are not designed well, if a company doesn't do as much investing in its internal controls as it does in its risk management, its trading systems, then they are vulnerable to having a problem of that kind. And then they lose their credibility in the market and for everything else.

Mr. MARKEY. Today, is there a reasonable likelihood that a quant would get caught if he decided to engage in activities that are illegal? Inside of the derivative?

Mr. BREEDEN. Well, we know from the Kidder, Peabody case that there are firms—I think it is reasonable to say that there are some firms whose internal controls and internal auditing is not adequate to police.

Mr. MARKEY. The Kidder, Peabody case went on for months and months without detection. And I guess the question is, what is the possibility that this is something that is more frequent right now, all undetected, possibly?

What is the likelihood that they can hide smaller things in there that could go undetected indefinitely in terms of illegal activity? In other words, is Kidder the iceberg or is Kidder the tip of the iceberg with regard to the amount of illegal activity that could be conducted without the knowledge of the supervisors in these firms using traditional supervisory techniques?

Mr. BREEDEN. I think the Kidder case is the exception and not the rule, and that for most of the major financial firms, they have good programs. It is possible for people to play games with books and records and accounting systems, and they don't always get caught the first day they try and do it. But I think that kind of an apparent major breakdown, from what one reads in the press, is the exception, happily, not the rule. But it is an area that every company has to realize the importance and be willing to invest in good internal controls.

Mr. MARKEY. Mr. Corrigan.

Mr. CORRIGAN. Let me just try, Mr. Chairman, to address this.

I think your question is, is it likely that somebody who is up to mayhem is going to get caught? My answer is, yes, it is likely. But it is not certain.

And there is no conceivable way that we can build certainty into this arena. But what we can do, as I indicated at the end of my statement, is pay a hell of a lot attention, yes, to controls and systems and all the rest of it. But equally as much attention to the people side of the equation, the cultural side of the equation. And that people and cultural issue, Mr. Chairman, I think applies not just to the firms in the private sector, but I think it applies equally to the regulatory community itself.

And here I would like to say something, and I think Mr. Breeden would join me in this, that I could never say before, and that is I think that the relatively small number of people that we have in the Fed and the SEC and in the other agencies, considering their numbers and what we pay them, these people are doing a terrific job. And I think that we all owe them a great debt of gratitude for what they are doing.

But to answer your question, in my judgment, the likelihood is that that rogue person, the probabilities are that they are get caught, but I don't want any illusions, there is no fail-safe way to stop someone who is up to no good. And all we can do is make sure that when that thing does happen, that the penalties, the sanctions that fall upon those individuals, are firm, are harsh, and that we then go forward. But you can't have a fail-safe system.

Mr. MARKEY. I don't disagree with you. But on the other hand, the profits that can be generated from this kind of trading put tremendous temptation in the path of too many people, in my opinion. And we have to have adequate internal controls for the supervisors as well, whose careers are tied to the profits of any particular desk at any agency—I mean at Kidder this Joe Jet was responsible for $150 of $750 million of profit at Kidder.

It is a lot of pressure on a lot of people surrounding this one little operation. And to a certain extent, it probably answers the question of why people weren't looking too closely, because there was a success story there.

Should we consider, Mr. Corrigan, a statutory requirement that each firm's internal controls be subject to an annual audit, certified by independent outside auditors, to give that additional protection?

Mr. CORRIGAN. Again, I don't think so.

First of all, I can't speak for the SEC, but I certainly can speak for the Federal Reserve, and I think that the Federal Reserve and its examination processes and procedures already does this. Not just in the specific areas that you have looked at, but as Dennis would say, even in terms of the reliability of contingency backup systems and operating systems.

So again, I don't know what the commission does, Richard.

Mr. MARKEY. Mr. Breeden, what would you think about an independent audit?

Mr. BREEDEN. Well, the requirements for an audit today do include outside independent auditors reviewing internal controls. So to some degree, it is not a full-blown freestanding audit of the controls themselves, but there is a review of internal controls as part of the normal audit process.

Certainly the SEC, like the Fed, for the broker-dealers, focuses very heavily and quite directly on the adequacy of internal controls. But I will say in the marketplace there is a natural tendency on the part of—and I tried to get at this in my testimony—there is a natural tendency on the part of companies to want to hold down all their costs. And very frequently people worry about finding the cheapest audit, not the best audit.

And I don't want to sound self-serving here, but there can be differences in the quality and you sometimes get what you pay for. And firms often see investing in high-powered workstations and analytics, to model derivatives, as something that will help them increase their trading profits, and so they are always willing to invest in that.

Ironically, the thing that is the biggest risk to their long-run success is the adequacy of their internal controls and there some companies have the wisdom to invest in the systems they have there, and others do not. And that is something that is just a marketplace phenomenon.

Mr. MARKEY. Mr. Weatherstone.

Mr. WEATHERSTONE. I felt tempted to ask to make a comment simply because of all the discussion that we have had this morning. I think this is the key issue. The quality of the people who are involved in the—we are talking about derivatives, in the derivatives business, but it applies to the whole institution, as a matter of fact, but particularly in this area.

And if there was one area where I would say we would place emphasis, it is on quality of people, not necessarily about the rules, but frankly rules are very useful, regulations are useful, and even legislation is useful, I realize that. But I think it is what you do with that which is so key. And I think selecting right people, training them, and setting an example, which I think starts at the top, that when you talk about controls and ethics and standards, you mean it, and you demonstrate it by your behavior. So if—I think that is of overriding importance to me.

And when you go back to these models, frankly, there are some complicated models out there, but the real skill is not so much is what is in the model, but the application of it and the reactions to changing circumstances. The worst thing about rules and models is they stop people thinking. And once you stop people thinking, you are in trouble.

So I keep coming back, you have got to have good people and you have got to keep them thinking.

Mr. MARKEY. All right. But I guess what I am asking is given the lesson we have just learned from Kidder—an eternal lesson—that when the profit potential is so high and the personal gain is palpable, it is possible to broaden out even beyond one individual to two, to three, to more, who become part of the problem. That masks it from the heads of the firms and the regulators.

And the question is, in this particular area, is it becoming easier to engage in activities that are illegal, that could cause real problems in terms of confidence in the market?

It is possible, is it not, to engage in a very sophisticated network of parking inside of these derivatives, if you would want to, Mr. Weatherstone. And I guess what I am asking you is whether or not it might make some sense to have independent audits come in as well, to put an extra pressure on those operatives that might be tempted inside of the firm to engage in such practices, and to let them know that there is a point in time in which the day of reckoning has arrived.

They are not their own auditors, in other words, they are not going to be able to certify to their own supervisors or to the CEO of the company that everything is copacetic. Someone else is coming in as well to check their work.

Mr. WEATHERSTONE. I understand what you are suggesting. I happen to think that most institutions or the banks, anyway, I mean, we have the Federal bank examiners, the State bank examiners, we have our outside accountants, our internal auditors. I am really not convinced that putting another layer of auditors would add.

Mr. MARKEY. Again, I am not concerned with you, I am not concerned with J.P. Morgan, I am not concerned with Goldman; I am concerned with the second and third tier firms that don't have th

same commitment to compliance, or the same level of quality of personnel that you have at Morgan or at Goldman. What do we do with those firms? Your rejects, in a lot of ways, in terms of your decisions as to whether or not to hire them.

Mr. WEATHERSTONE. If we are talking about participants, I think they have their outside auditors and their supervisors, regulators, whoever they happen to be, whether it is the Fed or the SEC. I would kind of question whether a third audit would help that much.

I think the—you start with the responsible management. The other participants in the market are also valuable, frankly, if they see something strange going on at other institutions, I think there is enough understanding of important issues that they will let their colleagues know that there is something strange happening here.

Part as another comment I made, the importance of understanding and education, what one would hope to do, and I think Jerry mentioned it, was that if there is a problem and somebody decides to do something off the books in some way, or put some false valuations, what you have to do is through one's internal control system, first of all to stop accidental, accidents happening through lack of understanding. And then second, if there is abuse as opposed to an accident, you got to catch it quickly. And so you have your systems organized in such a way that when something unusual crops up, and it may be making profits as well as losses, frankly, that draws it to your attention, you get people there who are not only following the rules, but are thinking, they are alert, there is something different going on here, I am going to find out what it is.

And I would ask the questions until I find out. If I don't understand the first time, I will ask it a second time. And then a third time. And if I don't get a satisfactory answer the third time, maybe there is a problem. Either I have a problem or they have a problem.

Again, I think the management is absolutely key.

Mr. MARKEY. Again, we don't need laws, though, for well-managed firms, OK? And we don't manage firms and don't need laws for firms that aren't desperate for profits. We don't need laws for people like that. But we do need laws for people, who we all know, that try to get up as close to the line as they can and are sometimes tempted to cross that line if they think they can get away with it. That is essentially what this debate boils down to, you know, whether it be exploiting town treasurers or using derivatives for nefarious purposes for which they were never intended.

Can I just ask each one of you to give us a 1 minute summary of what you want us to retain as we continue on in our three hearing series on this subject?

And if we could, we will just begin with you, Mr. Breeden, if you could give us your 1 minute summation.

Mr. BREEDEN. Mr. Chairman, I think that this hearing and inquiries like it are constructive when they try to look carefully at what is really going on in this market, not in exaggerated fears. This is a very large, important market. It contributes to our economy. It contributes to the quality and efficiency of our financial markets.

I think that in the main, the major firms in it are proceeding with great care and great diligence, but there are certain, what you characterized, "eternal problems," things like the risk of misbehavior within firms, that obviously individual companies have to keep a close eye on.

I think for the future, that there is not a case for stepping in with major legislative programs, that this is a market that is, generally speaking, evolving carefully and well. But we should for the future also make sure that improper practices don't develop.

Mr. MARKEY. Mr. Weatherstone.

Mr. WEATHERSTONE. I think I would like everyone to remember that the market was created out of the needs of our clients, both in this country and all around the world, in response to increases in international trade, movement of funds, volatility, and the wish on the part of many clients to manage their risks more efficiently.

And I would hope as a result of that, that it will grow in a way that doesn't produce problems and to the extent that the industry can tackle the underlying issues which are very basic issues, that is better, to the extent also that the regulators understand what is happening and can regulate intelligently, I think that is very positive as well.

Mr. MARKEY. Thank you, sir.

And Mr. Corrigan.

Mr. CORRIGAN. In a word, I think, Mr. Chairman, what I would like to see you retain is "balance." When I think of the issues we have discussed this morning, again in the broadest of macro-prudential concerns, I think there are some issues here. And I have tried to indicate to you and to others some of the things that I think we should be thinking about in the context of those broad macro-prudential-type issues.

Having said that, the other side of the coin, the balance, is that all of what we have seen in the evolution and development of these markets is serving a distinctly useful purpose, and what we have at the end of the day, I think, is a community of interests among the Congress, the regulators, the private sector, and I think that community of interests going forward can best be served in a context in which we retain that balance, that we not overreact.

But I want to agree with Dennis, now being a private sector practitioner myself, I think that this is clearly an area in which the private sector has to be willing to step up to the plate and provide an extra element of leadership in a context in which the concerns that you and others have expressed have to be taken seriously.

Mr. MARKEY. I would say that both you and Mr. Breeden have obviously made the transition to the private sector very successfully. And I appreciate the caution that you send to this subcommittee from that perspective.

I want to thank each of the witnesses for their testimony before the subcommittee this morning.

As I indicated at the beginning, today's hearing is the first in a series that this subcommittee will be holding to investigate the public policy implications of the growth of the derivatives market. While the witnesses that have testified here today have expressed some skepticism about the need for additional legislation in this area, I am not at all convinced that volunteerism by the dealers

and incremental adjustments to existing regulations by the regulators will be sufficient to respond to the new risks created by derivatives.

Clearly, we want the industry to upgrade their internal controls and risk management systems, and I am pleased to hear that this is occurring.

We also want to see the regulators move forward to improve their supervision over these markets. But at the same time, the subcommittee must take note of the fact that there are black holes in the current regulatory structure that leave some dealers subject to little or no effective supervision.

We must also note that improvements in disclosure and accounting treatment of these new products have occurred at an unacceptably glacial pace. That must change. We are not seeking to ban derivatives or force these innovative financial products to move offshore. All we want to do is to assure that the regulatory system that we have in place mitigates the potential for derivatives to disrupt the financial system, that dealers and users have strong internal controls and risk management systems, and that there is adequate disclosure and customer protection.

I think that those are all reasonable goals that all sides of this debate could agree upon. And we want to work with everyone involved to achieve those goals and to add that sense of predictability and assurance as to what the conditions in that marketplace are, while letting all legitimate transactions continue on as before.

We want to thank our distinguished witnesses for their testimony today. We would like to work closely with you as the GAO reports to us next week and then the Federal regulators the week after, trying to devise some means by which we can put together a package that will work for this marketplace.

This hearing is adjourned. Thank you.

[Whereupon, at 12:13 p.m., the hearing was adjourned, to reconvene at the call of the Chair.]

DERIVATIVE FINANCIAL MARKETS

THURSDAY, MAY 19, 1994

House of Representatives,
Committee on Energy and Commerce,
Subcommittee on Telecommunications and Finance,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:45 a.m., in room 2123, Rayburn House Office Building, Hon. Edward J. Markey (chairman) presiding.

Mr. Markey. Good morning. Welcome to the Subcommittee on Telecommunications and Finance. Today the subcommittee is holding the second in a series of oversight hearings focusing on derivatives and their impact on the United States and global financial system. Derivatives are financial products whose values are dependent on or derived from the value of the underlying stock, bond, foreign currency, or commodity.

In recent years, they have come to play an increasingly important role in our financial system, allowing securities firms, banks, corporations, pension funds, mutual funds, municipal governments and other institutions to reduce their borrowing costs, hedge against adverse changes in interest rates or market movements, or engage in speculation.

While public and media interest in derivatives has greatly increased in recent months, it is important to note that today's hearing represents one step in a deliberative process that began back in June of 1992, when this subcommittee wrote to the General Accounting Office to request a comprehensive study of the derivatives market. At that time the subcommittee noted that the trading of new and complex derivative products by financial institutions and their customers had greatly increased in recent years, creating a corresponding need to assure that knowledge of how to manage and oversee the risk associated with these products was keeping pace.

The subcommittee asked the GAO to examine the nature and extent of the use of derivative products and determine how well the dealers and end-users of these products handled the related risks. In addition, the subcommittee asked the GAO to examine how well Federal regulators protect the Federal interest and to identify any regulatory inconsistencies or gaps in regulation that might result in harm to the financial system.

Today's hearing is D-Day—Derivatives Day—at the subcommittee, in which we will finally be hearing from the GAO on the findings and recommendations of its comprehensive derivatives investigation. Of course, we will not be asking Comptroller General Bowsher and his elite corps of auditors to storm the beaches this

morning. We will, however, be asking for GAO's guidance on what regulatory and legislative measures are necessary if we are to successfully avert the potential for a future derivatives Dunkirk.

While today's hearing necessarily focuses on some of the risks associated with derivatives, I would like to stipulate at the outset that this subcommittee recognizes the considerable benefits these products provide to our financial system. We are not seeking to ban derivatives. We agree that these innovative financial instruments are an important component of modern financial activity and provide useful risk management tools for corporations, financial institutions, and governments around the world.

We also recognize that many "derivatives" are not new and that not all derivatives raise the same level of public policy concern. Exchange-traded futures and options, for example, have been around for decades and are already subject to extensive schemes of Federal regulation aimed at assuring fair and orderly markets. Similarly, so-called "plain vanilla" over-the-counter put and call options on stocks and bonds are familiar products with well-understood risks and benefits. What is new and what gives rise to a heightened level of concern is the proliferation of increasingly exotic, customized over-the-counter derivatives that enable users to make synthetic side bets on global financial markets.

The responsibility of this subcommittee is to see to it that regulators have the tools they need to minimize the potential for such derivatives to contribute to a major disruption in the financial markets, either through excessive speculation and overleveraging or due to inadequate internal controls and risk management. We must also assure that there are appropriate customer protections in place in the form of full disclosure, accurate financial accounting and appropriate sales practices.

The GAO derivatives study has identified some serious gaps in the current legal and regulatory structure relating to derivatives. In light of GAO's findings, I cannot agree with those who would argue that the thousand points of light of industry volunteerism and a few incremental changes by regulators can effectively address the risks posed by exotic derivatives.

The derivatives markets will operate more efficiently if there is an effective regulatory structure in place to curb excessive speculation, abusive or fraudulent activities, and unsafe and unsound business practices. I believe that this requires both regulatory and legislative reforms.

This morning's hearing will afford the subcommittee an opportunity to explore in some detail the GAO's specific recommendations on what actions are needed to protect the financial system from the new risk created by derivatives. I want to personally thank Comptroller General Bowsher and his dedicated staff for all of the hard work they have done in preparing this report, and I look forward to the testimony. That completes the opening statement of the Chair.

I will now turn and recognize the ranking minority member, the gentleman from Texas, Mr. Fields.

Mr. FIELDS. Thank you, Mr. Chairman. Today we hold the second in our continuing series of oversight hearings on the subject of derivative financial markets. At the subcommittee's first hearing held

last week, three prominent financial executives, including two former market regulators, made clear that in their view no new legislation or separate regulation is necessary to deal with the derivatives financial market.

Today, we hear a different story. Yesterday after 2 years of study, the GAO released its report on the derivatives marketplace. As I am sure everyone in this room knows by now, the GAO report contains a number of recommendations for new legislation and additional regulation of derivatives.

As a threshold issue, I look forward to hearing the views of our distinguished witnesses on what is so unique about derivatives that requires changes to the regulatory structure currently in place. Why do we need special rules for specific products when the risk associated with many different financial products are basically all the same? Some people might argue that there are more risks in different financial products other than derivatives.

A number of the GAO recommendations will prove controversial. One of the most potentially troublesome proposals is that the SEC should insure that companies have internal reporting systems to assist and manage the risk of derivatives. I am very interested in hearing our witness discuss how the GAO expects this particular task to be accomplished.

Are we talking about disclosure of the corporate end users policies and practices regarding risk management and internal controls or are we talking about providing indirect involvement of the government in the decisions of corporate end users on how to use derivatives or how to control risk taking?

Now, to me, that is a frightening prospect to get the government involved at that level in corporate America. It is a longstanding tenet of U.S. corporate governance that the taking on and management of risk is fundamentally a private management decision subject to shareholder oversight. It is what senior management and corporate directors are paid to do.

As I have said before, any attempt to turn the SEC into an invisible member of every corporate board in America will be viewed as a major intrusion of the Federal Government into the business decisions of corporate management. That would be absolutely wrong. We must also consider that it is likely that companies would severely limit their use of derivatives if they were required to have separate government-mandated risk management systems for these instruments. This would significantly hamper the ability of U.S. companies to compete in the global marketplace either by hedging risk or taking advantage of profit opportunities in the derivatives markets.

Another troublesome proposal in the GAO study is that Congress could provide the SEC with the direct authority over the derivatives affiliates of securities firms. I think it is important to remember that it is because of the SEC's current stringent net capital rules on derivative products that most securities firms conduct their derivatives activities in triple-A rated affiliates which are outside direct SEC oversight.

However, when Congress passed the Market Reform Act of 1990, we gave the SEC indirect oversight authority over the activities of the affiliates of securities firms. Specifically, the holding company

risk assessment rules developed pursuant to the Market Reform Act allow the SEC to monitor the financial condition of affiliates to help assess any problems at the holding company level.

I think before we begin discussing new legislation to expand SEC authority over the affiliates of securities firms, we must thoroughly examine the law as it stands today to determine whether lesser measures—as an example, an SEC rulemaking pursuant to existing authority—would be sufficient to deal with any concerns associated with the derivatives activities of broker-dealer affiliates.

We must also consider that security firms probably would move their derivative affiliates overseas if there is an attempt to bring them under direct SEC supervision without substantial change to the SEC net capital rule. Of course, not all of the GAO's proposals will meet with the same degree of controversy. I think most would agree that the accounting treatment and disclosure requirements for derivatives that follow up behind the curve of this rapidly growing market, provident issues in the disclosure area, are already moving forward. Enhanced disclosure is at the very core of the current derivatives report of the global derivatives study group of the Group of Thirty. The message that I basically would like to leave with everyone here today is that the GAO report is an important first step as we conduct our oversight of the derivatives marketplace, but it is only a first step. The report probably raises more questions than it answers.

More than anything else, the GAO's effort illustrates to me that the subcommittee has a lot of hard work left to do before we begin drafting any legislation. The derivatives market is far too big, it is far too complex, it is far too important to hastily move forward in the regulatory arena.

I look at derivatives as the Mr. Goodwrench of the financial product world. Derivatives are tools that allow corporate managers to eliminate, stabilize or accept risk. For example, if General Motors builds a factory in Germany that automatically has a current risk, the company's choice is whether to manage that particular risk. Derivatives give it that choice.

As we look at ways to refine the regulatory structure for derivatives and other complex financial products, we must be sure that in a rush to regulate, we do not take important risk management tools out of the hands of U.S. companies. They need the tools to compete effectively in a global marketplace.

Finally, the GAO report recommends that Congress systematically address the need to revamp and modernize the entire U.S. financial regulatory system. I agree with that, and I believe firmly that we cannot legislate in the derivatives area without restructuring our financial regulatory system to reflect the realities of today's rapidly changing marketplace in a global environment. Thank you, Mr. Chairman.

Mr. MARKEY. The gentleman's time has expired. The Chair recognizes the gentlelady from California, Ms. Schenk.

Ms. SCHENK. Thank you, Mr. Chairman. I want to begin by commending you for holding these hearings. They are certainly timely and appropriate. While derivative financial products are not necessarily new, as you pointed out, they are becoming rather complicated, and they are increasingly misunderstood by virtually ev-

eryone, including apparently some of the most distinguished representatives of corporate America.

Hopefully, this series of hearings will help to educate at least the 22 members of this committee about these important financial instruments. I have a few observations to make, Mr. Chairman.

First, I believe we should recognize that derivatives, when used properly, do have enormous value. Every day corporate America uses these products to hedge risk and to make more responsible financial decisions. While the growth of this industry has been interpreted by some as a sign of great risk, it is undoubtedly an indication that derivatives make good financial sense to a diverse group of end users.

Procter & Gamble's $102 million loss in derivatives may have made headlines, but every day derivatives are used in positive, low-profile ways to spread and diffuse financial risk. But this is not to say that we should adopt a policy of benign neglect towards this market. I am simply saying that we should approach the issue with certain balance.

The flexibility that derivatives offer end users is an important asset in today's global market. However, when giant losses by end users of any financial instrument begin to pile up, investor confidence slowly erodes, confidence generally in the markets and confidence, as we all know, is an elusive quality, but it is crucial for the integrity of our financial markets. So we must draw a balance between the clear benefits of derivatives and the possibility as yet unconfirmed that their use may present new risks to our financial system. Through these hearings, Mr. Chairman, we must find out where to draw that line.

Unfortunately, I am going to have to run to a markup on maritime reform fairly soon, and I may miss the opportunity to pose my questions, so with that in mind I would like to just quickly run through some of the issues that concern me, and I will forward my questions to the GAO for written responses, if I may.

First, why does the increased use of derivative products present a systemic risk to our financial markets? Specifically what properties unique to derivative trades present new market risks? Also, how have past cases of failure by firms dealing in derivatives affected our financial markets?

Second, are derivative products regulated in other countries and if so, to what degree? On a similar note, what is the likely effect of direct regulation by the SEC on American leadership in this industry?

Third, I understand that much of the data in the GAO's report reflects financial conditions at the end of 1992. As Mr. Corrigan pointed out last week, much has happened in the past 18 months, both within the industry and within the respective regulatory agencies. Do the GAO's findings reflect these recent actions, and if not, why not?

Lastly, what does GAO recommend in the way of specific regulation of end users of derivatives? Like the chairman, I am concerned about the example of the unsophisticated town treasurer. However, I am concerned that overregulation of large corporate end users could be an unnecessary waste of precious Federal resources. Perhaps our time would be better spent in educating town treasurers

than in protecting Fortune 500 companies from expensive mistakes.

In closing, again, Mr. Chairman, I want to applaud you for moving so aggressively on this issue. It is crucial that we learn more about it, and I do look forward to the GAO's testimony.

Mr. MARKEY. The gentlelady's time has expired. The Chair recognizes the ranking minority member of the full committee, the gentleman from California, Mr. Moorhead.

Mr. MOORHEAD. Well, thank you, Mr. Chairman. I want to join the others in welcoming you here today. I know we are very fortunate to have this panel that has come to us today and certainly it may be well that perhaps some additional oversight over the derivative markets may be needed. It is very clear, however, that more information is needed before Congress and regulatory policymakers can develop effective supervisorial strategies.

I know you folks are getting a lot of opening statements today, and we are interested in the testimony that you may give, but it is important that we—many of us have other subcommittees we have to come and go to and we can't stay the whole time, which we would like to be able to do, but everything that you tell us will be in the record and will be reported to each one of us, so that we are well aware of all the testimony that there is.

Today, we have the report of the General Accounting Office. I am sure it will be a useful vehicle in focusing discussion on whether additional regulation is necessary. The recommendations of the GAO are a valuable complement to the suggestions made by the report of the Group of Thirty. Although this is a second hearing of the subcommittee on this matter, we must recognize that the congressional examination of derivative financial products has only just begun.

It has become clear quickly, however, that even the most preliminary requirements for an examination of derivatives are not yet available. Definitions are not in place for even the fundamental building blocks of this market. Questions still exist as to exactly what constitutes speculation, hedging, or proprietary trading. Even the fundamental question of what constitutes a dealer in derivatives is undecided. It is much too early to conclude that legislation is necessary or even desirable.

For weeks the attention given derivatives by the Congress and the press has resulted in a regulatory review by Federal banking securities and commodities regulators that is without precedence in my experience here in the Congress. Interestingly, the regulators are behind the curve.

The first comprehensive reviews of the derivatives markets were done by the industry itself. Indeed, the report of the Group of Thirty has become the operational guide book for establishing internal controls and management systems. I look forward to the testimony that you will give today. I know that especially the testimony of Comptroller General Bowsher is important to this committee so that we can better understand the issues that we must work with in determining what the Congress should do in response to the problem.

We thank you very much for being here today and we look forward to your testimony.

Mr. BOWSHER. Thank you.

Mr. MARKEY. The gentleman's time has expired. The Chair recognizes the gentleman from Virginia, Mr. Bliley.

Mr. BLILEY. Thank you, Mr. Chairman. Recent press coverage of derivatives have made Wall Street sound more like Las Vegas. Americans are led to believe that the derivatives market, much like Nathan Detroit's floating crap game, is conducted in back alleys with only the shadiest characters playing the game.

Ladies and gentlemen, nothing is further from the truth. Derivatives are used successfully every day by sound, legitimate businesses across the country. Household names like McDonald's and Procter & Gamble are the typical users of derivatives. And who are the largest users? The solid reputable U.S. banks.

Mr. Chairman, I do not know of any market throughout history in which there were not some losers. Let us not rush to judgment in this case. Let us not deprive our economy of a valuable tool in our quest for a risk-free market. Thank you, Mr. Chairman.

Mr. MARKEY. The gentleman's time has expired. The Chair recognizes the gentleman from North Carolina, Mr. McMillan.

Mr. MCMILLAN. I thank the Chair. I will be very brief. I would like to add my welcome to Mr. Bowsher and company to further enlighten us. I think the chairman and the ranking member have defined the question, if not the answer, and I think we have got a lot to learn, really a lot to learn. I know I have. I have been involved in the finance business a large part of my life. So I look forward to testimony today, and I think as we go into this, we need to not just simply focus upon the highly visible problems that may have resulted from a lack of understanding by one participating in the market or a few participating in the market, but we also need to look at what useful purpose they have served, to what extent have derivatives avoided loss, and to what extent have they created profits. We need to look at it in a balanced fashion and perhaps we can identify areas that may be serious problems and act intelligently. I hope so and look forward to your testimony.

I yield back the balance of my time.

Mr. MARKEY. The gentleman's time has expired. The Chair recognizes the gentleman from Illinois, Mr. Hastert.

Mr. HASTERT. Thank you, Mr. Chairman. Welcome, Mr. Bowsher. Here we go again. I see you have your old whole entourage with you as usual, and but that is another story. We will do that another time. I am looking forward to the hearing.

I read your report, your almost 200 pages here, how we are going to regulate industry and get back into the boardrooms of corporate America, and I think that is interesting. I think there is many questions that are left unanswered by your report. Certainly, before this committee limits what has been for the majority of corporate America a very successful tool for managing risk, we need to know what the fall out is going to be of your recommendations.

In the process of protecting stockholders from bad business decisions made by corporate America, we need to ensure that we do not drive companies into foreign derivatives markets where we know even less about what is going on. Your report recommends more disclosure. I believe we need to know more about what kind of disclosure would be needed, what the practical limits there of disclo-

sure are, and how useful the information will be a month after it is disclosed.

Similarly, I have numerous questions on your recommendation that internal controls be in place for end users. What would these controls look like? Would this lead to, in effect, a government support or approval of one or two types of risk management models over others, and would government be the de facto chairman of the board, limiting the options these boards now have to managing their own risks?

I look forward to your comments as always, General Bowsher, and appreciate the opportunity to hear your testimony today. Yield back.

Mr. MARKEY. The gentleman's time has expired. Are there other members seeking recognition at this time to make an opening statement?

The Chair sees none.

[The prepared statement of Hon. Richard H. Lehman follows:]

STATEMENT OF HON. RICHARD H. LEHMAN

Thank you Mr. Chairman, I would like to express some thoughts that I have about derivatives markets. While many analogies have been made about derivatives, including alligators on the cover of a prominent business magazine, I prefer to think about them as calculated risks, not unlike rotisserie league or another zero-sum game based on currencies, equities, or commodities; interest rates; or from a stock market or other index instead of baseball.

Neither party entering into a derivative contract has control over the outcome of the transaction—they cannot add or subtract value, they can only sit and watch. The problem with this scene is obvious if, for example, the parties engage in an interest rate transaction and the Fed is working its voodoo as it has been recently.

The GAO report that looked at financial derivatives focused on the dealer community because of the need to protect the financial system, namely, the big commercial banks, the major securities firms, and a few insurance companies. The complex connections that develop among these entities through derivatives certainly require review, but I am more concerned about the end users of these products.

We have begun to see big losses being racked up by some of these players: smaller banks, industrial companies, insurers and other financial services firms, pension funds, and governmental units such as municipalities. It's these last two that I am most worried about because their losses have a direct effect on the lives of everyday Americans. If a constituent's pension or a constituent's city takes a hard hit in one of these transactions, I can assure you that he or she will feel the repercussions, and I can assure you that they will be coming to us to do something about it. That is why we are here today.

The complexity of these derivative financial products is such that many of the people buying them are not fully aware of the possible consequences. As someone who has just begun looking into this matter, I don't blame them.

The long-term credit risks (counterparty ability to pay the largest loss), the possible market risks (especially in foreign exchange), and the valuation risks (mainly accounting difficulties) are all issues that must be addressed. But they don't necessarily have to be addressed by this panel or this committee. I am heartened by efforts, such as those by the Group of 30, to bring some structure to these constantly evolving transactions.

I would also like to remind the committee that if we rush to legislate wrongfully in some of these areas, we will only succeed in pushing this American-dominated market offshore. All it takes is a computer and a phone, and even I could arrange to set those two instruments up.

Mr. MARKEY. We will turn, then, to you, Mr. Bowsher. We welcome you back to the subcommittee. You have done excellent work for us in the past, and we very much appreciate the effort that you put into the production of this report.

When I called over there 2 years ago to ask for a study on this subject to be done, I know that you had to make a decision as to

the amount of resources which you could dedicate to a subject which is this complicated and important, and I know that you did, in fact, make a decision to delegate a considerable amount of the resources from the GAO into this study. That means a lot to this subcommittee, and it is a part of the continuing relationship that we have with you. And I want to tell you how much we respect the work which you have done in the past and how much we appreciate your appearance before us here today. Whenever you feel comfortable, please begin.

STATEMENT OF HON. CHARLES A. BOWSHER, COMPTROLLER GENERAL OF THE UNITED STATES, ACCOMPANIED BY DONALD CHAPIN, CHIEF ACCOUNTANT; JAMES L. BOTHWELL, DIRECTOR, FINANCIAL INSTITUTIONS AND MARKETS ISSUES, GENERAL GOVERNMENT DIVISION, ACCOMPANIED BY MICHAEL A. BURNETT, AND CECILE O. TROP, ASSISTANT DIRECTORS

Mr. BOWSHER. OK. Thank you very much, Mr. Chairman and members of the committee. I would like to introduce my team first. On my left is Cecile Trop from our Chicago regional office. Next to me here is Mike Burnett, who headed up this very large study, Jim Bothwell on my right is my issue area director in all banking and securities areas, and on my extreme right is Don Chapin, our Assistant Comptroller General and Chief Accountant at the GAO.

We are pleased to be here today to discuss the Federal oversight of derivative activities, and as you know, we issued this report yesterday, and it responds to your request as well as requests from several other committees. In my testimony today I will briefly summarize our major conclusions and recommendations and then answer any questions you and the other members may have.

In the past two decades, fundamental changes in global financial markets, particularly the increased volatility of interest rates and currency exchange rates, prompted a number of public and private institutions to develop and use derivatives.

Derivatives use was accelerated by the continuing globalization of commerce and financial markets and the major advances in finance information processing and communications technology. Derivatives are financial products whose values are based on the value of underlying asset or reference rate or index, and we focused on four basic types of derivatives—forwards, futures, options, and swaps.

Now, these basic products can also be combined to create more complex derivatives. Some derivatives are standardized contracts traded on exchanges, others are customized contracts that include negotiated terms such as amounts, payment timing, and interest or currency rates, and when contracts are not traded on an exchange they are called over-the-counter derivatives.

Derivatives serve important functions in the global financial marketplace. Among their benefits derivatives provide end users with opportunities to better manage financial risk associated with their business transactions, and this is generally referred to as hedging. They also provide opportunities to profit from anticipated movements in the market prices or rates, and this is generally called speculating. Derivative activities has grown to at least $12

trillion in notional amount by the end of 1992. This growth and the increasing complexity of derivatives reflect both the increased demand from end users for better ways to manage their financial risk and the innovative capacity of the financial services industry to respond to market demands.

Because of derivatives growth and increasing complexity, Congress, Federal regulators and some members of the industry are concerned about the risks derivatives may pose to the financial system or to individual firms, investors and maybe ultimately to the U.S. taxpayers. These concerns have been heightened by recent reports of substantial losses by some derivative end users, including losses totaling in the hundreds of millions of dollars by some U.S. firms. The largest recent loss reported was by a German firm that involved assistance of more than $2 billion from 120 banks. I might point out that that is larger than the Lockheed or the Chrysler or New York City bailouts, just to put that in perspective.

We found that much OTC derivatives activity in the United States is concentrated among 15 major U.S. dealers that are extensively linked to one another and to end users in the exchange traded markets. For example, as of December 1992, the top seven domestic bank OTC derivative dealers accounted for more than 90 percent of total U.S. bank derivatives activity. Similarly, the securities regulatory data indicates that the top five U.S. securities firms dealing in OTC derivatives accounted for about 87 percent of total derivatives activity for all U.S. security firms. Substantial linkage also exists between these major U.S. derivative dealers and foreign derivative dealers. For example, 14 major U.S. OTC derivative dealers reported to us that transactions with foreign dealers represented an average of about 24 percent of their combined derivatives notional amounts or, in other words, about a fourth of the derivatives is done with overseas counterparties.

This combination of global involvement, concentration, and linkage means that a sudden failure or abrupt withdrawal from trading of any of these large U.S. dealers could cause liquidity problems in the markets and could also pose risks to others, including federally insured banks and the financial system as a whole.

Although the Federal Government would not necessarily intervene just to keep a major OTC derivatives dealer from failing, the Federal Government would be likely to intervene to keep the financial system functioning in case of severe financial stress. While Federal regulators have often been able to keep financial disruptions from becoming crises, such as in the Bank of New England and the Drexel situation, in some cases intervention has and could result in a financial bailout either paid for or guaranteed by the taxpayers.

Primary responsibility for effective management of a firm's financial risks rests with boards of directors and senior management. A system of strong corporate governance such as that required under the FDIC Improvement Act for large banks and thrifts is particularly critical for managing derivatives activities because they can affect the financial well-being of the entire firm. Until recently, however, no comprehensive guidelines existed against which boards and senior management could measure their firm's risk management performance. But in 1993 a Group of Thirty-sponsored study

identified improvements that were needed in derivative risk management and recommended benchmark practices for the industry. The Office of the Comptroller of the Currency and the Federal Reserve also issued guidelines for the banks that they oversee, and I think just recently out there in Chicago at a meeting both Mr. Ludwig and Mr. Greenspan emphasized that they were going to put on additional efforts for risk management supervision of the large bankers in this derivatives area.

Now, the regulators and the market participants said improvements in risk management systems have already been made as a result of the Group of Thirty recommendations and Federal guidelines. However, we noted that no regulatory mechanism exists to bring all major dealers into compliance with these recommendations and guidelines. Further, while actions the major dealers have reported taking are important, the Federal Government also has responsibility for insuring that safeguards exist to protect the overall financial system.

Federal regulators have begun to address derivatives activities through a variety of means, but significant gaps and weaknesses do exist in the regulation of many of the major dealers. For example, security regulators have limited authority to regulate the financial activities of securities firm affiliates that conduct OTC derivatives activities.

Insurance companies, OTC derivative affiliates are subject to limited State regulation and have no Federal oversight, yet OTC derivative affiliates of securities and insurance firms constitute a very rapidly growing component of the derivatives market. The growth rate of OTC and exchange-traded derivatives—and we give that combined because that was the only data that was available—was 100 percent for the insurance firms and 77 percent for securities firms compared to 41 percent for banks from 1990 through 1992.

In contrast to insurance and securities regulators, bank regulators have authority to supervise all the financial activities of banks and their holding companies. While these regulators have improved their supervision of bank derivative activities, their approach still has weaknesses such as inadequate regulatory reporting requirements and insufficient documentation and testing of internal controls and systems.

Further compounding the regulators' problems and contributing to the lack of knowledge by investors, creditors and other market participants are the inadequate rules for financial reporting of derivatives activities. We found that the accounting standards for derivatives, particularly those used for hedging purposes by end users, were incomplete and inconsistent and have not kept pace with business practices. We also found that additional disclosures are needed to provide a clear distinction between dealing, speculative and hedging activities and to quantify the interest rate and other market risks.

Insufficient accounting rules and disclosures for derivatives increase the likelihood that financial reports will not fairly present the substance and the risk of these complex activities. In addition, the lack of rules for certain products make it likely that accounting

for these products will be inconsistent, thereby greatly reducing the comparability of financial reports.

Now, we believe that innovation and creativity are strengths of the U.S. financial services industry and that these strengths should not be eroded or forced outside the United States by excessive regulation. However, we also believe that the regulatory gaps and weaknesses that presently exist must be addressed, especially considering the rapid growth in derivatives activity. The issue is one of striking a very proper balance between allowing the U.S. financial services industry to grow and innovate and to protecting the safety and soundness of the Nation's financial system. Achieving this balance will require unprecedented cooperation among U.S. and foreign regulators, market participants and members of the accounting profession.

Given the gaps and weaknesses that impede the regulatory preparedness for dealing with a financial crisis associated with derivatives, we recommend that Congress require Federal regulation of the safety and soundness of all U.S. major OTC derivative dealers. The immediate need is for Congress to bring the currently unregulated OTC derivatives activities of securities and insurance firm affiliates under the purview of one or more of existing financial regulators and to insure that the derivatives regulation is consistent and comprehensive across the regulatory agencies.

We also recommend that the financial regulators take specific actions to improve their capabilities to oversee OTC activities and to anticipate or respond to any financial crisis involving derivatives. Our recommendations also address the critical roles of the board of directors and senior management of the major derivatives dealers and end users and the need for improved accounting standards and disclosure requirements for derivatives activities.

While our recommendations address regulatory gaps and weaknesses in the context of the current regulatory system, the nature of derivatives activities clearly demonstrates that this system has not kept pace with the dramatic and rapid changes that are occurring in domestic and global financial markets. Banking, securities, futures and insurance are no longer separate and distinct industries that can be well-regulated by the existing patchwork quilt of Federal and State agencies. Therefore, we also recommend that the Congress begin to systematically address the need to revamp and modernize the entire U.S. regulatory system.

Mr. Chairman, that concludes my prepared statement. We would be pleased to answer any questions.

Mr. MARKEY. Thank you very much, Mr. Bowsher. The Chair will recognize himself for a first round of questions.

Mr. Bowsher, the regulatory and legislative reforms GAO is proposing are intended to prevent derivatives from contributing to disruption in the financial system. Now, as you know, in a joint statement issued yesterday, several industry trade associations attacked the recommendations in your report, arguing "that if implemented, the GAO recommendations would increase the cost and reduce the availability of these essential transactions."

The groups went on to announce that "we are convinced that any legislation having these effects will harm the American economy, therefore we strongly oppose such proposals."

How do you respond, Mr. Bowsher, to the accusation that your recommendations are going to harm the American economy?

Mr. BOWSHER. Well, we don't think they would, Mr. Chairman, because you have got to look at it this way. You are talking about 15 very large dealers here—the big banks, the big security firms, and three big insurance companies, and the banks are moving already to put good risk management systems in place.

They are making the investments, and their bank regulators are checking those out, and we met with one of the big banks in the Midwest here just last week, and I think they indicated to us just exactly what we were hoping was happening, and that is that they have invested very much in their risk management systems and their controls. They have their outside CPA firm checking them out. They are working with the OCC, which is their Federal regulator, and they are feeling that they are moving ahead to a very safe and sound system.

They have also created a risk management committee of their board of directors to help oversee all of this. That is really what we are recommending here. In other words, what we are recommending, I think, most of the big dealers are already moving on because they themselves are concerned that they have a safe and sound operation here.

Now, what we are saying is that the bank regulators have the opportunity under present legislation to check this out. We think that some Federal regulator should have the same opportunity in the other two areas because it is important not that people say they are in good shape, but that it gets checked out, and, of course, one of the things we had recommended in the legislation back in 1991, which I think some of the larger banks are moving on, is to set it up as part of the annual audit and have the CPA firms do that, and that is somewhat similar to some of the regulation overseas by systems such as the German system. So what we are recommending here is something that I think they are moving on, there are costs that they recognize that they have to invest if they are going to be in this business, and so I think the statement yesterday by these trade associations kind of fanning this idea of huge costs or additional costs, I think, it is a red herring myself.

Mr. MARKEY. So let's divide the question, then. You are saying that right now banking regulators largely have the authority they need in order to ensure that many of the safeguards which you are recommending are built into banking practices?

Mr. BOWSHER. That is correct.

Mr. MARKEY. But conversely in the insurance and securities industries, for example, there is not a similar authority given to some Federal regulator in order to ensure that those firms, as well, are complying with generalized standards that the banking industry is now accepting?

Mr. BOWSHER. That is correct.

Mr. MARKEY. And not complaining that it is undermining their business opportunities; is that correct?

Mr. BOWSHER. And, obviously, it is not undermining their business opportunities.

Mr. MARKEY. So we have the banking industry now accepting these standards with banking regulators ensuring that banks are

complying, but at the same time there is a regulatory black hole which exists over in the securities and insurance area.

Mr. BOWSHER. At the same time, Mr. Chairman, I want to make the point that we have visited these other organizations, and my impression is like the big security firms, they are making the same investments.

Mr. MARKEY. What you then recommend is that there be some uniformity to it to ensure that across all of these industries there is some consistent standard which is being used and being monitored and that right now we have a divided regulatory scheme, one which covers the banking industry. It doesn't cover these other industries, and may or may not be complied with by those that aren't covered.

Mr. BOWSHER. If I could just add one more point, and that is that when we have visited with these large institutions, like the securities firms, one thing that interests us is that some are going at it in a different way than others.

In other words, all of them, I think, are trying very hard to get what they think is the best risk management system in place, but some are going at it in one way and others are going at it in another way. It seems to me that one of the things you do need is somebody, then, to come and look at it and see if there are gaps within either of those approaches, and that was really what the bank out there in the Midwest said was one of the things they were getting out of their OCC review.

Mr. MARKEY. So let's deal, then, with the other side of the coin. What is the cost of inaction in this area? What would happen if we don't put in the safeguards to cover these other parts of the financial structure that are not now covered under the banking regulations in terms of the likelihood that at some point down the line Federal regulators will have to intervene to keep the financial system from breaking down because we won't have built in the proper anticipatory safeguards?

Mr. BOWSHER. Well, I think the problem is that if we don't get some of these gaps—in other words, what our report does really is—and what you asked us to do is to look and see are there gaps in various areas, such as in the regulatory system, in the systems, in the accounting disclosure. If we don't get on top of those, then what you do is you run the risk that you could have some crises in the future that maybe could have been prevented, and I think this is an area where we have been getting some warnings here.

In other words, we have been getting some warnings of some $100 million losses not just by P&G, but by several firms, some dealers, some end users, and then that German situation I think was a very big warning because of the size and the amount of—the number of banks that had to be pulled together to bail out that situation, and so I think what that indicates to you is there are some problems out there, and it is important to deal with those problems.

It is a little bit like if you remember, Mr. Chairman, on the government securities, you saw some warning signs there some years back, and you asked us to do a study and I think your committee here and the treasury and the SEC and the Federal Reserve got

together and finally passed some legislation. It seems like we have not had trouble.

Mr. MARKEY. Thank you. In your prepared statement you noted that the sudden failure or abrupt withdrawal of a large U.S. derivatives dealer from the market could pose problems to other dealers, including federally-insured banks, and ultimately to the overall financial system. If we fail to take proper anticipatory steps now, is there a greater or lesser chance that Federal regulators will have to step in later, leaving the taxpayers to foot the bill?

Mr. BOWSHER. Well, I think there would be greater risk if we don't step in and deal with some of these gaps right now, no question about it.

Mr. MARKEY. The GAO study warns that while many of the types of risks associated with derivatives are present in other types of financial products, such as the risk of counterparty defaults or adverse market movements, these risks may be more difficult to manage with derivatives.

Can you explain why that is so? How do you respond to those who argue that the issues of credit and market risk that these instruments raise are nothing new?

Mr. BOWSHER. Well, there is no question that the other financial transaction that banks and security firms enter into have similar risks, but what you have here in the derivatives area is a new and sometimes quite complicated set of financial instruments, and we have seen like in unwinding the Bank of New England and the Drexel situation and even what I have read about on this German situation, it takes quite a bit of time, sometimes months to unwind these situations. Like in the Bank of New England you had a $30 billion bank off the balance sheet and a $30 billion bank.

Luckily, as they unwound it, it was a successful situation, but it took months to do it. I know one large securities firm which lost $300 million in a situation there where one of their traders put the tickets in the drawer; they lost that money, some of it, because they were just trying to figure out what he did and how to unwind it. So these are complicated instruments, especially the more exotic ones, and people who say this is exactly the same business that we have been doing for many years I think are understating the situation.

Mr. MARKEY. Thank you, Mr. Bowsher. My time has expired. The Chair recognizes the gentleman from Texas, Mr. Fields.

Mr. FIELDS. Thank you, Mr. Chairman. Mr. Bowsher, going to your testimony, you talk about the concentration. It seems at this particular moment you have a fairly small universe of dealers, insurance companies, banks, if I understand your statement correctly, and having said that, let me disagree with the chairman just a moment.

I do not see a regulatory black hole when it comes to the broker-dealer affiliates. If I understand the Market Reform Act of 1990, the SEC has indirect oversight authority over the activity of broker-dealer affiliates, specifically that the holding company risk assessment provisions of that particular legislation allows the SEC to monitor the financial condition of broker-dealer affiliates to help assess any problems at the broker-dealer level. Is that correct?

Mr. BOWSHER. Well, it is unclear. In other words, some people—I think Mr. Breeden claimed that they did. But in our review in talking to them, they obviously have some reporting capability because of that legislation, but didn't have the ability to go in and really review the risk management systems like the bank regulators can do. We believe they didn't have that authority and some of their people told us they didn't think so, either, so I think this is a cloudy area where I think you need more testimony and more people giving you advice on it. Our impression was that they did not have the full range of ability.

Mr. FIELDS. OK. Well, some of us do believe and the concern that some of us have is that if there is an attempt to bring these broker-dealer affiliates under direct SEC provision, then you are going to see many of these affiliates go offshore, go foreign. To me that is counterproductive in terms of our ability for oversight.

Mr. BOWSHER. We don't want that at all. In other words, we are not recommending anything here that we think would lead to that nor is that our desire. In other words, I think it is important here to recognize that what we are saying is that we think that the managements of these big firms are making the investments. They are, I think, doing a good job. We just think there needs to be some ability for the regulator to be able to—at least one regulator to check it out.

Mr. FIELDS. Well, that underscores a concern that many of us have in rushing to judgment, that there are outstanding questions, particularly in the regulatory area. Let me turn to the insurance companies. As I understand, these are subject to State regulation.

Mr. BOWSHER. That is correct.

Mr. FIELDS. Has there been a problem with the State regulators?

Mr. BOWSHER. The State regulators have not generally looked at this derivatives area very much was what we were told at that time, and so I think what you have here, again, is you have insurance companies that are dealing in derivatives who might have adequate risk management systems and controls, but nobody has really checked that out, and we think that you should have some kind of an oversight there. Now, maybe the States could do it, you know.

Mr. FIELDS. When you say no one has checked it out, did you not check it out?

Mr. BOWSHER. We went and met with them, but we did not do a detailed assessment of their systems, no, we did not.

Mr. FIELDS. So, in other words, that is still a cloudy question for those of us sitting on this panel?

Mr. BOTHWELL. I would like to make one clarifying comment on the insurance companies. Basically, if the insurance company is using a derivative product to hedge its own assets or liabilities, that could be used inside the insurance company itself and it would be looked at by the State insurance regulators during their examinations.

However, the dealing activities, the large scale dealing activities that these three large insurance companies are doing, they are in separate affiliates. They are separate from the insurance companies, and they are not looked at by the State insurance regulators.

There is no capital requirement and there is no examination requirement for those affiliates that are dealers.

Mr. FIELDS. But are those triple-A rated?

Mr. BOTHWELL. Yes, I believe some of them are.

Mr. FIELDS. So, in other words, if I could just segment so I understand, I think Mr. McMillan was correct just a moment ago in talking about how complex this area is and how many of us are trying to grasp the complexity of this, but just very simplistically from the broker-dealer affiliate, many of us feel that there is authority now for oversight. There are many of us who feel that there is that oversight authority with State regulators and would question perhaps your impression that the State can't do the job that you feel the Federal Government can do and then, third, you have the banks and I think we concur that the banks are moving in the direction of the oversight authorities in that particular area. So my question is, is this perhaps the time for our immediate focus to be on the development of standards that are consistent globally, and as I understand it, effort is being undertaken by international banking regulators and rather than independent domestic action, shouldn't we involve ourselves in a process such as that so that we have that consistency?

Mr. BOWSHER. Well, it would be very great to get that consistency, let me tell you, that would be the best of all worlds if we had the same consistency on an international basis, but I think what we have seen in the harmonization of accounting standards and banking standards and everything like that, that you make that progress sometimes over a number of years, and so I think one of the things you would have to consider is whether you want to wait for that or whether you want to get our own house in order here and then also work to achieve that harmonization with the overseas dealers.

I think another point I might make here, Mr. Fields, and that is that not only do you have to have the standards, but the regulators have to have the capability to do this review, such as the detailed systems review and management risk. This takes today, looking at these kinds of systems and models, some very talented high-priced people, generally speaking, and so one of my concerns, even with some of the regulators here, is do they have enough capability yet to really do the job?

I think the bank regulators are starting to do the job, but this is not something that is simple or easy to do, and that is one of the reasons why we have pushed very much for what I would call a corporate governance part of the recommendations, and that is that the board of directors and the audit committees should be hiring outside experts to look and see how well their systems are working, and I would think publicly report that so that the regulators can see, but also the stockholders and people who are relying upon it.

Mr. FIELDS. One last quick question. I could not tell from your study whether you visited corporate users of derivative products in making your assessment.

Mr. BOWSHER. We did visit some corporate users; that is correct. Could I answer one question, too, with Mr. Fields that he had in his opening remarks about the end users and whether we were

talking about the SEC, what their role is. What we are really saying is the SEC traditionally gets information from the large corporations, you know with the 10 K filings and the annual reports.

In this day and age of the computers and the systems being as complex as they are, especially in this area, it seems to us that they should be adding some additional disclosure requirements at least as a start for the major end users, the ones that are into these complex derivatives, to find out if they have risk management systems, if they have outside people looking at it and things like that. This is what I think a lot of people need is the additional information.

Once you get the accounting standards set and modernized, then you would hope the SEC would work on getting that reporting flowing too, so much of this can be done under the SEC's existing disclosure requirements if they wish to ask those questions.

Mr. FIELDS. Mr. Bowsher, just going back, I would like for you to clarify for me what authority the SEC has now under the Market Reform Act because, as I look at this it appears they have that authority.

Mr. BOWSHER. Well, the Market Reform Act, now you are talking about the affiliates, are you?

Mr. FIELDS. Yes.

Mr. BOTHWELL. Mr. Fields, the Market Reform Act certainly gave the SEC the authority to require reporting of information from any affiliate that can materially affect the financial condition of the broker-dealer, so there is no question about the SEC's ability to gain information from the derivatives affiliates, and they are doing so on a quarterly basis. We don't think it is enough information, but they are attempting to gain some information on the activity of the dealer affiliates of securities firms. They certainly do not have the authority to set the capital standards for these affiliates.

Right now, to bring that activity into the broker-dealer, the current net capital rules are very onerous on derivative-type products. And as you pointed out, that was the choice. Bring it into the broker-dealer under the current net capital rules or go overseas, they would probably choose to go overseas. However, the SEC realizes that the current net capital rules with regards to derivative products are perhaps too onerous and have issued a concept release to try and relax and modify those capital rules, so it isn't necessarily the case that you bring them in under existing capital rules. That is not what we are arguing at all.

With regards to examinations, they do not now, I don't believe, think that they have the authority to go and do the examinations with the SRO's as they do with broker-dealers.

Mr. MARKEY. The gentleman's time has expired. Again, just to make this point, the banking regulators have the ability to command reports, to supervise, to set capital standards. The SEC has the ability to ask for reports, but not to supervise and not to set capital standards, OK? So we have that gap that exists between existing authority for banking regulators and those for securities and for insurance regulators, and that is essentially what we are talking about. And the SEC has told us they don't believe they have the capital standard setting capability or the ability to supervise under the Market Reform Act.

The Chair recognizes the gentleman from Virginia, Mr. Bliley.

Mr. BLILEY. Thank you, Mr. Chairman. Mr. Bowsher, amidst all this recent press hoopla about derivatives, I came across an interesting article in the Wall Street Journal which indicated that financial derivatives have been in use in this country since as far back as the Civil War. Apparently, at that time textile mills in London and Paris wanted to guard against the devaluation and hedge the possibility that a long war would deplete cotton supplies and increase prices.

The Confederacy issued a bond that entitled the mills to cotton if they could break the blockade, and ultimately the notes lost worth when the South was defeated, but for a time they provided European mills with a way to manage risk in a volatile period. My point is that complex derivatives have been around for a long time.

As we heard during our hearing last week and as you state in your report, the risk posed by derivatives exists for many financial activities. Why, then, do we need special rules for these products? What makes over-the counter derivatives any more dangerous than foreign exchange transactions, for example?

Mr. BOWSHER. Well, basically what you have got now is the computer allows you to design some very complicated derivative financial instruments, and people are modifying instruments and changing them, so today the complexity is much greater than what it was back, I would say, before 1975, let's say, and so that is what you have here is that you have a much larger volume, much greater complexity. Therefore, the risk management of all this is much greater than what it used to be.

Mr. BLILEY. On page 85 of the report you make the argument that Congress needs to regulate securities and insurance firm affiliates because, and I quote, "these security firms and insurance companies are large financial firms. As in the case of a major bank failure, a crisis involving derivatives that affects one of these firms would likely affect the financial system and require Federal intervention to resolve." That statement does not reflect our experience and seems unnecessarily alarmist to me.

During the debate on the banking bill, witnesses like former SEC Chairman Breeden testified that one of the strengths of securities regulation is that no one, not Drexel Burnham or E. F. Hutton is too big to fail. Why do you think if Goldman Sachs failed because of derivatives or any other reason, for that matter, that the Federal Government would bail them out? Can you cite an instance where the Government ever bailed out a broker?

Mr. BOWSHER. I think the experience that we had in the 1987 stock market drop there was that the Federal Reserve had to push through a lot of money through the banks to the brokerage firms because to a great extent they didn't know what the situation was when the computer systems went down at that time, and so you had at that time a situation where the Federal Reserve was trying to shore up, I think, the liquidity of the entire financial services industry.

The big 15 here, you might say, do an awful lot of business with each other, and to a certain extent about 40 percent of all the derivatives work is with each other, so you have tremendous linkage, and also what you saw in 1987 out there is when something hap-

pens to the equity markets like in New York, then the derivative markets in Chicago and other places start to kick in because of things like that, so our big concern here is we just don't know how this would all play out in a time of stress, and we are just saying that the linkages are much greater now than what they used to be.

Mr. BLILEY. Many U.S. companies look to that treasurer's office as an independent profit center rather than viewing it as a cost center that simply provides services to the operating divisions of the company. As long as the goals and limits of such policy have been approved by the board, there is nothing inherently wrong with such a decision, is it?

Mr. BOWSHER. Nothing if it has been approved by the board, but it has to then be followed closely. In other words, this, I think could be the situation at many corporations today, and so then what you have to do is as these derivative instruments that you have entered into are reacted against the markets, you have to see how things are going and you have got to have a risk management approach. Sometimes that, I think, has been well explained to the board, sometimes maybe not so well.

Some of the ones that have reported losses here have indicated that maybe they didn't have that type of review process in place so I think that this is very much within corporate governance, and we just think it should be strengthened there and I think maybe also the stockholders and the creditors should be aware of just how much of this activity is going on. I think that gets to the disclosure issue.

Mr. BLILEY. One last question, Mr. Bowsher. We have recently experienced a period of market volatility. The prime has risen 125 basis points, the dollar has struggled against foreign currency, and the stock market has certainly been uneasy. Recent press reports have focused on a few firms that have had some unsuccessful derivative transactions.

Would you agree that without derivatives, many more firms would have suffered losses during this volatile period?

Mr. BOWSHER. I just have no idea whether there would have been more or less.

Mr. BLILEY. Thank you, Mr. Chairman.

Mr. MARKEY. The gentleman's time has expired. The Chair recognizes the gentleman from Oklahoma, Mr. Synar.

Mr. SYNAR. Thank you, Mr. Chairman. I want to play off what Mr. Bliley was talking about which is these linkages, and how solid these legal fire walls are between these holding companies and their affiliates in times of financial crisis. We do have historic perspective on this. In the cases of Drexel and Continental Illinois and the Bank of New England the facts show that when the holding company got—when the affiliate got in trouble, this was a very serious problem up and down the ladder.

Isn't it true that that same danger that a major loss from derivatives by their affiliate could endanger the rest of the firm up and down?

Mr. BOWSHER. Yes, I think that is a potential, yes.

Mr. SYNAR. OK. Second, yesterday Chairman Levitt of the SEC warned "the use of derivatives by money market funds merits special attention." I guess the first question is how prevalent are these

derivatives by mutual fund managers trying to juice up their returns for their fund?

Mr. BOWSHER. I think they are into it quite heavily, but, Jim?

Mr. BOTHWELL. Mr. Synar, we didn't really survey mutual funds as end users of derivatives. However, we did survey pension funds, and we found out that they are pretty heavy users of derivatives, something like in the order of 70 percent of the pension funds, and they did cite one of the factors for using derivatives was to increase their yields.

Mr. SYNAR. How easy is it for a mutual fund investor to find out whether his fund invests or not in derivatives?

Mr. BOTHWELL. I think they would have to rely on getting their prospectus, getting their new prospectus and looking at it. A number of mutual funds, as you may be aware, are stock mutual funds, are buying foreign stocks, they want to pick the companies for the growth prospects. They don't want to necessarily engage and assume foreign currency exchange risks, so a number of them are engaging in a lot of currency swaps here to avoid the foreign currency risk and they are just concentrating on picking companies whose prospects they think are very good.

Mr. SYNAR. That is a pretty sophisticated understanding by an investor, wouldn't it be?

Mr. BOTHWELL. Yes, and they might not even notice it in the change in the prospectus.

Mr. SYNAR. Would you be willing to survey mutual funds regarding their derivatives holding as a follow-up to this?

Mr. BOTHWELL. I believe SEC, through Chairman Levitt's concern, may be planning to do that. We could certainly check with them and find out and get back with you on that. If they are not planning to do something, perhaps we could.

Mr. SYNAR. If I understand the Republicans' argument, at least Mr. Bliley and Mr. Fields today with respect to derivatives, it is that the derivatives market is dominated by high quality, high credit quality institutions that are highly sophisticated and more than capable of handling and understanding the risk of the derivative invested. Your report pretty well supports that given the limited number of people that are involved and the percentage of the market that they control.

I guess the question is that if you take that to the natural extension, which is that they believe market forces and regulations exist to protect the investor, let me ask what market forces or regulations exist to keep weaker participants out of the derivatives market or require stronger participants to set aside greater amounts of capital as their risks increase?

Mr. BOWSHER. I think that is one of the worries that people in the industry even have told us on several occasions, and that is that you are bound to have new entries come in to this type of a market.

Mr. SYNAR. This is what happened in the junk bond market. We started off with the big, respectable, high quality, high risk investors as it became more attractive. What market forces are there?

Mr. BOWSHER. One of the things I might point out, Congressman Synar, is that lots of times you can maybe get some of the business by having lower costs and therefore maybe not the same invest-

ment in your risk management systems and other things like that, so that is one of the things that I think is worrisome. I think that is why you want your regulatory structure to be in place so that you can be reviewing this, even though it might be not a large percentage of the total volume, why it could be——

Mr. SYNAR. Are there any market forces or regulation that give us some sense of protection?

Mr. BOWSHER. Well, in the banks again, the bank regulators would have the opportunity to look, as new banks come in or banks start to expand their activities in here, but you would not have the——

Mr. SYNAR. Your table number 2 in your executive summary, I think, tells the story. If you look at the securities firms' affiliates and the insurance, there is absolutely no market forces or even minimum reporting really necessary in both securities and insurance, so what you have here is that you have pretty free run of weaker competition coming in; isn't that correct?

Mr. BOWSHER. I think that it would be much easier to come in in the securities area than it would be in the banking area.

Mr. SYNAR. Is one of your greatest concerns, you mentioned this a couple of times during your testimony, isn't one of your major concerns the gap between the various institutions, bank securities and insurance companies that exist right now?

Mr. BOWSHER. That is one of our major concerns, and it is really the gaps that are out there, not only in this area but in the accounting, the financial reporting, the disclosure, the international, those are the gaps that we think are important for the Congress to address.

Mr. SYNAR. OK, thank you. Thank you, Mr. Chairman.

Mr. MARKEY. The gentleman's time has expired. The Chair recognizes the gentleman from North Carolina, Mr. McMillan.

Mr. MCMILLAN. Thank you, Mr. Chairman. I would like to go back to something I raised in my opening statement in terms of trying to get this thing in perspective. Have you in any of your analyses tried to examine the degree to which derivatives have served a constructive purpose, the degree to which they have not just resulted in loss, but profit? The primary purpose of a hedge or derivative is the avoidance of loss, which we typically don't report in financial statements. Yet, if that is the object of the exercise, in most business contexts, then it seems to me that has to be examined in terms of the positive effect that it has had.

Take the Bank of New England. We brought this up the other day. We talked a lot about the failure of the Bank of New England. The testimony seems to indicate that the bank failed not because of its involvement in derivatives, but because of other risks that it was engaged which are presumably given oversight by the various regulatory agencies. I think we need to be very careful in attributing that to something that perhaps did not exist. Or perhaps we need to go further and say did any activity by the Bank of New England in hedging its risks or exercising risk management avoid loss and perhaps ameliorate the effects of what in fact occurred?

Mr. BOWSHER. First, let me say, Congressman McMillan, there is no question in our examination, and I think most other people who have looked at this area that there are many benefits from the use

of derivatives, and it has helped many of our major corporations and companies hedge risks. This is especially true since 1971 when President Nixon closed the gold window and went off the Bretton Woods. We went back into the world market at that point in time, and so therefore our companies have lots of time to hedge currency exchange situations and also interest rates and that, so these are very useful instruments in many, many cases.

In the Bank of New England, it was clear that it was the loans and the real estate loans that got the bank into trouble. It was not the derivatives. But what was interesting is how little was known about this $30 billion off-bank or balance sheet thing that was going on until the regulators had to go in and unwind it and then how long it took to unwind it.

I think that is one of our problems and one of our situations that we would hope that could be improved in the next few years is for better disclosure and better reporting on these activities and not just have it all off balance sheet and stuck in a couple of footnotes.

Mr. McMillan. I think you make a statement in your own report on page 54, which I think supports what you just said. The derivatives-related credit exposure for the seven U.S. bank dealers was, with one exception, much lower than the credit exposure arising from their loans.

On the question of reporting, under normal SEC rules, 10-K filings, what is the current interpretation with respect to the requirement that unusual exposure from derivatives either way be a part of such filings and therefore routinely available to stockholders?

Mr. Bowsher. Let me ask Don Chapin down on my right here to answer that question and also maybe explain just where the FASB and the SEC is at this time on all this.

Mr. Chapin. As you know, the accounting standards are set by the Financial Accounting Standards Board. They set not only the accounting rules, but also the disclosure standards. The SEC generally accepts the standards as the basis for reporting under the Securities Act, so in effect the standard-setting process is in the hands of the FASB and the SEC observes what they are doing, has some influence on what they eventually determine, but does accept the rules as set by the private sector, so that when you look at the standards-setting process, you have to look at what the FASB is doing, and what we have done in this report is to outline the areas where the standards have holes in them or have shortcomings.

For example, in the area of disclosure, just one example, the FASB has not yet been able to require disclosure of the amounts at risk in derivative activities that are speculative. They have a number of problems, definitional problems and measurement problems to determine how much is at risk in any given situation, so that vital piece of information is not being disclosed in any kind of uniform fashion, and it is not disclosed at all by many, many companies.

Now, that is a disclosure problem that the FASB is trying to solve. It has not yet been able to solve it, but until they do, investors and counterparties and regulators, to the extent they rely on published information, are not going to have sufficient information to judge the extent of speculation that is going on or the amounts at risk for the particular company that they are looking at.

That is just one example. There are many more of the gaps and weaknesses that exist now because the FASB has not been able to deal with all of the questions that they need to deal with.

Mr. McMillan. I think you raise an interesting point, and through some personal business experience I know that occurs. So it really has more to do, does it not, with not so much additional regulation, because the regulators may not know what to do, either—it has to do with a determination as to what the degree of risk is in a given pattern of activity, type of activity, and the accounting standards people are sometimes slow to react to that, and the practice goes on and doesn't get reported as such, and I think that is a legitimate area of concern that we should try to focus on.

Mr. Chapin. I think so, too. I think many people will acknowledge that accounting and disclosure is one of the major concerns that exist now about derivative products. These are complicated instruments, but the standard-setting process has been late, it has not yet done its job. They have been at this process for 5 years trying to deal with financial instruments. There are major blockages right now in solving some of these issues, and until the board is able to cut through these blockages, we are not going to have the standards we need.

Mr. McMillan. Has my time expired?

Mr. Markey. Yes, the gentleman's time has expired. The Chair recognizes the gentleman from New York, Mr. Manton.

Mr. Manton. I thank the chairman. I suppose the reason we are here today is to determine whether or not we should regulate. At an earlier hearing on May 10th some prominent former regulators who are leaders in the financial services business, Richard Breeden, Gerald Corrigan, and Dennis Weatherstone, testified before this committee and said they felt we didn't need regulation, that such things, and I made a few notes here, as voluntary actions, market forces, some incremental regulatory change, improved risk management practices, exemption of federally insured deposits from the derivatives market and the authority of the SEC under the Market Reform Act of 1990, particularly in areas of disclosure, better training and supervision of employees, establishment of international standards for documents and for clearance and settlement and other things. They also said that derivatives do not create new risk, but rather shift the risk. Perhaps you could comment on that.

Mr. Bowsher. Yes. Well, let me comment on the first part, and that is that there is really, I think, pretty widespread agreement here about the need for the individual firms to properly disclose to the shareholders and to the outsiders their derivatives activity and to implement any appropriate internal controls and risk management systems. That was said here in account of that hearing that you cited there, Mr. Congressman, and I don't think there is any disagreement and that is certainly what we are recommending, too.

The big issue that your committee and other committees asked us to look at—are there any gaps in regulation, and what we are reporting here is that the bank regulators have the ability to look and check out how well the individual banks and holding companies are doing when they report, and what we are just saying is that the securities affiliates and the insurance companies that are

in this in a big way basically do not have that same supervision and oversight, and that is a gap that we think that you ought to give some consideration to possibly changing and improving.

Mr. MANTON. Now, by attempting to fill these gaps, who are we really protecting? I just looked at the staff report of some of the more sensational losses that have been reported. Metallgesellschaft, the German company, a rather large enterprise, Procter & Gamble, J. P. Morgan, Mead Corporation, Atlantic Richfield; these are not exactly widows and orphans, and they are very seasoned players in the financial markets, so my question is really who are we protecting here?

Mr. BOWSHER. Well, the main thrust here of our report was on the major dealers, which were the big banks, the big securities firms, and the three big insurance companies that are dealing with most of these complex derivatives, and so those are the ones that we are saying should have this kind of oversight, and our concern is for the overall financial system, and if you are going to get into a crisis, as we have in the past sometimes on other issues in the banking and in the securities area, what we would hope is that you have the systems in place that you would get—early warning or that you would get—have the ability to deal with those crises. So we are not talking about the large corporations as far as this regulatory oversight.

Now, we also did comment on the oversight or the corporate governance area where we thought any large corporations are dealing—are into these as end users, and you cited a number of them that have got in trouble here recently in that, why, we just think it is important that the corporate governance be strengthened, that the risk management systems be strengthened in those places, and that it would be good if the SEC in their oversight of the financial disclosure could ensure that that is happening to the extent that they can.

Mr. MANTON. What about the comment that derivatives do not create new risks, but rather shift the risk?

Mr. BOWSHER. Well, I think it is—all financial instruments carry a certain amount of risk, and what you have had here in the last 10 years is a great growth in the derivatives markets, and also much more complexity, and so that you have risks here that many of these institutions in this forum did not have some years back, and they themselves, in other words, the boards of directors of your big banks and your big dealers and that, they are investing a lot of money in risk management systems and internal audit and internal controls because they don't want to have a problem with that, so what we are recommending they really are already moving ahead and doing, and what we are really saying in the banking area, the regulators can go in and review and check how well that is being done. In the securities and the insurance business, you don't have that oversight.

Mr. MANTON. Is there any point to our waiting before we rush to regulating, to see that these actions that are being taken voluntarily, perhaps as a result of the wake-up call of the report and these hearings, that perhaps the industry can do it on their own?

Mr. BOWSHER. Well, I think the industry can do a lot of it on their own and I think they are doing it on their own, so then it

is a case of getting it reported, and one of the things we recommended is that they have one outside unit, maybe like their CPA firm or some other firm come in and review their systems and report publicly as to how well their systems are and everything like that, and then I think with the oversight by the government regulators could be done very efficiently and not be too costly.

Mr. MANTON. Thank you, sir. Yield back the balance of my time, Mr. Chairman.

Mr. MARKEY. The gentleman's time has expired. The Chair recognizes the gentleman from Illinois, Mr. Hastert.

Mr. HASTERT. Thank the chairman. Chairman Bowsher, I have to come at this thing, I guess, as a layman. I haven't had extensive financial experience in the past, but I think that there is just some glaring questions that I have to ask concerning this.

First of all, are you talking about using these instruments to, especially if you are dealing with foreign currencies and doing foreign markets and have to deal with foreign currencies to protect against loss; is that right? So is it your experience that most of these companies that are engaging in this business are trying to protect against loss or shifts in value of foreign currencies as opposed to the dollar when they are doing legitimate business, but something out of their control, this is a protection; is that correct or not?

Mr. BOWSHER. That is a good portion of the derivatives business and that is where they are trying to hedge those risks on both interest rate and currency transactions.

Mr. HASTERT. Of course, every time you deal in the market if you make a profit, probably somebody is going to have a loss; is that correct?

Mr. BOWSHER. There is always a counterparty here; that is correct.

Mr. HASTERT. So that is kind of the natural part. So one of the real things that you are looking at here, I know you have made a lot of references to banks, and the other corporations that are engaged in this business. The banks are a little bit unique in a sense. They have depositors, the U.S. Treasury is involved, you have Federal deposit insurance that is a part of this thing that you have to protect, and so the government does have responsibility and you are saying that because that government responsibility and actually risk out there because you have depositor insurance and you don't want those institutions to go down, that they are doing some oversight in that; is that correct?

Mr. BOWSHER. That is correct.

Mr. HASTERT. And they have done a pretty good job because of that interest that they have in depositors insurance and that economic interest ultimate taxpayers have in that. Do you find that is a little bit different in the corporation situation where you have insurance companies and people, big corporations are dealing in foreign markets? There is a risk that when you—as opposed to a depositor and you are a shareholder, there is a little bit different situation with the relationship of that company; do you feel that is right or not?

Mr. BOWSHER. There is a different relationship, but with some of your big securities firms we have a Federal insurance program there, too.

Mr. HASTERT. So, in essence, then when these people are making these transactions, it is probably in the best interests of that corporation that they are very careful and try to hedge the risk that is out there especially dealing with foreign currencies and not bringing a loss or not intentionally trying to bring a loss to their businesses, are they?

Mr. BOWSHER. Oh, no.

Mr. HASTERT. But then the government ought to be involved, you are saying in looking into those transactions, those proprietary decisions and second guessing?

Mr. BOWSHER. No, no, not at all.

Mr. HASTERT. I misunderstood you.

Mr. BOWSHER. We are not saying the government should be looking. We are saying the government should be looking at the risk management systems and the overall controls and that they have to make sure that they are running this business, you might say, under control here, and we would hope that the corporate governance is working well, but if it isn't, then it seems to me that some kind of an oversight recommendations by the regulators makes some sense so that you can get on top of a situation before it turns into a crisis.

Mr. HASTERT. Who might these regulators be?

Mr. BOWSHER. It could be the bank regulators; it could be the SEC.

Mr. HASTERT. The bank has a different responsibility. The banks, corporations are corporations. Do you think the bank regulators ought to be regulating corporations as well?

Mr. BOWSHER. No, no, no.

Mr. HASTERT. That is what you just said.

Mr. BOWSHER. That is basically the SEC, the disclosure from the end users, if that is what you are talking about, the corporations that are doing this work?

Mr. HASTERT. You said the regulators ought to be looking at it and making these decisions. I said who are they. You said bank regulators. And then you said, no, it shouldn't be bank regulators looking at corporations. I just want a straight answer.

Mr. BOTHWELL. I think there is a little ambiguity here. Are you talking about major dealers that are securities firms?

Mr. HASTERT. I said there is a different realm out there. Banks are banks, corporations are corporations, the general came up and said, well, they ought to be looking into that. I said who are they, who should those regulators be? He said they ought to be the bank regulators, and I said looking at a corporation?

Mr. BOWSHER. I think maybe I misunderstood your question.

Mr. HASTERT. Well, who are they?

Mr. BOWSHER. It would be the SEC for the corporations.

Mr. HASTERT. So they ought to have——

Mr. BOWSHER. The end users.

Mr. HASTERT. They ought to have the responsibility of looking into corporations much like they look into utility companies and those type of things.

Mr. BOWSHER. They look at the financial reports, the audit reports, the 10-K's that come in and what we are saying in this area maybe it is appropriate now to ask some questions and get some

information flowing in as to how well—how much derivatives dealing is being done, and more disclosure and how good their risk management systems are, and have they had them checked out by somebody.

Mr. HASTERT. The gentleman from Texas asked me to yield. I would be happy to yield.

Mr. FIELDS. I just want to make sure one thing is clarified. When you were trying to draw a parallel between FDIC and SPIC, as I understand, what the securities investors protection corporation does is basically replace lost certificates. It doesn't guarantee against loss, and also, as I understand, it is funded through fees on transactions, so there is no real parallel to the FDIC; is that correct?

Mr. BOTHWELL. Yes, that is correct, but I think the other point was that with the FDIC Improvement Act of 1991, there is a small, but very important provision there that opened up the Federal discount windows to allow the Fed to lend to securities firms and other financial institutions other than banks, so there is a connection to the Federal Government through the Federal Reserve discount window for other types of——

Mr. FIELDS. Correct me if I am wrong, if I understand the thrust of the gentleman's questions. He is talking about domestic taxpayer risk. There is no parallel between banks and the securities industry.

Mr. BOWSHER. I think he is talking about corporation end users and you are talking about the securities.

Mr. FIELDS. No, I think earlier you were drawing the parallel between the risk that the taxpayer would suffer under a bank loss and then trying to compare that to a loss if there was a loss by a major securities firm. Uncle Sam is not going to come in and bail out a securities firm loss as they would a bank.

Mr. HASTERT. If I can reclaim my time, just one last question. I follow some of your logic, although I don't probably agree with it, but would you say in the end game that companies that you want to come in and do audits on and regulate in the sense that are doing this activity do owe their stockholders, and I say again stockholders and depositors are a little different situation. You assume some risk when you are a stockholder, but you say the government ought to come in, do this regulatory activity, but do you think those corporations owe their stockholders the ability to minimize risk when they do involve themselves in a foreign market such as Procter & Gamble and other companies and then would you also make a judgment if they didn't cover this risk, if they said, gee, if we are going to be regulated on this all of a sudden we don't want to get involved so we are not going to do it, and so they do a good job doing business overseas, but all of a sudden there is a change in foreign currencies and because in your proposed regulation they don't get into it and they really have a loss.

Would you reprimand them for that also? Is it a double type of oversight or regulation that you try and impose on American business?

Mr. BOWSHER. No. What we are recommending here, Mr. Hastert, is that they should be running their business on a day-to-day and doing whatever financial dealings that they feel they

have to do, and if they are doing overseas business they are obviously going to be dealing in derivatives to hedge some of that risk. There is just no question about it, and that is the way it should be.

What we are saying, though, is that we would like to make sure that when they are doing a fair amount of work here in the complex derivatives area, that that should be disclosed to the stockholders and possibly——

Mr. HASTERT. Just to follow up on my question, are you also going to expose it when they don't do proper derivative hedging?

Mr. BOWSHER. Well, I think that would come out in their financial results. That would come out in their financial results, yes.

Mr. HASTERT. Thank you, Mr. Chairman.

Mr. MARKEY. The gentleman's time has expired. Again, just to clarify this point, the issue is that securities dealers, since 1991, have access to the Fed's discount window, and as a result that means that if they get into trouble, they get a liquidity safety net provided by Uncle Sam; is that not correct?

Mr. BOWSHER. That is the potential.

Mr. MARKEY. So there are taxpayer dollars, there is Federal money, then, at risk if there is a liquidity problem.

Mr. FIELDS. Would the chairman yield?

Mr. MARKEY. Yes.

Mr. FIELDS. Has that ever been used?

Mr. BOWSHER. It has not been used.

Mr. BOTHWELL. It has only been available since 1991.

Mr. MARKEY. I guess our point is we don't want it to be used, so we are not prophesying a catastrophe. We are trying to build in the protections that will not necessitate the use of this Uncle Sam bailout of securities firms in order to protect a systemic problem.

The Chair recognizes the gentleman from Texas, Mr. Barton.

Mr. BARTON. I thank the chairman. One of the bad things about going last is that all the other Congressmen have asked the so-called smart questions that the staff prepared, so I am kind of left to my own devices here. I am going to ask a few elementary questions because I do want to try to get an understanding of what a derivative is and I am going to start at the personal level, and you tell me if this is a personal derivative.

About 6 months ago I thought it was a good time to refinance my home mortgage, so I began to look at various interest rates that I could get, and I found out that if I wanted a fixed interest rate at 7 percent I had to pay two points or a point maybe, and if I wanted a fixed interest rate at 8 percent I didn't have to pay any points and then if I wanted a variable interest rate that rolled over at the end of the first year, I might have to pay a different set of points.

If I paid for something that I actually had to pay points, when I paid for those points, basically I am purchasing a derivative contract, am I not?

Mr. BOTHWELL. No. The points are just adding to the interest costs of your mortgage.

Mr. BARTON. But isn't that what derivatives do, you pay something up front so that you minimize your risk in the long term, whether it is an interest rate risk or a currency risk?

Mr. BOTHWELL. To use an analogy of a mortgage, if you had chosen the fixed rate mortgage and sort of locked in a fixed rate and then by chance if you felt that interest rates were going to decline, you could swap paying that fixed rate for a variable rate mortgage, pay some premium, but this is sort of an unrealistic example because they really don't have those types of interest rate swaps for amounts as small as mortgages, at least my size house.

Mr. BARTON. But isn't that what I am doing when I decide if I take a chance, if I think interest rates are not going to go any lower, so I buy—I pay up front for a 6 percent——

Mr. BOTHWELL. No, you are just choosing among several options, a variable rate mortgage versus a fixed rate mortgage interest rate versus points. That is not a derivative.

Mr. BARTON. Isn't that what a company does when they go into the derivatives market, they are trying to obtain certainty from an uncertain situation by hedging and purchasing a derivative?

Mr. BOTHWELL. Yes, they are using derivative products to shift their risks from foreign currency fluctuations or from interest rate fluctuations, and you can do that by purchasing the original underlying instrument in a certain way or you can offset it by purchasing a derivative later.

Mr. BARTON. OK. I guess I am a little confused, but we all agree that derivatives minimize risk in the future if they are done properly; is that right?

Mr. BOTHWELL. It can be used to hedge or reduce risks. They can also be used to leverage and assume risk and take very large speculative positions on future market movements. They can be used either way.

Mr. BARTON. Now, let me ask another sophomore question. The Federal Government has extensive holdings, financial holdings, and we also have extensive transactions both in commodity goods and our agricultural programs overseas and in our foreign aid programs and in our military sales programs.

Would there be any reason for the Federal Government to purchase derivatives or involve itself directly in the derivatives market as a consumer in any of those programs?

Mr. BOTHWELL. Oh, yes, it could. As a matter of fact, in our end user survey we did survey some State and local governments.

Mr. BARTON. I was talking about the Federal Government.

Mr. BOTHWELL. There was not widespread use by governmental units, there is some, and it may be increasing and it certainly could be applicable to the Federal Government as well.

Mr. BARTON. Do you know for a fact that any Federal agency has participated?

Mr. BOTHWELL. I don't know of any. No.

Mr. BARTON. Would it be to the taxpayers' advantage?

Ms. TROP. There actually has been a case, one or more cases, where the Federal Government has been involved in derivatives. They had an option pilot program. There was somewhat recently in options a pilot program where farmers were encouraged to use derivative products as an option or an alternative to receiving certain kinds of Federal supports.

Mr. BARTON. So there are some limited examples of that; is that what you are saying?

Ms. TROP. Yes.

Mr. BOWSHER. Quite limited, though, I think.

Mr. BARTON. Would it be your advice that we should participate more? Would we get more bang for our taxpayer dollar spent in those programs if we did or not?

Mr. BOWSHER. I think one of the problems might be, I remember when I served on the Chrysler loan board we had some decisions to make, and I remember the Secretary-Treasury at that time was always reluctant to get into the position of, as he called it, speculating on the markets from the Federal Treasury point of view, and I think there would be some concern of that in this situation.

Mr. BOTHWELL. I don't believe it is U.S. Treasury policy to be using derivatives.

Mr. BARTON. Then, my last question is I see over and over in these studies that these companies and brokerages that participate in the derivatives market as market makers need better risk management programs. Now, give me an example of one of your case studies where you would specifically say here is the better risk management program that if I had been running the show I would have put in place.

Do you see what I am trying to get at? I mean, we all know we want to manage risk, and it is all well and good to talk about it, but give me a specific example.

Ms. TROP. Probably the best thing to do is to give you an example of how a company, let's say an oil producer——

Mr. BARTON. No, no, specific. I would like a specific—we studied this particular case and in this particular case they needed this particular risk management place, program in place and there wouldn't have been a problem. I want a specific example, a specific company or a specific brokerage, not a general hearts and flowers theoretical example.

Mr. BOTHWELL. Mr. Barton, in our audit work we did not go out and seek to find specific examples of where problems occurred in end users of derivatives and weaknesses. There have been a number of benchmark guidelines put forth by this Group of Thirty study. It was a pretty exhaustive study by the industry itself.

Mr. BARTON. But you didn't study specific companies and specific transactions? I thought that was the whole purpose of the report.

Mr. BOTHWELL. What we did for the seven major bank dealers, we looked at the bank examinations for these banks, and we found out in a number of these examinations there were specific major weaknesses cited in their risk management systems. Such basic things as failing to set or follow risk limits, such things as failure to document transactions.

Mr. BARTON. But there is no specificity in the study that has just been released and it says, to use Congressman McMillan's example, the Bank of New England, had they done X in this transaction under——

Mr. BOTHWELL. Mr. Barton, under our audit authority under the Bank Audit Act we cannot release specific information about open bank institutions.

Mr. BARTON. Well, the point I am trying to make, and I am going to yield back, we should, if we are going to begin to try to set regulations or encourage the Congress to set guidelines for people in

regulatory authority to enact new regulations, we should at least be able to point to specific examples with specific recommendations that would have prevented a certain negative activity in the past. That is all I am trying to say. Instead of talking in general terms, we can all be real theoretical.

If we are going to come in and enact any kind of legislation in a theoretical sense, we ought to be able to back up the recommendations with specific activities in the past that would have prevented damage. That is all I am trying to say. I thank the panel and I would yield back, Mr. Chairman.

Mr. BOWSHER. I just might say, Mr. Barton, that I think the regulators do those exams of the individual things and they could provide you with those examples.

Mr. BARTON. Thank you.

Mr. MARKEY. The gentleman's time has expired. We will turn to a second round, then, of questions from the subcommittee members. We can, in fact, find specific examples and make those executives sitting down here the poster children for the need for regulation, or we can deal with it in a more generic way, which is what we are trying to do, although there are ample numbers of examples that are already out there.

I think the Metallgesellschaft case is a good one where the Deutsch Bank and 120 other banks in not just Germany, but around the world, had to take some time and $2 billion in order to bail out Metallgesellschaft—a word which translates to anybody else, but that company gets the shaft because of their dealings in derivatives. Ultimately, as we know, there is enormous exposure, and in that case thousands of people may have to lose their jobs at that company, which is another question, when people do invest in these companies, whether it be Procter & Gamble or any of these other particular institutions.

I think that people think they are investing in Ivory Snow and get an idea that that product might be an important product that people will be buying in the marketplace, and perhaps the treasurer of the company is, in fact, taking proper hedging strategies in order to protect the investment, but that there is not a derivatives speculative wing of Procter & Gamble out there, as well, or else perhaps if they thought they wanted to invest in that, they would be over at Goldman, they would be over at Citicorp investing in a financial institution that is engaging in speculative derivatives products, so that is the distinction here.

Yes, there are important hedging derivatives products that corporations should be and are engaging in, but then there are other activities that ordinary investors right now are not familiar with that many of these corporations are, in fact, participating in without the proper safeguards.

How would you respond, Mr. Bowsher, to the argument of those who say we shouldn't worry about the fact that some derivatives dealers are not subject to periodic examinations and capital standards since the discipline of the marketplace and the imperative of maintaining their triple-A or double-A ratings will assure that such firms do the right thing. Can we safely rely on the magic of the marketplace to assure that all dealers engage in safe and sound

risk management practices or should we extend SEC authority to cover such firms?

Mr. BOWSHER. We think that there should be at least one regulator overlooking these major dealers here, and we think that the market certainly isn't the one, but we think that this is an area that the systems are very important, the controls are very important, the leaders of these big companies all agree to that. There is no debate, as I say, on that, and we just think that it is a gap that should be addressed, and I think what we are recommending here is very sound, very reasonable, very prudent, not that costly over and above what they themselves are recommending that they do, and so I think it is a gap that just needs to be addressed.

The big thing is to avoid crisis or in the time of crisis be able to get timely fashion that you can act and minimize those downturns, and I think if you talk to Jerry Corrigan or any of the people that have been involved in it, I have been involved in a couple of them, why, I can tell you that one of your big problems is information flow and knowing where you stand, and right now a lot of the information flow on derivatives is quarterly, which is much later than what the managements feel they need.

When we are talking now to some of these senior management leaders of these 15 big organizations, they are spending money to design systems that give them real time information, not even daily information. That is how anxious they are about the risk movement that they have got involved in.

One of the big areas they are worried about is the settlement process that they don't think is fast enough, and so I think that is an indication that in managing their businesses, they are concerned, therefore it seems to me that the regulators and the Congress here should be equally concerned that we have the systems in place, and this includes some of the new entries and people like that in addition to the big ones.

Mr. MARKEY. So some of these firms argue that if we gave the authority which you say is lacking over to Arthur Levitt, the Chairman of the Securities and Exchange Commission, the once head of the American Stock Exchange, that he could use that, then, to destroy this marketplace, and that that would be the purpose to which the Securities Exchange Commission and Arthur Levitt could put these powers to use. Or, as some of us contend, it would be used in a way that could help to solidify that marketplace to protect the system generally, but also to assure that there is more predictability and confidence in the marketplace.

What is the likelihood of Arthur Levitt using this power if we gave it to him, as the former head of the American stock exchange, to undermine this very valuable marketplace?

Mr. BOWSHER. I don't think the risk is very much at all. I think Arthur Levitt is a very responsible person. He knows the area, and I think he would do it in a very responsible way, and I think that nothing is hurting this industry more right now than picking up the paper once a week and finding that another company has lost $100 million or a dealer like Kidder has got a situation where, obviously, the controls were not what they have to be.

I mean, Jack Welch is doing literally now at Kidder what we are recommending. I think if you think back when Warren Buffett

came into the Salomon Brothers situation, the first thing he did was ask for a review of the controls because he recognized that that had to be one of the problems, so what we are recommending here, I think, is, again, as I say, very prudent, very much the meat and potatoes that you need to be in this business, and what we are asking is that there be some oversight here by the appropriate regulator in the government. Nothing that we think should drive it off there or add huge costs. It should be done in a proper way.

Mr. MARKEY. As you know, the SEC has been trying to deal with the unregulated dealers that are affiliates of securities firms by changing its net capital rule to attract the derivatives business back to the regulated entity. Your recommendation seems to suggest that instead of doing this, their authority should be extended to cover the unregulated derivatives dealer. Why have you chosen that alternative?

Do you have doubts about the efficacy of changing the net capital rule?

Mr. BOTHWELL. Mr. Chairman, we really don't endorse any particular agency in terms of extending its authority over the security affiliates or the insurance affiliates.

Mr. MARKEY. Your point is that some agency should have responsibility, but you are going to leave it to us on whether it should be banking, insurance or securities?

Mr. BOTHWELL. Exactly, yes.

Mr. MARKEY. What should we do about private industrial companies, such as Enron, which have also emerged as significant derivatives dealers? Should they be subject to SEC or some government agency oversight and regulation?

Mr. BOWSHER. Yes. That is the one where we refer to them as the end users, and what we are saying is the major end users who are dealing extensively in the complex derivative area should be asked to properly disclose the activity, and I think the SEC should have some kind of an effort going to see if they are getting their systems in place, is the corporate governance working. That is really what we are asking here is the corporate governance working at those corporations, and are they bringing anybody in from the outside to check out, you might say, their internal efforts.

Mr. MARKEY. Thank you. My time has expired. Let me recognize the chairman of the full committee, the gentleman from Michigan, Mr. Dingell.

Mr. DINGELL. Mr. Chairman, I want to commend you for holding this hearing. I want to thank you for the inquiry in which you are engaged.

Mr. Bowsher, I am happy to welcome you and your associates to the committee. As you know, I have great respect for you personally and also for the General Accounting Office. You have made, I think, a number of very useful inquiries here, have gathered some very useful facts, and made, I think, some very helpful suggestions, the first of which is the question of accounting principles. You have said that accounting principles for derivatives have not kept pace with business practices.

I note that in most of the instances where there has been trouble with regard to derivatives, people haven't really known what they were doing or what they were getting, what the risks were or what

was going on. That, I think, is one of the bases for your comments here. Is that a correct statement?

Mr. BOWSHER. That is a correct statement as far as public disclosure. In other words, generally speaking, here I think most of the stockholders, the SEC, anybody else on the outside was not aware of really what was happening there.

Mr. DINGELL. It also appears that some of the corporate officers were not.

Mr. BOWSHER. And maybe some of the corporate officers were not, and that gets to the issue of corporate governance. In other words, in your risk management system, what kind of system do you have in place that authorizes going into these various transactions? What kind of system do you have in place that monitors how the markets are doing versus what risk you have taken, and then, obviously, if you get into a situation where you are starting to lose on things like that, what is the decision-making process of making those tough decisions, and they are tough decisions.

Mr. DINGELL. It also appears that there is no understanding in many instances on the part of corporate accountants either of how these things work, what they are, what are the warning signals, how you keep track of them or how you detect risk in time that you can warn your corporate principal that there may be a problem.

It also appears they don't even know in some instances, in the history that you reviewed, where potential peril lay at the time that the company actually entered into the agreement to use or purchase the derivative; isn't that right?

Mr. BOWSHER. Well, that is right. As Don Chapin previously described here, the accounting standards, they have just not been able to come up with them. They have been working on them, but as long as you have that situation, then you don't have a uniform or standardized reporting of which corporations are required to report, and that is a very big weakness, and, of course, you can take that overseas, too, because as we pointed out earlier here, about 24 percent, 25 percent of all the transactions here among the 15 big U.S. dealers is with overseas counterparties, and so they, too, are in a situation where I think many of them do not have this properly recorded or disclosed and that.

Mr. DINGELL. A lot of these derivatives relate to management of international risks which means that you add an entirely new level of complexity and risk which is probably poorly understood at best by Americans; isn't that right?

Mr. BOWSHER. That is right. See, that is where you add what is sometimes referred to as legal risk and sovereign risk. In other words, you have situations there that you have to be willing to take on some risk maybe that their countries' laws or their countries' parliaments might change, and so that risk is there, no question.

Mr. DINGELL. Now, you also defined those dealers and people in the derivatives business, some of whom are regulated and some of whom are not. It is also true that not only are some not regulated, but there are differences in the kind of regulation; isn't that right?

Mr. BOWSHER. That is correct.

Mr. DINGELL. Now, you have mentioned that the SEC has authority over some, but not of others; is that right?

Mr. BOWSHER. That is correct.

Mr. DINGELL. That is a matter of concern. I would note that the authority that the SEC appears to have relates to capital adequacy and also the general levels of competence of the people who are regulated; is that correct?

Mr. BOWSHER. Well, we have a chart on page 11, and basically we say there that the SEC has reporting requirements which are quarterly, and then they really don't have examination oversight or capital requirements over these affiliates.

Mr. DINGELL. My very competent staff member agrees with you. The SEC does not have jurisdiction or authority over the general level of competence of people in this business, so what is there that can be done to develop something to, first of all, assure that SEC's authority is broad enough to reach all the people that they should reach and, second of all, what do we do to develop the competence to assure adequate disclosure and information gathering here because that appears to be our most basic concern. Could you answer those questions, please?

Mr. BOWSHER. Yes. I think on the dealers you would have to have legislation. On the end users, I think much of it could be done through the disclosure requirements and enhancing those by the SEC, and I think the SEC does need to enhance the competence of their staff in the area of systems and controls and that, so that they can actually do the type of work. This is very difficult work.

In other words, the complexity of these financial instruments has reached a stage where the big dealers now are hiring some very talented, high-priced mathematicians and physics majors to design their models and review what they are doing. To assess this takes some real competence on the part of government regulators.

Mr. DINGELL. Right now, it is also fair to say, however, that the competence of these people may not be up to the task that they are given in terms of writing the derivative. If you make yourself some bad assumptions, if you are doing a derivative, you can all of a sudden find you have problems down the road?

Mr. BOWSHER. That is correct. That is where the end users, I think, have gotten themselves into some of the problems that they have got themselves into. Some of the people that have designed the thing maybe didn't explain it fully or maybe they didn't fully understand it after it was explained, something like that, and that is why I think the end users, through the corporate governance or the role of the board of directors, the audit committees, the management has really got to strengthen their oversight over this derivatives activity that they are doing.

Mr. DINGELL. Well, the end user, that is a nice word, but it doesn't necessarily define them as the person who is the last person at risk in the chain of risk. It is fair to say that a lot of them are acting on behalf of other persons; for example, pension funds, banks, trust and fiduciary agencies of one kind or another.

If their competence is limited, there is somebody further down the road who could be hurt. For example, I have been told this is a phenomenon which could affect, for example, money market fund holders and, as a matter of fact, I gather has already done so. What

do we do to insure that the end user really has the competence to deal with his responsibilities to persons who are essentially, then, his end user?

Mr. BOWSHER. I think in the corporate end users you can do it through the corporate governance area and through the SEC requiring further information. I think in the pension area and some of the others, then you would have to design a different review process, and, of course, one company the other day did lose quite a bit of money in one of their employee pension funds.

Mr. DINGELL. Now, we have these sales practices, you have a fellow who develops a fancy derivative and he goes around and peddles it. What do we do about the sales practices and requirements with regard to sales practices? In connection with sales of ordinary securities, we require them to tell the truth. That was thought originally to be very painful and quite annoying, but the securities industry has learned to live with it comfortably over the 30 or 40 or 50 years they have had it.

Now, my question is, is there some similar imposition we can make on the peddlers of these kind of things by addressing their sales practice requirements?

Mr. BOWSHER. Well, that gets to the issue of suitability, and it is one that we had some discussion, but I wouldn't say we studied enough in this review that I want to make recommendations today. It is one of the things we are thinking of looking at in future work.

Mr. DINGELL. If you would look at that, it would be very much appreciated because I think that that is a component of any intelligent addressing of the questions we have before us. Mr. Chairman, I have consumed a great amount of your time. I want to thank you and commend you and Mr. Fields both for the work you are doing here. This subcommittee does fine work, and I am very appreciative of the effort that both you and Mr. Fields and the members of the subcommittee put into these questions.

Mr. MARKEY. Thank you, Mr. Chairman. We very much appreciate it. Thank you. The Chair recognizes the gentleman from Texas, Mr. Fields.

Mr. FIELDS. Thank you, Mr. Chairman. I will try to be extremely brief. I appreciate your patience, Mr. Bowsher, and certainly appreciate you being before us today. I think this hearing affords us an opportunity to learn more about what is a very complex yet important issue. Building on something——

Mr. BOWSHER. I might make an offer, too, Mr. Fields, that we would be happy to come over and spend more time with you or any of the other members.

Mr. FIELDS. I appreciate that. In fact, I was going to ask the chairman to make a unanimous consent request that the record remain open so that additional questions can be propounded to our panel and, again, because of the complexity——

Mr. MARKEY. Without objection, so ordered.

Mr. FIELDS. Building on something Chairman Dingell was talking about, and I think it is an area of agreement in regard to accounting standards and perhaps being behind the curve in this particular area, I alluded to that in my opening statement, as I understand the financial accounting standards board has authority now

to do what we are talking about subject to SEC oversight. Is that correct?

Mr. BOWSHER. Yes, that is correct.

Mr. FIELDS. OK. Also, to put a few things in perspective, because I was a little disturbed about the article that appeared in The Washington Post yesterday, and I think, again, if I understood what you were saying just a moment ago, you alluded to that, the stories that are out there that are very inflammatory that you have got a $12 trillion terrific, the sky is falling. If I have heard your testimony today, that is not your feeling. If anything, if I could characterize your feeling is that there is some gaps that needs to be reviewed and perhaps appropriate action taken whether it is regulatory or legislative.

Mr. BOWSHER. I think that is right. In other words, I think what we are reporting today here is there are some gaps. What we are hoping is that either through enhanced capability by the regulators or through some basic legislation here, on getting the coverage proper, and certainly by action by the FASB and things like that, that these gaps could be filled up and therefore our risk would be less.

I do not see it as a huge risk that is different than, let's say, some other risks that are out there, but it is a very complicated new area. I think one thing that might help understanding is if I could have Cecile here just describe the different levels of complexity of the instruments if that would be helpful. I think that would give you some——

Mr. FIELDS. That would be helpful. I want to continue on this concept of perspective. Some of the examples that have been thrown around today, and I won't get into the details of the example, but one was a $300 million loss. As I understand, that particular transaction was fraudulent. There is no regulatory authority, no legislation that is ever going to cover fraud. Another example that was used today was the example of——

Mr. BOWSHER. If I could just comment on that, I think it was a good illustration of where that organization realized that they had weaknesses in their risk management system, and they had to shore that up, and they have done it from their discussion. We haven't reviewed it in detail, but that is the kind of situation that they would like to minimize in the future, and I think all the other dealers would like to minimize in the future, so that somebody can't pull that fraud on them to the extent that it happened.

Mr. FIELDS. But when you are talking about fraud, I don't think you can single out one financial product. It could happen in any number of different products or services.

Mr. BOWSHER. Sure.

Mr. FIELDS. The other example that has been bandied about was a company losing X amount of dollars, but what hasn't been added to that statement was that the company for the quarter actually netted out, you know, made money, so I would hope that when these examples are being used they would be kept in a perspective.

One last aspect of this perspective, because I am really concerned about something you said, Mr. Bothwell, and that is preemption of State regulatory authorities, and if I understand what this report calls for is basically preemption of State law and regulating insur-

ance affiliates, and if I understand the situation again talking about a small group of players, both as broker-dealer affiliates and insurance affiliates, the vast majority, if not all of these are triple-A rated, and, again, I don't pretend to understand what triple-A necessarily means, but I guess that means well-capitalized, certainly well-scrutinized, certainly well-recognized in the investor community.

Mr. BOTHWELL. If I may just answer that, I don't think it necessarily preempts State regulatory authority over insurance companies. These are affiliates outside the insurance company in most cases. With regards to triple-A ratings, that means a private rating agency has gone in and looked at the operations of the affiliate and is satisfied it has a sufficient amount of capital. However, things move very, very quickly in this industry and what looks like a good capital situation one week may look like a very bad capital situation the next week. I don't think given the Federal interest and the stability of the financial system that we are talking about here you want to rely on private rating agencies to protect that interest.

Mr. FIELDS. Let me go back and make sure I understand, because if I understood what you just said, I do think you are saying preempt State law in the affiliate of that insurance company.

Mr. BOTHWELL. The State law doesn't extend to the affiliate of the company.

Mr. FIELDS. It could, though, couldn't it?

Mr. BOTHWELL. In a mutual insurer it could.

Mr. FIELDS. OK. I do want to direct a question, not at this time, but I want to propound it in a written form regarding SPIC, because I want to make sure that I understand what we were talking about just a moment ago because I may have—I may disagree with the image that was left in comparing SPIC to the FDIC, so I will submit that question in writing.

Mr. BOTHWELL. We will be glad to do that.

Mr. MARKEY. The gentleman's time has expired. The Chair will recognize himself once again.

Mr. Bowsher, who polices the derivatives market for fraud and manipulation? Who has responsibility to ferret out the fraud and manipulation in the derivatives marketplace?

Mr. BOWSHER. For the over the counter, I think, Mike here can give you the best answer.

Mr. BURNETT. When CFTC was given authority to exempt these products from their exchange regulatory scheme, they did not give away their authority to regulate against fraud.

Mr. MARKEY. Are derivatives securities?

Mr. BURNETT. Are derivatives securities?

Mr. MARKEY. The Securities and Exchange Commission has jurisdiction over securities. Are derivatives securities?

Mr. BOTHWELL. If the over-the-counter derivatives were securities, then the affiliates would be illegal broker-dealers, so they are not defined that way.

Mr. MARKEY. Fine. Thank you. Are they futures?

Ms. TROP. Some are, some aren't.

Mr. MARKEY. Some are, some aren't. Are they neither?

Ms. TROP. There is a gray area. There is an area where there is some ambiguity about whether specific products are futures or securities or something else.

Mr. MARKEY. Who has jurisdiction if they are neither?

Ms. TROP. No one.

Mr. MARKEY. No one. So fraud and misrepresentation, deception, as the chairman said, telling the truth could just fall between the cracks if there is no further definition of who has responsibility over fraud and manipulation in this marketplace; is that correct?

Ms. TROP. That is correct. I would just add a caveat and that is to the extent that a product that is not defined as a security or future is, let's say, conducted in a bank activity, then you would still have Federal oversight in that regard, so you are really talking about something that is going on unaffiliated.

Mr. MARKEY. What if it is done by an insurance company?

Ms. TROP. Exactly, an affiliate of an insurance company.

Mr. MARKEY. Well, exactly what? Exactly, that there is no regulation?

Ms. TROP. Exactly, no regulation.

Mr. MARKEY. So fraud and manipulation doesn't have a specific definable meaning in terms of a crime that could be committed and prosecution that would be forthcoming and as a result, a disincentive to the insurance company or the securities firm from engaging in that kind of activity; is that true?

Ms. TROP. Yes.

Mr. MARKEY. Thank you. Let me follow up on one other question that the chairman of the full committee raised as well, which I think is right on point. Should the corporate end users of derivatives be required to disclose whether their audit committee or board has reviewed or approved the company's derivatives activities, whether the corporate treasury is a profit center, whether it is speculating or hedging, or whether its derivatives portfolio has been subjected to a stress test of possible adverse market or interest rate environments, and if so, what the projected losses would be.

Mr. BOWSHER. Well, I think some series of questions like that by the SEC on the reporting to them on the end users that are major players in this complex derivative market is what is needed, and whether that is the exact set, but some of those questions, I think, would be the ones that ought to be considered.

Mr. MARKEY. How important is this stress test question, Mr. Bowsher?

Mr. BOWSHER. Well, the stress test for the dealers is very important. In other words, those systems should be stress tested. If you remember, when we had the stock market crash in 1987, that was one of the problems up at the New York Stock Exchange, and we went up there and looked at that at the request of this committee. They had lots of problems. John Phelan said at the time that he recognized they had problems and he would like to get on top of those problems.

They brought in the experts from the outside to improve those systems, and they also asked if GAO could come in and check it out periodically because they wanted that independent check. Since then, as I understand it, the SEC has done some of that checking.

That is the kind of thing I think that is needed there. That gives you then a certain sense of confidence that your systems are going to be able to handle the volume or the volatility that you are going to be looking at.

Mr. MARKEY. So if the stress test would demonstrate a potential 80 percent loss to the end users' portfolio, shouldn't that be disclosed to the public that a stress test that has been conducted that would, in fact, potentially result in an 80 percent loss to end users? Is that a relevant fact for potential investors to have available to them?

Mr. BOWSHER. I think if you have that kind of problem, not disclosing it is not good at all.

Mr. MARKEY. So where authority is lacking on the part of the SEC or other regulatory agencies in order to require that these kinds of stress tests that have traditionally been conducted in other areas, where that authority may be lacking, is that a reasonable authority to give over to the regulatory authorities?

Mr. BOWSHER. I think so.

Mr. MARKEY. How important is it?

Mr. BOWSHER. I think it is important. As I say, especially for the bigger dealers.

Mr. MARKEY. OK, thank you very much. Let me ask the next question. In light of the recent losses at Procter & Gamble, at Mead, at Marion Merrell Dow, at Gibson Greeting Cards and others, do you think that many derivatives users will pull out of the market or retrench? What will be the effect here in terms of the transience of this marketplace if there are continued public revelations about losses in this marketplace?

Mr. BOWSHER. We haven't done a study, but I would think—and people are writing about this—that most boards of directors and most CEO's are going to be a little more careful as to just what their derivative transactions are, and I think we will probably be putting in place better risk management systems in those end users.

Mr. MARKEY. But not necessarily all?

Mr. BOWSHER. But not all, and that is where I think you would like to get some kind of reporting to the SEC.

Mr. MARKEY. Thank you. Some have suggested that we don't need suitability standards. The chairman of the full committee referred to this as well, suitability standards for multinational corporations. What about less sophisticated institutions, such as pension plans, State and local governments?

As you know, one of the principal reasons why we authorized the NASD to develop sales practice rules for the government securities market, a piece of legislation that we moved out of the Energy and Commerce Committee last year and was signed by the President, was the concern that we had over losses by such institutions in Treasury and Government agency IO's and PO's and other structured bonds.

It is the town treasurer who may not be as sophisticated. It is the smaller pension fund manager who may not be as sophisticated as these quantitative mathematical geniuses who are constructing these customized derivatives. Should we consider sales practice rules for derivatives in those areas where there may be more vul-

nerable customers who, as the chairman of the committee pointed out, are representing the widows and the orphans in the financial system?

Mr. BOWSHER. I think that is something that maybe should be looked at. We did not look at it enough that I would want to give you a firm answer here, but——

Mr. MARKEY. Mr. Bothwell?

Mr. BOTHWELL. Just one additional comment. The OCC, the Comptroller of the Currency, Mr. Ludwig, is proposing some suitability requirements for the national bank dealers so that at least one regulator in this multiregulatory environment here is proposing that, and——

Mr. MARKEY. So, again, you have that gap where the banking regulator is moving and yet the securities and insurance regulators are not.

Mr. BOTHWELL. I think Chairman Levitt is also concerned about this issue as well.

Mr. BOWSHER. One thing I might point out, too, Mr. Chairman, is that lots of times in the past with the different instruments that were being presented to them, sometimes the town treasurer was considered a sophisticated investor, but when you are being presented some of the financial instruments that are now being created, I just don't know where that, whether that definition still holds.

Mr. MARKEY. So if the SEC is lacking legislative authority to put suitability rules on the books in order to be consistent with the Comptroller of the Currency over the banking area, it would be necessary for this committee to authorize the SEC to move in that area. And, in your opinion, Mr. Bothwell, would that be appropriate?

Mr. BOTHWELL. Well, I think you would certainly want to ask Mr. Levitt that. It would certainly seem to me if it is appropriate for one segment of the dealer, why not the other. You might ask that of Mr. Greenspan as well because the Fed has not proposed that requirement, either.

Mr. MARKEY. Thank you.

Mr. BOTHWELL. Just one additional thing, when we were talking about banks, the FDIC has done virtually nothing in this area, although we haven't identified any State-chartered banks, nonmember Fed bank that is a major dealer, there certainly could be one that emerges in the future.

Mr. MARKEY. One of the great structural strengths of the mutual fund industry is the fact that they are required by statute to price fund shares every day. This requirement of disclosing the fund's net asset value has been a key component of the trust and the confidence that millions of investors have in the integrity of the industry.

Do those mutual funds that make use of more exotic derivatives risk being unable to determine an accurate and reliable value for them, thus jeopardizing their ability to calculate an accurate and reliable net asset value each day?

Mr. BOWSHER. I think there is some concern here that has been discussed by some of the regulators after the recent problems with like that one hedge fund that found that they were not able to find

a market for some of the—and therefore some people were saying that the industry had created certain products, weren't able to price them, weren't able to even sell them, you might say, into a viable market, so these are some of the concerns now, and I think one of the SEC commissioners spoke about it the other day in one of his speeches.

Mr. MARKEY. Well, they are an important end user, and as we know, of the 20 or 30 million Americans who invest in mutual funds, one-half of them have family incomes of $50,000 or less, and with the exception of their home, that may be their other major investment. So these end-users that we are talking about are mutual funds, but mutual funds working for most ordinary Americans who have an investment, so to the extent to which there could be an additional risk and that risk is in a particular fund, that information, I think, is relevant.

In a speech delivered last October , Henry Kauffman noted that the G-30 study called for dealers to measure the components of revenue regularly and in sufficient detail to understand the sources of risk. Mr. Kauffman went on to suggest that what the lack of revenue attribution implies is that market participants may be trying to downplay the amount of market risk they are taking at least during the course of a trading day as they operate in the markets.

If as many in senior management maintain that the bulk of the profit comes from running the casino rather than playing at the tables, that should be backed up with hard numbers. Otherwise, the suspicion is that profits stem mainly from position taking which entails market exposure and not from marrying bids and offers. Unquote.

Do Federal regulators, Mr. Bowsher, currently have sufficient information regarding what proportion of dealer derivative revenues come from position taking versus marrying bids and offers? Shouldn't the regulators get more of this type of data if they are to have a full picture of, in Mr. Kauffman's words, who is running the casino and playing the tables?

Mr. BOWSHER. There is no question, that is one of the gaps here that we are reporting in our report, that it is one of the recommendations that we made that you have got to have better disclosure so you can tell those kind of breaks that he is talking about.

Mr. MARKEY. When this committee was investigating the government securities problems, we sought to obtain data on the sources of profits by the primary dealers from agency and principal transactions when issued and repo trading, and we found that the regulators had very little solid data on the firm's sources of revenues. If the amount of data was so spotty in the treasury market, I suspect it is even worse in the derivatives market.

Can you give us your assessment of what the profile of that set of regulations looks like right now?

Mr. BOWSHER. Yes, I think the data coming to the regulators and that is very limited.

Mr. MARKEY. Very limited?

Mr. BOWSHER. Yes. What they are getting more is the gross notional value and things like that, but as far as the details by prod-

uct line, you might say, or profitability, they are not getting that information.

Mr. MARKEY. That is very helpful. Thank you. I see that you have also called for all the financial regulators to obtain better data on counterparty concentrations. Can you explain what that means and why you think there has to be better information?

Mr. BOWSHER. That is the situation where your counterparty is one of your big risks, and therefore how good are these various counterparties and how much concentration there is.

Mr. MARKEY. Could you give an example of what you are talking about?

Mr. BOWSHER. Like if you have an overseas bank, let's say, and they see a trend where more and more of the counterparty is going to that one institution, then I think they have to be concerned that that one institution can play out their role as a viable counterparty. One of the stories that came out on this German manufacturing company was that some of the people at the exchange became worried as they saw their situation, and then started to ask for some collateral and things like that, and so that was the case of where, when they did have some information on counterparty they got worried. They started to work on the situation.

I suspect that if they had not done that, you might have an even bigger problem there.

Mr. MARKEY. And, again, in many ways we are flying blind in terms of what is going on with many of these counterparties?

Mr. BOWSHER. Certainly, in time of crisis, that has always been one of the great things is where is all the investments and the money and the cash flow and everything like that. You have got to have some good information, and today that information should be available with the computers and the communications and everything like that.

Mr. MARKEY. I would like to ask another question about derivatives and mutual funds if I could go back to that for a second. A second fundamental structural strength of mutual funds relates to the prohibition enacted by the Congress on the use of leverage by the funds. Leverage is a financial turbocharger; it accelerates movement. The higher the leverage, the faster you go.

In financial markets leverage accelerates the ability to make money in up markets and the risk of losing money when things turn down. Because of the nature of mutual funds, there has long been a broad understanding that leverage is inappropriate. The SEC has conceded that it doesn't know the extent to which funds are involved in speculative derivatives because some derivatives employ substantial leverage. Are we risking allowing leverage to sneak in the back door when it is prohibited from coming in the front door of mutual fund policies?

Mr. BOWSHER. I think there is that potential.

Mr. MARKEY. Right now we have no way of knowing?

Mr. BOWSHER. The SEC does not know at this point.

Mr. MARKEY. Does not know, very helpful. Thank you. Let me ask, if I could, if the gentleman from Texas has any additional questions that he would like to pose.

Mr. FIELDS. Not necessarily questions, Mr. Chairman. I have just been sitting here listening to this exchange and, first of all, again, I want to compliment the chairman. I think this is a very complex area we are talking about, big dollars with $12 trillion is bandied about, a lot of questions have been raised, but I have to tell you that my overall concern is what could be the apparent intrusiveness of the Federal Government in the corporate board room?

I think there is a real distinction when the taxpayer has a risk and when the taxpayer does not have a risk. I would like to think that we live in a risk-free society, however, that is not the case, and I just hope as we proceed in this particular matter, we look at what is in place, authority that is already given.

We realize that the world has shrunk. We are interdependent on a number of different financial markets, and I would hate to see us put ourselves in a position where we cannot compete with other companies, other concerns abroad, or that we create such a standard or so much regulation that we drive good American companies and individuals abroad, that we don't get the benefit of their services, their insight, their creativity.

So I want to thank you, Mr. Chairman, for calling this hearing. I think it has been very informative and Mr. Bowsher, I want to say to you, I appreciate you coming and testifying before us. I will accept your offer of continuing the dialogue. I look forward to that, and certainly this will enlighten all of us.

Mr. BOWSHER. If I could just maybe answer Mr. Fields' concerns that we ourselves here are not recommending anything that we think would get the government in an intrusive way into the corporate board room or drive the business offshore.

In other words, we hope we are recommending a series of recommendations here that would reduce the risk and be prudent and not overly costly to the overall system.

Mr. MARKEY. Gentleman's time is expired. Let me just follow up then on the point that the gentleman from Texas has been raising several different ways, and I think it is a very important consideration, and that is the linkage of global markets by way of derivatives strategies increasing risk and the need for better international cooperation, which I think we could finish up the hearing just touching upon and noting the interconnection of all of these markets.

In a 1992 report, the Bank for International Settlements noted that the interdependent nature of derivatives markets suggest that a crisis starting in one market could likely spread to international financial markets with a negative impact on global economic activity.

Your report concurs with this evaluation. Would you say it is more likely that if a systemic crisis relating to derivatives ever occurs, it would be more likely for it to start abroad and spread to the United States, or is it just as likely that a problem will begin at home and spread over to Europe and Asia?

Mr. BOWSHER. I think it could happen either way, Mr. Chairman. In other words, we don't know, and it could also start, you know, with financial problems in the system that are not directly related to derivatives, but the derivatives could come into play as part of the crisis.

Mr. MARKEY. My sense, in talking to various participants, is that as inadequate as our controls may be right now, that there is a higher probability that the meltdown could begin from Kuala Lumpur or from even London more likely than it could occur coming out of the United States, just in terms of probability, and that it does create some concern for us because of this modern telecommunications link to the global financial marketplace.

Many have suggested that the global linkages that derivatives establish between U.S. and foreign markets call for a coordination of capital standards applied to banks and securities firms, both in the United States and abroad.

What do you see as the prospects for such harmonization of capital standards occurring any time soon?

Mr. BOTHWELL. Well, the banks, the bankers seem to be making quite a bit of progress in terms of coming up with international accepted capital standards for banks. Unfortunately, the progress with the securities regulators hasn't been as good and so——

Mr. MARKEY. Why is that, Mr. Bothwell? What is it that differentiates bankers from securities firms or insurance companies in terms of their ability to harmonize?

Mr. BOTHWELL. I think in a number of other countries you have what is called universal banking where the security operations and the banking operations are all in the same business.

In the United States, of course, we separated the securities firms from banking so we have separate regulators.

So I think internationally they join together to start to discuss harmonization of standards. In the foreign countries, they are sending one regulator. In the United States, we are sending at least—regulators from the SEC as well as the bank regulators.

Mr. MARKEY. Are you aware of any? Because of this linkage that exists through the banking regulators in most of these countries in supervising these products, are you aware of any foreign countries which allow unregulated derivatives, derivatives dealers to operate without being subject to supervisory examination and capital standards?

Mr. BOTHWELL. We looked at quite a few foreign countries, certainly not all foreign countries, and we did find that sort of the regulatory umbrella included the derivatives dealers in those countries. We didn't do an assessment of the quality of regulation.

Mr. MARKEY. So there is a bit of an irony here for there may be tougher regulation in many of these countries than there is here domestically in terms of capturing the insurance related and securities firm related trading activities.

Mr. BOTHWELL. Yes, indeed. It is an irony that is not lost on the Brits for sure.

Mr. MARKEY. So if your unregulated dealers go abroad, they will be regulated; is that correct? Is that the irony, that if they move their operation, the securities or insurance company dealers today, and they put them in London, they might wind up being regulated?

Mr. BOTHWELL. Yes, that is correct.

Mr. MARKEY. So we drive them into the arms of another country's regulations. That would be the net result of what we would accomplish by putting on our own regulations.

Mr. BOWSHER. You used the word tougher. It might be the words "more comprehensive" because sometimes they are not as thorough as ours.

Mr. MARKEY. I appreciate that, but something is better than nothing.

Mr. BOWSHER. Yes, and they have it under the umbrella, you might say.

Mr. MARKEY. The United States was unsuccessful in trying to convince British and our European regulators at IOSCO to establish common capital standards in the past.

Given that difficulty, what would you say the prospects are for international coordination of capital standards for derivatives transactions, and how about the prospects for legally enforcing netting agreements?

Mr. BOTHWELL. Mr. Chairman, I think whatever the prospects are, I think they would be greater if the United States gets its own house in order first and we can go to those negotiations with our own set of consistent capital standards.

Mr. MARKEY. And how do we make sure that it doesn't become a race to the bottom where we say, well, goodness, if we have the lowest level of regulation in the world, we will have the largest part of this extremely dangerous market located right here. How do we avoid that?

Mr. BOWSHER. Well, we can be good negotiators, and I have been involved in a fair number of negotiations over a number of years on accounting standards and auditing standards.

And I find if we have our own set of standards in good shape, it gives you a big leg up at the negotiating table. And generally speaking, most of the other countries want to do the right thing.

So if they can get a model that they see makes some sense, why then they will tend to go with you more likely than not. Doesn't always happen.

In some countries, like I remember on the government auditing standards, I thought that I had everybody in agreement in 1989 at our big meeting in Berlin, and then the French, as only the French could do, stepped in and decided that we hadn't properly recognized their different system in that.

But 23 years later here in Washington we did get an agreement.

Mr. MARKEY. The French would probably take that as compliment, unfortunately.

Gentleman from Texas.

Mr. FIELDS. Mr. Chairman, just before you give your concluding statement, I don't want it to go unchallenged. All of us don't believe our house is not in order or that we can't take existing authority and do what needs to be done, particularly without preempting State authority.

There is a real concern here that some of us share, so I didn't want it to go left unchallenged that our house is not in order on that, we can't do some things to make it a better house.

Mr. MARKEY. And that does conclude, unless other members have questions, our hearing, and I want to thank the Comptroller General and all of his staff, because there were many people across the country working with you that have made this comprehensive

study, and I think an intelligent and rational debate now is possible inside of the halls of Congress.

You have done an excellent job and I think that by laying out the benefits and the risks associated with the dramatic growth that has occurred in the derivatives markets, you ought to be commended for coming up with what I believe is a very balanced and reasonable set of recommendations for the regulators, for the FASB, to the dealer and end user community and to the Congress.

The GAO has really laid out a road map of the regulatory and legislative changes needed to assure that our Nation's regulatory system keeps pace with the dramatic changes that derivatives are creating in our financial markets.

As you know, next Wednesday, on May 25th, the subcommittee will be hearing from each of the Nation's top financial regulators, Federal Reserve Chairman Alan Greenspan, SEC Chairman Arthur Levitt, OCC Chairman, Eugene Ludwig, CFTC acting Chairwoman, Barbara Holum, and FDIC Chairman Andrew Hove.

We will be asking each of them to respond to the findings and the recommendations that you have provided to us today, including what actions they are taking at an administrative level to implement the reforms that you have called for them to put in place.

At the same time, we will be pressing the regulators to respond to the very serious deficiencies that you have identified in the current legal framework relating to derivatives. I personally find the presence of unregulated or largely unregulated dealers in this market troubling, given the very close interconnections between these firms.

I am not persuaded by the argument that market forces alone will protect our financial system against excessive speculation or overleveraging. I intend to press the regulators for answers on how best to deal with this situation, as well as how best to assure appropriate protections to the end users of derivatives in the form of better disclosures and appropriate sales practice standards.

Following next week's hearing, it is my intention to craft an appropriate package aimed at assuring that the necessary legislative and regulatory reforms that GAO has recommended actually takes place. We will want to work with everyone who is concerned about this issue.

We clearly don't want to invoke the law of unintended consequences, but we don't want those areas where we can see what the intended consequences will wind up being unless we act to go unattended to. And that is the context in which I would like to continue this dialogue.

I think the GAO has laid out a very comprehensive set of questions that have to be responded to, and I think that this committee has historically proven its capacity to deal with it in a rational way.

We can't thank you enough, and this hearing is adjourned.

[Whereupon, at 12:25 p.m., the subcommittee was adjourned, to reconvene at the call of the Chair.]

DERIVATIVE FINANCIAL MARKETS

WEDNESDAY, MAY 25, 1994

House of Representatives,
Committee on Energy and Commerce,
Subcommittee on Telecommunications and Finance,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:40 a.m., in room 2123, Rayburn House Office Building, Hon. Edward J. Markey (chairman) presiding.

Mr. Markey. Good morning and welcome to the Subcommittee on Telecommunications and Finance.

Today, the subcommittee holds its third oversight hearing focusing on derivatives and their impact on the United States and global financial system. Derivatives are financial products whose value is dependent on—or derived from—the value of an underlying financial asset or instrument. They are used by corporations, securities firms, banks, pension plans, mutual funds, and other institutional investors seeking to hedge their business or investment portfolio risks, reduce their borrowing costs, or engage in leveraged speculation on market movements.

Derivatives have allowed Wall Street to unbundle stocks, bonds, foreign currencies, or a reference rate of interest into their component parts and transform them into new hybrid products that may combine the properties and risk characteristics of several different underlying products or assets. While the alchemists of ancient times unsuccessfully strived to turn lead into gold, Wall Street's quantitatively-oriented financial alchemists have found in derivatives a modern philosopher's stone that enables them to transmute risk into a golden stream of fee and trading income.

Today, derivatives dealers offer both "plain vanilla" interest rate and foreign currency swaps, foreign currency forwards and OTC put and call options, along with much more risky and esoteric products such as swaptions, captions, floortions, accreting and amortizing swaps, digital options, butterfly spreads, condors, straddles, cylinders, and roller coaster swaps. While these exotic derivatives may provide end-users with important and useful risk management tools, they also contribute new sources of potential instability to the financial system and new disclosure and investment protection issues.

During our last two oversight hearings, the subcommittee heard two fundamentally different views of the nature of the risks associated with derivatives and the desirability of implementing regulatory or legislative reforms to respond to those risks. At the subcommittee's first hearing, we heard from several senior Wall Street

officials and former regulators who argued that a combination of industry volunteerism and incremental regulatory change would be sufficient to avert the risk that derivatives might threaten the safety and the soundness of the entire financial system. Last week, however, the subcommittee heard a rather different and more sobering perspective from the General Accounting Office.

Based on an exhaustive 2-year investigation into the derivatives market, the GAO identified serious gaps in the current legal and regulatory framework that allows derivatives dealers affiliated with securities firms or insurance companies to largely escape the type of regulation which is already in place for derivatives dealers affiliated with banks. The GAO's testimony also identified potential gaps in anti-fraud and anti-manipulation enforcement authority and sales practices regulation as well. In response, the GAO recommended that this regulatory black hole be plugged by granting a Federal regulator, such as the Securities and Exchange Commission, appropriate authority to conduct examinations and set capital standards for these currently unregulated dealers.

The GAO also made a series of recommendations aimed at improving Federal supervision of bank dealers. These include developing consistent capital standards, requiring independent and knowledgeable audit committees, performing comprehensive annual examinations and requiring bank dealers to provide better information on counterparty concentrations and the amount and type of their derivatives holdings.

Finally, the GAO recommended improvements in disclosure and accounting treatment of derivatives. These recommendations were aimed at ensuring that major end-users of derivatives improve their internal controls and risk management systems and that investors receive full and accurate disclosure regarding the derivatives activities of corporations, mutual funds and other major institutional end-users of derivative financial products.

At today's hearing, the subcommittee will be asking each of our Nation's top financial regulators to respond to the findings and the recommendations outlined in the GAO report. We will be asking the regulators to respond to the GAO's call for currently unregulated dealers affiliated with securities or insurance firms to be brought under some Federal supervision. We will also be asking the regulators to respond to the GAO's recommendation for improvements in supervision of bank dealers. And, finally, we will be asking the regulators to provide their views on the need for improvements in disclosure and accounting treatment of derivatives.

Neither the questions being posed today nor the legislative or regulatory reforms that ultimately grow out of these hearings are intended to ban derivatives. We want these innovative financial instruments to be available. We are only seeking to assure that Federal regulators have the tools needed to prevent or respond to the new risks derivatives might introduce into our financial system.

Again, I want to thank our witnesses for agreeing to appear before the subcommittee this morning.

That completes the opening statement of the Chair. The chairman recognizes the ranking minority member, the gentleman from Texas, Mr. Fields.

Mr. FIELDS. Thank you, Mr. Chairman. I want to commend you on calling this series of hearings.

Today, we will hear from the financial regulators about what, if any, additional regulation of the derivatives market is needed. For months, on their own initiatives, all of these agencies have been using their existing statutory authority to review activity in institutions under their regulatory umbrellas.

This ongoing process has already produced new regulatory guidelines from the bank regulators, significant progress at the SEC concerning the application of its net capital rule and CFTC rulemaking to ensure the legal certainty of a number of instruments currently trading outside designated contract markets.

While the GAO report works well to stimulate discussion, today we hear from the regulators who actually toil in the regulatory field, people whose decisions do much more than just stimulate discussion. As we know, their actions play a major role in the direction of investment in our country and around the world.

These are the regulators who must do more than just identify problems and recommend that they be corrected. These are the people who must find practical solutions that work without disrupting existing systems that would create panic and allow the law of unintended consequences to become paramount. In our search for comprehensive and rationalized regulatory schemes, we in Congress must never forget our responsibility to the business people of this Nation who create jobs and who suffer the consequences of disruptions in the financial system and our economy.

At the last hearing, GAO representatives testified they believe a taxpayer bailout is a possibility as the result of the failure of an affiliate of a securities firm. This conclusion arose from an analysis of the operation of the Securities Investor Protection Insurance Corporation and the fact the broker-dealers have access to the discount window of the Federal Reserve Board. The analysis of SIPC was seriously flawed.

As I said during the May 19th hearing, Uncle Sam does not bail out brokers. SIPC insurance is not FDIC insurance. In the words of the GAO report on SIPC dated September, 1992, SIPC's protections differ fundamentally from Federal deposit insurance. SIPC does not protect investors from declines of the market value of their securities. The major risk that SIPC faces, therefore, is that broker-dealers will lose or steal customer cash and securities and violate the customer protection or net capital rules. In other words, SIPC does not bail out brokers who fail.

Furthermore, the Federal Reserve making liquidity available to brokers on a collateralized basis during times of crisis is financial regulation, not taxpayer bailout. The debate is being clouded by a confusion of Federal regulator involvement in resolving problems caused by the failure of a financial institution with a concept of a taxpayer bailout. I look forward to the testimony today of both the SEC and the Federal Reserve correcting the record on this subject.

I also ask unanimous consent to place in the record a letter I received from the securities industry association yesterday concerning the issue.

Mr. MARKEY. Without objection.

Mr. FIELDS. In my mind, the report of the GAO raises the question of what is the appropriate role of government in dictating the management systems corporations use to obtain information for their decisionmaking process. In our review of this issue, it is important to draw distinctions between those organizations that operate with a Federal safety net of deposit insurance and those that do not.

Consequently, I am pleased to see that the bank regulators have been active in promulgating guidelines for derivative instrument management in their institutions. In light of the greater taxpayer exposure, that is desirable. Whether additional regulations is necessary for noninsured financial institutions or for corporations outside of the financial sector remains to be seen. And I must note for the record that most of the witnesses who are coming before this subcommittee continue to question whether legislation is appropriate at this time.

Mr. Chairman, I will continue to work with you on this oversight investigation and in addressing any problems that we discover. And, again, I appreciate us having this hearing.

[The letter referred to follows:]

Securities Industry Association

1401 Eye Street, NW • Washington, DC 20005-2225 • (202) 296-9410 • Fax (202) 296-9775

May 24, 1994

The Honorable Jack Fields
U.S. House of Representatives
2228 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Fields:

From reports of the testimony given last week in connection with the publication of the General Accounting Office's report on derivatives, it appears that there is some confusion concerning differences between the FDIC and SIPC, and whether the existence of SIPC — in conjunction with the ability of broker-dealers to obtain secured loans from the Federal Reserve during a liquidity crisis — constitutes a federal "safety net" for the securities industry. SIA takes exception to this manifest confusion. Below is a brief discussion on point.

A. SIPC and FDIC

In 1970, Congress enacted the Securities Investor Protection Act ("SIPA") which was designed to address concerns about the safety of customer assets held at securities firms. SIPA adopted two primary methods of realizing this goal.

First, it required the Securities and Exchange Commission ("SEC") to promulgate financial responsibility rules for U.S. securities firms. This has been primarily effected by the adoption of SEC Rule 15c3-3, which requires firms to segregate customer cash and securities from the firm's own proprietary accounts, and SEC Rule 15c3-1 – the net capital rule – which requires securities firms to have sufficient liquid assets to be able to satisfy all liabilities, including customer claims.

Second, SIPA created the Securities Investor Protection Corporation, a non-profit, membership corporation. Membership in SIPC is not voluntary, and with certain limited exceptions, SIPC's members are brokers and/or dealers registered with the SEC. The SIPC, unlike the FDIC, is neither a government agency nor a regulatory authority. If a member firm fails, SIPC is granted the exclusive authority under SIPA to initiate a liquidation proceeding of the firm. Pursuant to the liquidation, the firm's customers receive all securities registered in their names, and on a *pro rata* basis, all remaining customer cash and securities held by the firm. If after this process there are unsatisfied customer claims, the SIPC fund is available to satisfy customer claims up to a maximum

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of $500,000 in securities, or $100,000 in cash. SIPC's funds come solely from assessments collected from its' members, and interest earned on its' investments in U.S. government securities.

In the event that the SIPC fund was deemed insufficient to guarantee customer protection, SIPC is authorized to borrow up to one billion dollars from the Treasury. However, in the entire 24 year history of SIPC it has never sought to use this authority, and has operated since its inception without the expenditure of government funds. Moreover, SIPC's 1993 annual report indicates that the SIPC fund stood at $791.4 million as of December 31, 1993, the highest it has ever been.[1] In addition, SIPC has obtained a revolving line of credit from a consortium of banks in the amount of one billion dollars.[2] Since its inception through year end 1993, SIPC has instituted 244 proceedings under SIPA. As a result of the increasing vigilance of the SEC and the industry self-regulatory organizations over the financial solvency of securities firms, in 1993 SIPC instituted the smallest number of liquidation proceedings in its history, three.[3] Thus, the likelihood that SIPC would seek to borrow from the Treasury seems more remote than ever.

In 1992 the GAO undertook an extensive examination of SIPC at the request of Congress, including a careful analysis of the differences between bank deposit insurance and SIPC. Referring to one of the most important differences between SIPC and the FDIC, the report noted:

> [The] SEC's customer protection rule prevents broker-dealers from using customers' securities and funds for proprietary purposes. By contrast, the essence of banking is that banks use insured deposits to make loans and other investments. Consequently, by guaranteeing the par value of deposits, FDIC protects depositors not only against the disappearance of deposits due to bookkeeping errors or fraud but also against bad investment decisions by such banks. It is much riskier for the government to protect depositors against the consequences of bad investments, as FDIC does, than only against missing property, as SIPC does.[4]

The fundamental difference between SIPC and FDIC coverage is that SIPC covers losses through fraud, commingling of accounts or other wrongdoing by broker dealers. It does not cover the value of the assets placed with the broker dealer, simply replacement of the securities (and cash) in case of such wrongdoing. In contrast, FDIC insurance covers dollar for dollar the value of deposits placed with banks up to $100,000. The GAO's report concluded that "SIPC's protections differ fundamentally from federal deposit insurance."[5] We agree, and see no reason why GAO's views should have changed.

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[1] SIPC 1993 Annual Report, p. 8.
[2] SIPC 1993 Annual Report, p. 4.
[3] SIPC 1993 Annual Report, p. 3.
[4] Securities Investor Protection: The Regulatory Framework Has Minimized SIPC's losses (GAO/GGD-92-109, Sept. 28, 1992) p. 16.
[5] Securities Investor Protection: The Regulatory Framework Has Minimized SIPC's losses (GAO/GGD-92-109, Sept. 28, 1992) p. 15.

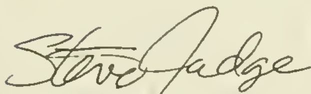
B. Access to the Federal Reserve During Liquidity Crises

The procedures regarding borrowing from the Federal Reserve seem to have been misconstrued at the Congressional hearings. While it is true that as a result of 1991 amendments to the Federal Reserve Act, the class of financial instruments that are acceptable as collateral was extended to include most securities,[6] there is absolutely nothing in the statute that singles out securities firms for special treatment.

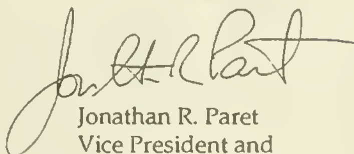
The 1991 amendment was intended to provide the Federal Reserve with the ability to reduce systemic risk that would result from a general liquidity crisis. Such a crisis could occur because securities firms were severely limited in their ability to obtain collateralized loans from the Federal Reserve. The 1991 amendment did not create a general borrowing authority for securities firms. Instead the amendment deleted restrictions contained in law at that time which prohibited the Federal Reserve from accepting as collateral the kind of assets which securities firms hold. The amendment put securities firms on a par with other corporations (both financial and non financial) in providing access to the Federal Reserve in emergency situations.

Indeed, the statute has always permitted the Federal Reserve Board "in unusual and exigent circumstances" to extend discount advances to "*any* individual, partnership, or corporation" who can demonstrate that it is unable to secure credit elsewhere.[7] Thus, in no way can this authority be said to constitute a special "safety net" for securities firms. If anything, one would be forced to say that the arrangement constitutes a safety net for the entire nation.

Sincerely,



Steve Judge
Senior Vice President
Government Affairs



Jonathan R. Paret
Vice President and
Legislative Counsel

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[6] This highlights a point that also seems to have escaped attention at the hearings; all borrowings at the "discount window" have to be fully collateralized to the satisfaction of the Fed. In what sense, then, can this be thought to place taxpayer funds at risk?

[7] Federal Reserve System § 343, 12 U.S.C. § 343 (1993) (emphasis added).

Mr. MARKEY. Thank you.

The gentleman's time has expired. The Chair recognizes the gentleman from Oklahoma, Mr. Synar.

Mr. SYNAR. Thank you, Mr. Chairman.

Very briefly, someone once said that it is amazing what ordinary people can do if they set out without any preconceived notions. When we started this process about a month ago, I had no preconceived notions, but I am beginning to believe there are some problems in the financial derivatives market that merit serious consideration. Some of the problems are minor; some of them are more troubling.

I think our job today and in the future is to go forward from these hearings and examine these markets to understand the problems and the impact, what solutions we might offer. While I am unconvinced that legislation is not needed, I think we are going to get an education today on what can be done short of that if we are going to have a successful derivatives market.

Mr. MARKEY. The gentleman's time has expired.

The Chair recognizes the gentleman from North Carolina, Mr. McMillan.

Mr. MCMILLAN. Thank you, Mr. Chairman.

I would like to add my welcome to the distinguished panel and to compliment the Chair on his considerable wit in his opening statement, which sounded somewhat like a derivative of one of Louis Rukeyser's opening statements on Wall Street Week.

This is the third hearing we have had on the subject of derivatives, and, hopefully, there will be even more because I don't think we have sufficiently explored the issue. Even though I spent most of my career in the investment business prior to coming to Congress, I have learned quite a bit in the two hearings that we have had and expect to learn more today. I think that is essential before we rush in to undertake sweeping regulation or legislation with respect to financial derivatives.

Throughout these hearings, much has been made of the lack of sufficient disclosure, and an absence of internal controls necessary to inform stockholders, management and perhaps depositors of the risks presented by the derivatives activity engaged in by some businesses. Indeed, in my own personal experience as a director of a financial services institution, I am convinced that we need to reexamine and improve the accounting methods and disclosure that govern these financial products as they evolve, both by providers and users, as well as encourage effective internal controls within firms who are engaged in derivatives activity.

I want to emphasize, however, that we not openly measure the risks that these derivatives potentially present to broker-dealers or end-users but that we account for the degree to which these derivatives perform their intended purpose, and that is to reduce or eliminate risk. After all, the principal purpose of these products is to limit uncertainty and manage risks for firms who find themselves exposed to the fluctuation of interest rates, currency markets and commodity prices.

Rather than regulate the internal controls within public companies who use derivatives, essentially trying to manage corporate balance sheets, we ought to consider improvements in the account-

ing rules for these financial products. If we can improve disclosure to shareholders by providing them with a true picture of the risk that a company is managing or assuming, corporate management will be more likely to use derivatives as a prudent hedge rather than as a speculative bet. And I think it is essential that we draw this distinction.

Once again, I wish to welcome our distinguished guests and look forward to their testimony and yield back the balance of my time.

Mr. MARKEY. Thank you.

The gentleman's time has expired. The Chair recognizes the gentlelady from California, Ms. Schenk.

Ms. SCHENK. Thank you, Mr. Chairman, and I, too, add my welcome to our very distinguished panel.

Today's hearing promises to shed important new light on the issue of derivatives, derivative financial products, and we are going to hear from the cops on the beat, the ones who can best tell us whether recent reports of derivative losses is cause for alarm or a mere blip on the financial radar screen.

I suspect that the truth, as usual, lies somewhere in between. And, as I said last week, this subcommittee must draw a balance between the clear benefits of derivatives and the possibility, as yet unconfirmed, that their increased use may present new risks to our financial markets.

I hope that our distinguished panel can address the issues that will help us to draw that balance.

Mr. Chairman, I have an opening statement that I would like to submit for the record so that we can get on to hear from our experts today. And, once again, I want to thank you for your leadership and your prompt attention to this issue. Once again, you have dared to tread where no one else dares to tread, and I think that the country will be the better for it.

Mr. MARKEY. Thank you. The gentlelady's time is expired.

[The prepared statement of Ms. Schenk follows:]

OPENING STATEMENT OF HON. LYNN SCHENK

Mr. Chairman, today's hearing promises to shed new light on the murky issue of derivative financial products. Today, we hear from the regulators—the cops on the beat who can best tell us whether recent reports of derivatives losses is cause for alarm, or a mere blip on the financial radar screen.

I suspect the truth, as usual, lies somewhere in between. As I said last week, the subcommittee must draw a balance between the clear benefits of derivatives and the possibility—as yet unconfirmed—that their increased use may present new risks to our financial markets.

I hope our distinguished panel can address the following issues to help us draw that balance.

First, I understand that much has happened in the past 15 months—in the market and in the agencies—to address gaps in the regulation of derivatives. To what extent do these actions satisfy some of the concerns expressed by the GAO?

Second, if the panel agrees with GAO that additional improvements in regulation are necessary, do they require new statutory authority to fill the gaps? What improvements can the SEC and bank regulators make under current law?

Third, what is the likely impact of Federal regulation on U.S. leadership in this industry? Last week, the GAO recommended that we harmonize regulation in this country with similar efforts overseas. I understand that our regulators are currently working with their foreign counterparts—I am interested in the progress of these discussions, and our panel's opinion of the possibility of harmonizing regulation in the global market.

Fourth, I'd like Chairman Levitt to address the issue of regulation of end-users. As I mentioned last week, I believe that the SEC's limited resources should not be

spent protecting Fortune 500 companies from expensive mistakes. However, the increased use of derivatives by money market funds or by public institutions may demand better Federal oversight.

I look forward to the panel's testimony, and I yield back the balance of my time.

Mr. MARKEY. The Chair recognizes the gentleman from California, Mr. Moorhead.

Mr. MOORHEAD. Thank you, Mr. Chairman.

It is always good to see Mr. Greenspan and other distinguished witnesses we have here this morning.

As this subcommittee continues its focus on derivative products, it seems very clear that there is no universal agreement as to what is needed.

At the subcommittee's first derivatives hearing, three senior Wall Street executives, including two former market regulators, stated firmly that no regulation was necessary to deal with the derivative problem at this time.

Last week, at a hearing on the GAO's recent derivatives report, we heard an entirely different story. GAO Comptroller General Bowsher testified that new laws and regulations are necessary, not only for the banks and other financial firms that issue and trade derivatives but also for the corporate end-users of these products.

Today, you Federal regulators charged with oversight in derivatives markets are going to respond, we hope, to the findings and recommendations of the GAO. I thank our distinguished panel of witnesses for coming here. I know it is probably a nuisance to come up the Hill as many times as you need to, but you are a great help as we try to weed through these problems and determine what really is necessary to do.

I haven't been persuaded so far that the case has been made for a new regulatory structure for derivatives. This is especially true in talking about expanded regulation of derivatives users, the individual companies that utilize derivatives to stay competitive in the global marketplace.

Some have cited recent events at Procter & Gamble, where there is evidence Congress should consider regulatory controls on the financial strategies of U.S. corporations, and said that derivatives are too complicated for corporate managers and directors to understand, that they are so complex they defy customary state of the art.

Complexity, however, does not equal riskiness. Most derivatives are no riskier than other financial assets. Moreover, in the country, as in all the market economies, decisions to set financial policies and implement financial strategies, including the use of derivatives, are private management decisions.

Wherever possible, it is best to allow shareholder accountability and competition to impose discipline on management decisions to hedge risks or to take advantage of opportunities in the derivatives markets.

Of course, this doesn't mean that regulators should be complacent. The testimony we will hear today makes it quite clear that the regulators are, in fact, not asleep at the switch.

For example, late last year both the Federal Reserve and the ECC issued guidance on derivatives risk management for use by their examiners and institutions they supervise. Staff from the Fed,

FDIC, ECC and OTS have had periodic meetings since October, 1993, to share information and development systems, accounting principles for derivatives.

The CFTC has completed a study of the OTC derivatives markets and conducted rulemaking proceedings in this area. The SEC has published a concept release that lays the groundwork for new approaches to capital requirements for derivative products.

All this activity is in addition to the self-regulatory efforts being undertaken by the industry. The Group of Thirty's Report has become the hornbook for establishing internal controls and risk management systems. In other words, the current regulatory regime for derivatives is working. The Federal financial regulators and industry are working diligently within the present framework to identify and address the potential risks, implications of over-the-counter derivative products.

We will have to see, based on your testimony and other information we get, really the direction we should go. We appreciate you coming and giving us your expertise on the subject.

Thank you.

Mr. MARKEY. The gentleman's time has expired.

The Chair recognizes the gentleman from Illinois, Mr. Hastert.

Mr. HASTERT. Thank you, Mr. Chairman.

I don't have a prepared opening statement, but I do have a couple observations I would like to share.

I think the whole issue of derivatives is certainly intriguing. We need to do some mental gymnastics just to try to follow and understand how they work. You are the third panel or third hearing that we have had on this issue.

Last week, at least in my opinion, we had General Bowsher up here and his entourage doing their usual display of give me a thesis and I will write a report to match it. I think in that GAO report, you know, they failed to show the difference between agencies that are covered by Federal insurance and hence taxpayer money and those that are not. There are differences between the banking industry and the private sector.

I think, in short, the question we have to ask if we are talking about serious regulation of derivatives, is where is the line? Where is the risk?

These are instruments that the private sector uses to hedge their risk—obviously, when you start to be in the commodities markets and other foreign trade issues, you are in a risk business. So if this is an instrument to hedge the risk. How far can you go? What good does it do in the private sector?

And, of course, where these risks, especially in the banking industry, are covered by protections underwritten by the Federal Government, hence the taxpayer, then that is a different issue. And where do we draw the line there?

So I am interested, certainly, in hearing this panel of experts today. I would also be interested in hearing you try to discern the difference between these two areas of use of derivatives. And, I certainly hope we will get to even a more objective report than we did last week.

Thank you.

Mr. MARKEY. All right. The gentleman's time has expired.

The Chair recognizes the gentleman from Ohio, Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

I, too, would like to welcome our distinguished panel and say it is obvious that this is a very important issue.

It is also obvious that we are not going to be legislating this year, based on the letter from Chairman Dingell to Mr. Levitt and Secretary Bentsen dated Monday the 23rd of May. It makes it quite obvious that the regulators and those that are involved on a day-to-day basis with these issues will be looking at the alternatives and making recommendations to the next Congress for legislation.

Having said that, I think it is important, Mr. Chairman, that the record reflect all of the testimony from our various expert witnesses.

I was struck by the unanimity of the first panel that we had, including former Chairman Breeden of the SEC, who made it quite clear that in their estimation there was not a need for legislation at this time. It will be interesting to compare their prescriptions to our panel today and to see exactly where we might be going with this entire issue.

But the message, it seems to me, is one of caution. GAO indeed last week in their fashion of, as I indicated before in another hearing, coming out of the hills and shooting the wounded, which they do very well, now set the stage for I think a more objective viewpoint from this very important panel. We look forward to their testimony and their recommendations.

I yield back the balance of my time.

Mr. MARKEY. All right. The gentleman's time has expired.

Are there other members seeking recognition for the purpose of making an opening statement?

The Chair sees none.

Mr. MARKEY. We will turn to our first witness, the Honorable Alan Greenspan, who is the Chairman of the Board of Governors of the Federal Reserve System. We welcome you back. Whenever you feel comfortable, please begin.

STATEMENTS OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM; HON. ARTHUR LEVITT, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION; HON. EUGENE A. LUDWIG. COMPTROLLER OF THE CURRENCY; HON. ANDREW C. HOVE, JR., ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION; AND HON. BARBARA P. HOLUM, ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

Is this microphone on? Is it on now? It is indeed.

Mr. Chairman, I appreciate very much the opportunity of appearing before you and this committee and request that my full remarks be included for the record.

Mr. MARKEY. Without objection, so ordered.

Mr. GREENSPAN. International financial markets have been vastly transformed in the last 10 to 15 years. Significant improvements in information and telecommunications technologies, the increasing importance of institutional investors, and the removal of capital controls by many countries have accelerated the growth of global

financial transactions. Together, these changes undoubtedly have increased the efficiency of financial markets.

At the same time, however, as the GAO report emphasizes, they undeniably pose challenges to financial market participants and to policymakers, which, if unmet, could leave the financial system more susceptible to periodic crises. Burgeoning derivatives markets have been, perhaps, the most intriguing part of this phenomenon but by no means the overwhelmingly dominant factor.

Market participants have been responded vigorously to these major financial challenges, especially those associated with the extraordinary expansion of OTC derivatives markets. With the Group of Thirty's principles serving as a benchmark, market participants have substantially strengthened their capabilities for evaluating market risks and counterparty credit risks. The risk management systems that the leading firms are implementing evaluate the risks of derivatives in terms of their impact on the full portfolios of financial instruments, not as unique instruments or as a separate business.

Market participants also have been working with regulators and with the Congress to reduce legal uncertainties that have arisen as new products and technologies have emerged. A series of legislative measures, for example, has substantially reduced uncertainties about the legal enforceability of netting agreements under U.S. law.

Finally, market participants and private clearing organizations have been working with the Federal Reserve, the SEC, and the other regulators to shorten settlement periods for securities transactions and to implement other measures to reduce the credit, liquidity, and operational risks in securities settlements.

What all these actions demonstrate is that risks in financial markets, including derivatives markets, are being regulated by private parties. The GAO report's concern that there are gaps in derivatives regulation is true only in the narrow sense that government regulations or regulators are not in all cases involved. In a more important sense, today's markets and firms, especially those firms that deal in derivatives, are heavily regulated by private counterparties, who for self-protection insist that dealers maintain adequate capital and liquidity.

Nonetheless, with the rapid pace of change in the international financial system, there is good reason to consider carefully whether private market regulation is as effective as it needs to be. The key question is whether private market regulation would be enhanced or weakened by further government regulation or legislation.

The Federal Reserve Board believes that there are ways in which regulators can and should enhance the effectiveness of private market regulation. As the GAO report appropriately notes, there is a critical need to make derivatives activities more transparent. Public disclosure must be improved, and consistent accounting standards must be developed. Transparency also can be enhanced by a coordinated international effort to collect the data necessary to construct comprehensive measures of the size of the global derivatives markets. The Group of Ten central banks recently agreed to initiate such an effort in response to a recommendation by a central

bank working group that was strongly supported by the Federal Reserve.

Regulators also must continue to work with the private sector, both domestically and internationally, to reduce legal uncertainty and to strengthen settlement systems, including systems for settling the very rapidly growing volumes of cross-border trades of financial instruments.

Mr. Chairman, you may appropriately ask whether there are systemic risks in these rapidly expanding financial markets that could threaten the tax-supported financial safety net administered by the Federal regulatory system. We are always alert to such possibilities, especially when new markets and products are being rapidly introduced.

The appropriate response to such challenges is to endeavor to identify the vulnerable positions in the system and to structure our regulatory response accordingly. In banking supervision and regulation, for example, we must recognize that changes in the technology of financial intermediation have permitted greater customization of financial products.

With financial products more heterogeneous, we must move away from simple one-size-fits-all regulatory approaches and adopt more flexible approaches that are attuned to the differences across banks in product mixes and risk profiles. This necessarily will require banks to assume greater responsibility for risk management and regulators to emphasize supervisory oversight rather than regulation.

In this regard, we are developing and hope soon to implement capital requirements for market risk that provide appropriate protection against market shocks. In this context, regulators are going to have to judge the magnitude of the market losses that bank capital should be expected to absorb. In making this judgment, regulators must recognize that there are some highly unlikely events, say, those that tend to occur only once in a half century, that may call for government actions to backstop bank capital so as to avoid systemic problems.

Setting capital requirements to insure against all risk is neither feasible nor desirable. First, insuring against extremely rare adverse outcomes would require a level of capital on which it would be difficult to earn a competitive rate of return. Second, and more important, we have to recognize that our job and the job of those we regulate is to prudently manage risk, not eliminate it. As I have discussed at length in other fora, prudent risk-taking is an essential ingredient, indeed, a necessary condition, for wealth creation and economic growth. To eliminate or discourage all risk-taking is a recipe for economic stagnation.

We must instead design our regulatory regime to manage risks in a prudent manner. Where we see opportunities for Federal regulation to enhance private regulation, we should implement it. Where we perceive private regulatory failure, we should step in immediately. But we must keep in mind that Federal regulatory intrusion in an inappropriate time or place can weaken incentives for private efforts and expose the overall system to greater risk.

Thank you, Mr. Chairman.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

[Testimony resumes on p. 188.]

[The prepared statement of Mr. Greenspan follows:]

Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

Thank you for this opportunity to present the views of the Federal Reserve Board on the recent report on financial derivatives by the General Accounting Office (GAO). Derivatives activities have important implications for the global financial system and the world economy. The Federal Reserve has devoted considerable resources to understanding these implications and to working with other authorities in the United States and abroad to develop appropriate public policies. This hearing offers an opportunity to review the policy actions that have already been taken and to discuss the need for further action by financial regulators, central banks, or the Congress.

As suggested in your letter of invitation, I shall begin by setting forth the Board's overall views on the impact of derivative instruments on our nation's financial system. Then I shall identify the challenges that derivatives pose to users and to policymakers and discuss the steps that the Federal Reserve has taken or plans to take to meet those challenges. I shall conclude with the Board's assessment of the need for remedial legislation relating to derivative instruments. In the course of this discussion, I shall respond to the principal findings and recommendations contained in the GAO report.

IMPACT OF DERIVATIVES ON THE FINANCIAL SYSTEM

The Board believes that the array of derivative products that has been developed in recent years has enhanced economic efficiency. The economic function of these contracts is to allow risks that formerly had been combined to be unbundled and transferred to those most willing to assume and manage each risk component. The importance of this function has increased, as competitive pressures have intensified in many economic sectors and as interest rates, exchange rates, and other asset prices have tended to be quite volatile. In

this environment, many financial and nonfinancial businesses, federally sponsored agencies, and state and local governments have concluded that active management of their interest rate, exchange rate, and other financial market risks is essential. They recognize that such risks, if left unmanaged, can jeopardize their ability to perform their primary economic functions successfully. Financial derivatives, especially customized OTC derivatives, allow financial market risks to be adjusted more precisely and at lower cost than is possible with other financial instruments. For this reason, many of these entities have come to rely on derivatives to achieve their risk management objectives.

While derivatives have enhanced the overall efficiency of financial markets and the economy, the Board recognizes that some derivatives are complex instruments that, if not properly understood and managed, can pose risks to individual users and possibly also to the overall stability of the financial system. The risks to individual institutions have been underscored by press reports of losses on certain derivatives contracts in the wake of the recent sharp increases in interest rates here and abroad. Case studies of these episodes undoubtedly will offer useful insights to users of derivatives and to policymakers. But, it would be wrong to draw sweeping conclusions from these events. Changes in interest rates and other market variables necessarily affect the fortunes of individual economic units. Many entities undoubtedly decreased their vulnerability through use of derivatives, and many others that elected not to use derivatives undoubtedly suffered losses.

The impact of derivatives on the stability of the financial system is a subject of ongoing debate. As I have noted, derivatives have allowed many businesses and governments to manage their risks

more effectively. Nonetheless, several plausible scenarios have been identified in which derivatives activities could be a source of systemic disturbance.

First, the failure of a major derivatives dealer could impose credit losses on its counterparties that could threaten their financial health. To be sure, the failures of derivatives dealers that have occurred in recent years have not imperiled any counterparties. Nonetheless, concentrations of credit exposures to derivatives dealers, like any other concentrations of credit exposure, clearly constitute at least a potential source of systemic difficulties.

Second, the dynamic hedging of options positions and certain other risk management techniques lead market participants to buy assets when prices are rising and sell when prices are declining. In principle, such behavior could amplify market price movements. For example, some believe that hedging associated with "portfolio insurance" programs contributed to the stock market crash in October 1987. Aside from these unusual market movements, little statistical evidence supports the contention that derivatives activities heighten volatility in cash markets. Nonetheless, some discount the results of such studies because their concerns relate to very infrequent events. The price amplification effects of dynamic hedging may be significant only after large price shocks.

Even if derivatives activities are not themselves a source of systemic risk, they may help to speed the transmission of a shock from some other source to other markets and institutions. Linkages among financial markets, both domestically and internationally, have become considerably tighter in recent years. Derivatives have contributed to this development, although other forces--the increasing importance

of institutional investors, improvements in information and telecommunications technology, and the removal of capital controls by many countries--clearly have been at work. Given these tighter linkages, if a major international financial firm came under severe financial stress, authorities could face significant difficulties in containing the effects on other institutions and markets. At a minimum, success would require close coordination with relevant authorities in the home country and abroad.

CHALLENGES POSED BY DERIVATIVES

The Board believes that to realize fully the benefits of derivatives and to prevent systemic disturbances, several important challenges must be met. The first, and perhaps most important, challenge is for both dealers and end-users of derivatives to implement sound risk management practices. Sound risk management clearly is the key to protecting individual firms. Perhaps less obviously, it also is the key to addressing systemic risk concerns. Consider the two scenarios that were identified earlier in which derivatives could be the source of systemic problems. In the first, the failure of a derivatives dealer inflicts serious credit losses on its counterparties. What this amounts to is a concern that these counterparties will not have prudently managed their credit exposures to the dealer. The most effective preventive measure is sound risk management--in this case, the consistent application of counterparty credit limits to the dealer and the use of risk mitigation techniques, such as netting or collateralization. In the second scenario, dynamic hedging strategies used by option writers produce selling pressures that impair market liquidity and amplify price declines, and, in the event, render the dynamic hedges ineffective. Here the underlying concern is that option writers have presumed a greater degree of

market liquidity than in fact exists and thus have overlooked the pitfalls of dynamic hedging. The best preventive measure is the systematic conduct of stress tests that would highlight those pitfalls and discourage excessive reliance on such vulnerable hedging techniques.

A second important challenge is to improve the transparency of derivatives activities. Accounting, public disclosure, and regulatory reporting requirements have fallen far behind developments in the marketplace. Improvements in public disclosure would aid derivatives participants in assessing the creditworthiness of their counterparties and would allow shareholders to gauge more accurately the effects of derivatives activities on public companies' risks and returns. Regulatory reporting also must be strengthened. This includes reporting to financial regulators for purposes of assessing the safety and soundness of regulated institutions. It also includes reporting of data required for macroprudential purposes, including reliable measures of the size of derivatives markets and the degree to which dealing activity in various market segments is concentrated.

A third set of challenges involves ensuring that the legal and institutional infrastructure of financial markets can safely accommodate the growth of derivatives activities. The potential for legal enforceability problems to result in losses was brought home forcefully to derivatives dealers in 1991, when a British court decision to invalidate derivatives contracts with certain local authorities in the United Kingdom resulted in significant losses to some dealers. Legislation has substantially reduced legal uncertainty in the United States and several other important jurisdictions, although significant doubts about the enforceability of netting agreements persist in other countries. With respect to the

institutional infrastructure, the tightening of linkages among markets, to which derivatives have contributed, heightens the importance of strengthening settlement systems for primary and derivative instruments so that they contain disturbances rather than transmit them to other systems and their participants.

STEPS TAKEN BY THE FEDERAL RESERVE TO RESPOND TO THE CHALLENGES

The Federal Reserve has taken a series of steps to strengthen the supervision and regulation of bank derivatives activities. As the central bank, with its overall responsibility for the soundness and stability of the financial system, we have worked to enhance the transparency of derivatives activities and to identify and eliminate legal uncertainties relating to derivatives and weaknesses in settlement systems.

In all of these efforts, we have worked closely and cooperatively with other regulatory authorities and central banks. Domestically, much of the work on banking regulation has been coordinated by the Federal Financial Institutions Examination Council (FFIEC) and, more recently, by the Interagency Task Force on Bank-Related Derivatives Issues. Also, since Secretary Bentsen asked the Presidential Working Group on Financial Markets to add derivatives to its agenda, this group has served as an important forum for coordinating government policy toward derivatives.

Internationally, the Federal Reserve has strongly supported, and frequently provided leadership for, cooperative efforts by the central banks and supervisory authorities of the Group of Ten countries. These have included the Basle Supervisors Committee's work on capital requirements, the Eurocurrency Standing Committee's plans to develop meaningful comprehensive measures of the size of the

derivatives markets, and the Committee on Payment and Settlement System's work on netting and other payment and settlement issues.

Strengthening Supervision and Regulation of Bank Derivatives Activities

The complexity and diversity of derivative instruments and activities present significant challenges to banks and supervisors alike, as the GAO report points out. These challenges are being actively addressed by the Federal Reserve, the other banking regulators, and the banking industry. The Federal Reserve's own efforts in this area date back to the introduction of OTC derivatives in the early 1980s, and these efforts have intensified in the last two years, as bank derivatives activities have expanded, especially at the largest banks.

It is important to recognize that significant advances in the management of market and credit risks, including improvements both in financial methodology and in the design of management information systems, lie behind the recent surge in derivatives activity. These advances have made independent, highly skilled risk management staffs and rigorous measurement and analysis of market and credit risks key elements of a sound risk management approach for trading activities, and more generally, for banking activities. The Group of Thirty report, *Derivatives: Principles and Practices*, published last summer, lays out these elements, and banking companies in the United States and abroad are aggressively pursuing the goal of comprehensive, state-of-the-art risk management systems. These systems will, without question, greatly strengthen the banking system's resilience.

Such major advances in risk management and internal control also have important implications for our supervisory approach to derivatives and other trading activities. The Federal Reserve is moving swiftly to assess these implications and incorporate them into

our supervisory process. In adapting our supervisory approach, we face the more fundamental challenge of ensuring safe and sound banking practices, while preserving financial innovation, not only in products but, most important, in the risk management process itself.

The examination process. The cornerstone of our supervisory approach is the annual full-scope examination. In the past six months, the Federal Reserve has completed two important initiatives that we believe have substantially enhanced the effectiveness of our examinations of derivatives activities and of trading activities generally. Last December, the Federal Reserve issued a letter (SR-93-69) to each Reserve Bank that set out a comprehensive examination policy for trading activities of state member banks, bank holding companies, and other banking offices under our supervisory jurisdiction. The Reserve Banks were instructed to distribute this letter broadly to banks involved in derivatives activities. The letter highlighted, for both examiners and banks, key considerations in evaluating the adequacy of an organization's risk management process and internal controls. Although the statement focuses on trading activities by dealers, much of its guidance is relevant to the derivatives activities of end-users, especially its emphasis on the importance of oversight of the risk management process by senior management and boards of directors.

Earlier this year, the Federal Reserve also issued a new comprehensive trading activities examination manual. This manual provides extensive guidance to examiners on preparing for and conducting the examination of trading activities, including examination objectives and procedures, internal control questionnaires, and in-depth discussions of how to evaluate all aspects of a bank's risk management systems. In this last area

especially, we have substantially revised and expanded earlier examiner guidance to reflect recent advances in bank risk management practices.

The manual also discusses at length procedures for evaluating internal controls in trading areas. For over two decades, internal controls have been an important focus of our examinations of banks with significant trading activities. The procedures we have developed rest on the extensive experience of our examination force and include the lessons learned from internal control breakdowns over this long period in a wide variety of trading operations.

Between examinations, the Federal Reserve actively monitors developments in trading and derivatives activities at the major banks in these markets. Supervisory staff at each Reserve Bank maintain close contact through meetings and telephone conversations with the management of the institutions they supervise. Supervisory staff also have ready access to management reports and other data not collected in quarterly reports of condition and income. During the volatile market conditions of the first quarter, for example, this access allowed the Federal Reserve supervisory staff to monitor the impact of market developments on bank trading activity and bank profitability.

The Board endorses the principles underlying the GAO's recommendations for strengthening the bank examination process. We believe our current coverage of risk management and internal controls in the annual full-scope examination meets the GAO's principal objectives. With the implementation of Section 112 of the FDIC Improvement Act, banking companies active in derivatives are further strengthening their internal controls to meet the act's specific requirements for independent, knowledgeable audit committees and internal control reporting. We believe that we have made significant

progress incorporating the internal control assessments by the board of directors, management, and auditors into our supervisory process, as the GAO recommends. The Board also agrees that bank supervisors should continue to enhance the information gathered in the examination process for trading and derivatives activities, and we believe our broad information-gathering power under our existing examination authority is an essential and adequate supervisory tool.

Capital adequacy. The Board recognizes the key role that bank capital plays in protecting the deposit insurance fund from the market, credit, legal, and operational risks that banks assume and manage. The growth in bank derivatives activities is requiring changes in the methods that bank supervisors utilize to assess capital adequacy, including changes in the key risk-based capital measure.

As the GAO report notes, measures of the credit risks associated with OTC derivatives were part of the original Basle Accord that was published in 1989. Two significant enhancements to the current measures are under development. First, the risk-reducing effects of legally enforceable netting agreements would be recognized under a proposal issued by the Basle Supervisors Committee last year. Last week the Board and the Office of the Comptroller of the Currency issued for public comment a proposal to recognize such netting in its risk-based capital guidelines, and a coordinated proposal by all the U.S. banking regulators is expected to be issued shortly. Second, the Basle Committee is giving serious consideration to increasing capital charges for credit risk on equity and commodity contracts and on longer-dated derivatives contracts generally.

Market risks are not yet incorporated in the risk-based capital measure, and the Board agrees with the GAO's conclusion that this is a significant omission that must be addressed as soon as

possible. It is important to recognize, however, that this issue is as complex and difficult as it is important. Regulators traditionally have utilized relatively simple, generic models to measure capital adequacy. Last year, for example, the Basle Supervisors issued proposals for revisions to the Basle Accord for the market risks of trading activities in debt, equity, and foreign exchange that involved fixed and relatively simple rules. Likewise, efforts by U.S. banking regulators to incorporate interest rate risk into risk-based capital standards initially focused solely on simple models specified by the regulators.

Although the market risks of many banking instruments, including many derivatives contracts, can be accurately assessed using such simple models, a considerably more sophisticated approach is necessary to assess more complex instruments, especially those with options characteristics, and to aggregate different categories of market risk. The recognition of the need for a more sophisticated approach has led banking regulators in the United States and abroad to explore carefully the potential for allowing banks to use their own internal models to assess the need for capital to cover market risk.

Under such an approach, regulators would specify the magnitude of the market shocks that they expect banks to be able to withstand. The banks would then use their internal models to simulate the effects of such shocks on the market value of their trading portfolio. Banks would then be expected to maintain adequate capital to withstand the declines in market value produced by the specified market stresses. Examiners would assess the adequacy of the models and related internal controls and allow this approach only if the models and internal controls met or exceeded specified standards.

The Board believes that this type of simulation or "stress testing" approach to assessing capital for market risk is the best means of addressing concerns about the complexity of derivative activities and about the potential adverse impacts of dynamic hedging strategies on cash and exchange-traded derivatives markets. Some of the market shocks that regulators would specify would be instantaneous and, therefore, would generate large simulated losses on dynamically hedged options positions. The need to maintain capital to support these losses would strongly discourage undue reliance on dynamic hedging.

Explicit in this approach is the need for regulators to make difficult judgments about the magnitude of shocks that bank capital should be expected to absorb. The temptation will be to embrace the notion that bank capital must be capable of withstanding every conceivable set of adverse circumstances. However, it is important for supervisors to recognize that bank shareholders must earn a competitive rate of return on the capital they place at risk and that capital requirements that are unnecessarily high will impede the functioning of the banking system. While the scenarios need to be sufficiently rigorous to provide prudential coverage in times of stress, we must recognize that even in very adverse market circumstances, banks can take steps to reduce their risk and conserve capital. Finally, we must also recognize that when market forces threaten to build momentum and break loose of economic fundamentals, as they threatened to do in the stock market crash in 1987, sound public policy actions, and not just bank capital, are necessary to preserve financial stability.

Disclosure. Public disclosure is another key element in our supervisory approach. The banking agencies have recently expanded the

quarterly call reports in several ways to address trading and derivatives activities, as the GAO report points out. Relevant reporting changes implemented in March include revised reporting procedures to reflect the adoption by the banking agencies of Financial Accounting Standards Board (FASB) Interpretation Number 39 (FIN 39) and the collection of information on past-due payments on interest rate swaps. Under FIN 39, organizations may offset the on-balance sheet assets and liabilities of multiple derivatives contracts with a single counterparty and report the net amount only where the right of set-off is legally enforceable.

The banking agencies have issued for comment a proposal to expand derivatives reporting significantly in September 1994. The proposed enhancements would, among other things, collect notional values and gross positive and gross negative fair values for exchange-traded and OTC contracts separately. The proposal also requests comment on collecting information on exposures reflecting bilateral netting agreements and on the effect of derivatives activities on interest income, interest expenses, and trading revenues of the institution.

Reporting of market risks also will begin to be included in the regulatory report framework by March of 1995, as the banking agencies design reporting in conjunction with the implementation of the domestic capital standard for interest rate risk mandated under FDICIA Section 305. Data required to implement the market risk capital standards being developed by the Basle Committee on Banking Supervision would be incorporated into this reporting framework as well.

I would stress that all of these efforts are only initial steps in a broader program of strengthening public disclosure in

response to major changes in the management of risks at banks and in the financial system more generally. The key to that program is the identification of a core set of information that all major financial market participants need to disclose in order that counterparties, investors, and financial regulators can adequately assess the financial condition and risk profile of those they deal with.

This core set of information should not be confined to derivatives activities, but should encompass all of the risk activities of the bank. In particular, the Board believes that measures of credit risk concentrations must aggregate exposures on derivatives contracts with exposures from loans and other activities. Likewise, measures of the sources of trading revenues must recognize that derivatives positions and cash positions typically are managed as a single portfolio. Requirements to report gains and losses on derivatives separately from gains and losses on cash instruments would produce a distorted picture of the sources of trading revenues whenever derivatives positions are offsetting other positions within the portfolio. What would be useful to users of bank financial statements would be a breakdown of trading revenues by underlying markets or risk factors, rather than a breakdown based on legal definitions of the instruments used to create the positions in the underlying risk factors.

Accounting. The development of comprehensive and consistent accounting rules is also an important concern of the Federal Reserve. As the GAO report points out, there is currently no single cohesive framework for accounting for derivatives and, as a result, banks are applying different accounting treatment to similar transactions. Obviously, it is difficult for regulators or the public to properly evaluate the risk of an institution--other than through an on-site

examination--without consistent accounting treatment of derivatives transactions. Accordingly, the Board joins GAO in strongly urging the FASB and the industry to move promptly toward a consistent and meaningful set of accounting standards. The Board will continue to work with the Interagency Task Force and the Working Group to find ways to advance this goal.

Sales practices. In your invitation, you requested that I address the nature and adequacy of existing protections afforded to end-users of OTC derivatives from abusive practices in connection with sales of such instruments. In OTC derivatives markets, as in the wholesale banking markets, banks have fundamental responsibilities to their shareholders that require them to conduct a thorough credit assessment of their customers. In making a credit assessment for a derivatives transaction, our supervisory guidance indicates that banks should not only assess the overall financial strength of a counterparty and its ability to perform on its obligation, but should consider the counterparty's ability to understand and manage the risks inherent in the product. Our supervisory guidance goes on to say that if counterparties are not sophisticated, the bank should provide sufficient information to make them aware of the risks in the transaction. Where banks recommend specific transactions for unsophisticated counterparties, the Board's policy guidance instructs the bank to ensure that the bank has adequate information regarding its counterparty on which to base its recommendation.

A bank active in OTC derivatives contracts has a particularly strong self-interest in creating and maintaining counterparty relationships, because it has a continuing exposure to the nonperformance of its counterparty for the duration of the contract. Necessarily, the bank must be concerned and must satisfy itself that

its counterparties are sufficiently able to handle the risks associated with the derivatives transactions. Because of the importance of these ongoing relationships, many bank derivative dealers have responded to the recent reports of end-user losses in transactions by reviewing their existing policies and procedures for possible strengthening, and we are closely following those developments.

But the burden of being informed in the marketplace, especially a wholesale marketplace, must not fall only on the dealer. As I noted at the outset of my testimony, derivatives increase economic efficiency by allowing the transfer of risk to those willing to bear it. For the transfer of risk to be effective and the efficiency to be realized, end-users must retain ultimate responsibility for transactions they choose to make. In a wholesale market, sophisticated and unsophisticated end-users alike must ensure that they fully understand the risks attendant to any transaction they enter.

The federal banking agencies put this principle to work in our supervision of bank end-users of derivatives. Before a bank engages in such transactions, we expect senior management and the board of directors to have a good understanding of the risks in derivatives transactions and to ensure that the bank has sufficient personnel with the required expertise, adequate accounting, risk reporting and internal control systems to manage those transactions, and the requisite financial strength.

Thus, the Board does not see the need for legislative or regulatory protection for end-users. Nonetheless, additional steps can and should be taken to heighten the effectiveness of existing

protections in the marketplace. Much more can be done to educate end-users and heighten their awareness of the risks in derivatives and of sound risk management practices. News reports of the recent losses incurred by sophisticated end-users of derivatives have no doubt intensified discussion of these instruments between boards of directors and financial management at many end-users and should spur consideration of enhancements to policies, controls, and reporting. Many information resources already are available to end-users, and the financial industry plans additional educational efforts. The Group of Thirty report, in particular, was directed at the end-user as well as the dealer community, and it probably deserves much wider reading among end-users than it appears to have received to date.

Improving Transparency

In addition to its efforts to strengthen banking supervision, the Board has supported a variety of initiatives that seek to meet challenges faced by all dealers and end-users of derivatives, banks and nonbanks. In particular, the Board believes that the most effective means of promoting sound risk management by the full range of dealers and end-users is by achieving improved public disclosure of derivatives activities. Enhanced financial disclosure by end-users of the nature and size of the risks being managed through derivatives transactions would contribute importantly to heightening board and senior management involvement in these activities. More important, it enhances the effectiveness of market discipline by derivatives counterparties, other creditors, and shareholders or constituents.

Along with the Securities and Exchange Commission and other U.S. banking and financial regulators, the Federal Reserve has been encouraging the Financial Accounting Standards Board to accelerate its

efforts to improve public disclosures by U.S. companies. In mid-April, FASB released a proposal that would require disclosure of additional information on the scale of derivatives activities, the purpose of those activities (trading or risk management) and, in the case of trading activities, the resulting net gains or losses. In addition, the proposal encourages (but does not require) disclosure of quantitative information on interest rate risks and market risks that is consistent with the way the entity manages its risks. We plan to respond thoroughly to FASB's request for comments on this proposal at a later date. Many of the requirements are similar to those proposed by the banking regulators for inclusion in the quarterly call reports. As I noted earlier, however, the Board does not believe that isolating derivatives trading revenues from other trading revenues is a useful step toward understanding the sources of revenues or the risks entailed.

The Board has also been actively involved in efforts by the G-10 central banks to address concerns about the transparency of derivatives activities. In October 1992, the BIS published a Study of Recent Developments in International Interbank Relations (the Promisel Report) that stressed the need for greater transparency. As a follow-up to this study, the Eurocurrency Standing Committee of the G-10 central banks created a working group to assess what data on derivatives would be useful to central banks in their responsibilities for conducting monetary policy and overseeing the stability of the financial system. The study group concluded that it would be very useful to have statistics on market size, measured both in terms of amounts outstanding and in terms of turnover. Because of the global nature of derivatives markets, comprehensive measures of market size require a coordinated international effort. In response to a

recommendation by the study group, the G-10 Governors recently approved the addition of questions on derivatives to the triennial survey on foreign exchange turnover that is planned for April 1995. The foreign exchange survey is a proven vehicle for collecting data from banks and other financial institutions. It is conducted by central banks and monetary authorities in more than twenty-five countries, including all significant financial centers.

More recently, the Eurocurrency Standing Committee has formed a working group to consider means of improving market transparency through enhanced public disclosure by market participants. Work is being done to explore the core information needs of market participants, including shareholders, creditors, and counterparties, with the goal of contributing ideas to the larger public discussion of improvements in financial disclosure. Similar efforts are being undertaken in the private sector, and the Board hopes that significant progress can be made soon toward international agreement on a framework for fuller and more meaningful financial disclosures.

Strengthening the Legal and Institutional Infrastructure of Financial Markets

The Federal Reserve also has worked with authorities in the United States and abroad to understand clearly the legal risks associated with derivatives and to reduce legal uncertainty. The Board has been especially concerned about the legal enforceability of the netting agreements for derivatives that dealers and other users increasingly rely on to mitigate counterparty credit exposures. The Board believes that certainty with respect to enforceability is critical for financial stability. If counterparties measure their exposures as net when the true exposures are gross, they could face

losses far larger than expected and possibly larger than they could readily absorb.

In the United States, legislation and regulatory action by the Federal Reserve have ensured legal enforceability for most derivatives contracts and counterparties. The most recent legislative action was a far-reaching provision of the FDICIA. This provision validated under U.S. law all netting contracts between and among depository institutions, broker-dealers, and futures commission merchants. Furthermore, it authorized the Board to broaden the coverage to other financial institutions if the Board determined that such action would promote market efficiency or reduce systemic risk. In March of this year, the Board adopted a new regulation (Regulation EE) that expanded the Act's coverage to include all major derivatives dealers, including affiliates of broker-dealers and insurance companies. Under the umbrella of the Working Group on Financial Markets, the Board is working with the other financial regulators to identify remaining enforceability problems under U.S. law and to develop solutions that the Working Group could recommend to Congress.

The stock market crash in 1987 demonstrated quite clearly that the capacity of the financial system to absorb shocks depends critically on the robustness of payment and settlement systems. Since then, financial transactions have grown rapidly and linkages between financial markets have tightened, in part because of the expansion of derivatives activities, making payment and settlement systems even more important for financial stability.

A 1989 study by the Group of Thirty set out recommendations for strengthening arrangements for securities settlements that are relevant to financial instruments generally. The study recommended that trades be settled promptly (no later than three business days

after the trade date or T+3), in same-day funds, and according to the principle of delivery-versus-payment. The report also noted the potential benefits of bilateral and multilateral netting arrangements.

In the United States, the Federal Reserve has supported the SEC's adoption of a rule requiring T+3 settlement of broker-dealer transactions in corporate securities. Together with the SEC, we are overseeing efforts by the Depository Trust Company and the National Securities Clearing Corporation to develop liquidity safeguards and other risk controls that would permit settlement of corporate securities trades in same-day funds. Other significant improvements to settlement arrangements in recent years have been the creation of a book-entry delivery-versus-payment system for Government National Mortgage Association securities (the Participants Trust Company) and a multilateral trade netting system for U.S. government securities (the Government Securities Clearing Corporation). In both cases, the Federal Reserve, SEC, and Treasury cooperated to ensure that the system operators employed adequate risk controls.

Internationally, the Federal Reserve has worked with the other G-10 central banks to address concerns about the policy implications of the development of cross-border and multicurrency netting arrangements for payments and for foreign exchange contracts. In November 1990, the Bank for International Settlements published the Report on Netting (Lamfalussy Report). This report, which was endorsed by the G-10 Governors, concluded that such netting agreements have the potential to reduce systemic risks, provided that certain conditions are met. Regarding those conditions, the report set out minimum standards for the design and operation of such systems. To enforce the standards, it established a framework for cooperative

central bank oversight of cross-border and multicurrency netting systems.

Follow-up work to the Lamfalussy Report has been carried forward by the G-10 Committee on Payment and Settlement Systems (CPSS), currently chaired by President McDonough of the Federal Reserve Bank of New York. The CPSS has afforded central banks the opportunity to discuss emerging payment system issues and to provide systematic public policy analysis of these issues to the international financial community. The Committee also has discussed proposals by groups of banks in Europe and North America to create clearing houses (multilateral netting systems) for foreign exchange contracts.

The CPSS recently issued a report on Central Bank Payment and Settlement Services with Respect to Cross-Border and Multicurrency Transactions, which examined a range of possible central bank service options to reduce settlement risks, especially in foreign exchange transactions. Some of the same issues were examined by Federal Reserve staff in a study of the potential benefits of expanded hours of operation for the Fedwire funds transfer service. This study concluded that longer Fedwire funds transfer hours could facilitate private sector efforts to reduce risk in foreign exchange settlements, such as the proposed foreign exchange clearing houses. This conclusion helped support the Board's decision in February 1994 to open the funds transfer service eight hours earlier (at 12:30 a.m. ET), effective in 1997.

NEED FOR REMEDIAL LEGISLATION

The GAO Report recommends that Congress enact legislation requiring federal regulation of the safety and soundness of all major U.S. OTC derivatives dealers, including securities and insurance firm affiliates that currently are not subject to such regulation. The

Report also urges the Congress to begin systematically addressing the need to revamp and modernize the entire U.S. regulatory system. As part of such an effort, the report suggests that Congress should debate and decide whether large-scale proprietary trading of derivatives or other financial instruments should be conducted only through separately capitalized subsidiaries of bank holding companies.

In light of the progress that the private sector and financial regulators have made in addressing the challenges posed by derivatives and the further progress that it anticipates, the Board believes that remedial legislation relating to derivatives is neither necessary nor desirable at this time. In particular, the Board does not support the specific legislative recommendations that are contained in the GAO report. As the Board has stated repeatedly, there is a pressing need to modernize the U.S. financial system and regulatory structure. However, the Board believes legislation directed at derivatives is no substitute for broader reform, and, absent broader reform, could actually increase risks in the U.S. financial system by creating a regulatory regime that is itself ineffective and that diminishes the effectiveness of market discipline.

Regulation of Nonbank Derivatives Dealers

The Board is not persuaded that public policy considerations require regulation of nonbank derivatives dealers. The rationale for such regulation apparently is that the activities of such dealers pose risks to their counterparties or otherwise heighten systemic risk and that federal intervention, possibly including a taxpayer bailout, could be necessary to protect the financial system. However, in our judgment market forces have been effective in restraining risk-taking by such dealers. Moreover, even if one of these dealers were to fail,

its failure is unlikely to threaten the safety net. Finally, absent broader changes in the federal regulatory framework for nonbank financial institutions, we foresee significant difficulties in fashioning an effective regulatory regime for the derivatives activities of such entities.

Market forces, reinforced by broad acceptance of the risk management principles I have discussed, appear to be constraining effectively risk-taking by nonbank dealers and encouraging implementation of sound risk management practices. Counterparties to derivatives contracts generally are quite sensitive to credit exposures and often transact only with dealers they judge to be of the highest credit standing. Such concerns about creditworthiness have prompted many of the unregulated derivatives dealers to establish derivatives products companies (DPCs) that conform to capital and operating guidelines set out by the credit rating agencies. The Group of Thirty's report appears to have captured the attention of senior managers of unregulated dealers, many of which participated in preparing or financing the report. Many of these firms are now using the G-30 standards as a benchmark to evaluate their practices and, where necessary, to implement improvements.

As I have discussed, the Board believes that the effectiveness of market forces will be strengthened by enhancements to public disclosure requirements that would apply to nearly all of the currently unregulated U.S. dealers. The Board also takes note of initiatives by the Securities Industry Association and others in the derivatives industry to work with the SEC and other regulators to develop voluntary minimum standards for business conduct by derivatives dealers. The details of such standards have yet to be worked out, and such an initiative may not yet have the support of all

unregulated dealers. Still, it seems a promising means of reinforcing the market forces that thus far appear to be working well. The enactment of legislation could well bring this promising initiative up short.

Of course, market forces and industry initiatives cannot eliminate the possibility that an unregulated derivatives dealer could fail. Even if such a failure were to occur, however, it is unlikely to place taxpayers at risk. The Bank Insurance Fund could be placed at risk if insured commercial banks failed to manage prudently their counterparty credit exposures to the failed derivatives dealer. But our examiners are trained to identify and criticize concentrations of credit exposure to a derivatives dealer or to any other counterparty. Nor is the fund maintained for protection of securities customers by the Securities Investor Protection Corporation (SIPC) likely to be jeopardized. Even if the failure of a derivatives dealer affiliate created financial difficulties for a broker-dealer, SEC requirements to segregate customer funds and securities protect the SIPC fund.

To be sure, resolving the failure of an unregulated derivatives dealer would pose challenges to financial regulators. The Federal Reserve and other authorities would carefully monitor the effects of a failure and would work with market participants to achieve an orderly wind-down of its activities, as they did in 1990 when the Drexel Burnham Lambert Group failed. However, it is important to recognize that this type of federal "intervention" does not place taxpayer funds at risk.

The GAO does not discuss clearly how the currently unregulated dealers should be regulated, but it appears to assume that the banking regulators' approach to safety and soundness could readily be applied to unregulated derivatives dealers. To the contrary, the

Board foresees significant difficulties in implementing such an approach without more thorough regulatory reform. Derivatives contracts and related hedge positions often are booked at different legal entities. For example, the market risk associated with derivatives contracts booked at derivatives products companies is transferred to, and managed by, other affiliates. Consequently, regulation of the full range of risks associated with derivatives dealing would require broad authority over affiliated companies or probably authority to regulate the entire firm on a consolidated basis. But such an approach would be difficult to implement at those dealers that combine financial and nonfinancial activities. In particular, design of appropriate capital standards would be especially difficult for such firms.

Congress should recognize that the enactment of legislation could create the mistaken expectation that federal regulation will somehow remove the risk from derivatives activities. We must not lose sight of the fact that risks in financial markets are regulated by private parties. The relevant question that we must address is whether private market regulation is enhanced or weakened by the addition of government regulation. For the reasons I have discussed, the Board fears that, in this instance, a weakening of private market regulation is the more likely outcome.

Proprietary Trading by Banks

The GAO Report suggests that Congress should review whether banks' proprietary trading activities in derivatives and other financial instruments should be forced into separately capitalized subsidiaries of bank holding companies. The basis for this recommendation apparently is a concern that such activities at some banks have become so large and so complex that they pose

unacceptable risks to the deposit insurance fund. However, the Board does not perceive the risks associated with proprietary trading to be inherently greater than those associated with other banking activities. Indeed, the same types of risks are involved--credit risks, market risks, legal risks, and operational risks. Some derivative contracts, notably options products, are quite complex, but a complex, difficult-to-manage option is imbedded in every fixed-rate home mortgage. As is the case for home mortgage lending or any other banking activity, whether proprietary trading places the deposit insurance fund at risk depends on the bank's capital, the degree of concentration in its risk exposures, the strength of its risk management systems and internal controls, and the expertise of its personnel, including senior management and risk managers as well as traders.

Moreover, we believe that implementing a segregation of proprietary trading activities would be extremely difficult. Proprietary trading activities are difficult to define in principle and certainly difficult in practice to distinguish from market-making and other customer accommodation activities of banks. Forcing all trading activities into a subsidiary would be a radical change, affecting what are by any definition traditional banking functions (foreign exchange dealing, for example). Such a drastic change could significantly impair U.S. banks' competitive positions vis-a-vis foreign banks.

I have discussed the steps that the Federal Reserve and other banking regulators already have taken to ensure that proprietary trading activities are conducted prudently. In particular, the Federal Reserve has made considerable progress in providing its examiners with the tools necessary to assess the effectiveness of risk

management systems and internal controls for trading activities and to identify and demand elimination of any material weaknesses. The Board has placed the highest priority on efforts to revise risk-based capital requirements to cover market risks. Although this effort is not yet complete, an assessment of the adequacy of capital to cover potential trading losses already is a critical element in our annual on-site, full-scope examinations. If a bank were to take trading positions that posed a threat to its solvency, we would insist that those positions be closed out promptly and that the board of directors take strong measures to prevent such a situation from recurring.

Recent examinations of the state member banks that are most actively involved in proprietary trading activities have not revealed significant problems arising from these activities. While our examination reports have cited certain deficiencies in specific internal controls, management is well along toward correcting them. The risk management systems of major dealer banks were severely tested by the recent volatility in financial markets. While the banks suffered losses trading in some markets, their risk controls worked. As losses developed, senior management of the banks were aware of the size of risk positions and of the losses. A combination of loss limits and senior management decisions brought risk positions down. Moreover, because their trading positions tended to be well-diversified across fixed income, foreign exchange, commodity, and equity markets in the United States and in many other countries, their overall trading activities most often remained profitable. Even viewed in isolation, the losses incurred in individual markets were a very small fraction of the capital that supports these banks' trading activities and ensures that shareholders, not taxpayers, bear the costs.

Of course, we must be cautious about drawing inferences from this single episode of market volatility. The banks involved are closely studying their recent experience and identifying ways in which risk management systems can be strengthened further. For its part, the Federal Reserve is reviewing these banks' experiences to identify ways to make further improvements to its supervisory and regulatory program.

Mr. MARKEY. Our next witness, the Honorable Arthur Levitt, Jr., is the Chairman of the Securities and Exchange Commission.

We welcome you back, Mr. Chairman. Whenever you are ready, please begin.

STATEMENT OF HON. ARTHUR LEVITT, JR.

Mr. LEVITT. Chairman Markey and members of the committee, I am pleased to appear today to testify on behalf of the Securities and Exchange Commission regarding derivative financial instruments and the General Accounting Office's report concerning financial derivatives.

It is widely acknowledged that derivative instruments are important financial management tools that, in many respects, reflect the unique strength and innovation of this Nation's capital markets. From the farmer who hedged his wheat crop against seasonal price changes 100 years ago to today's currency forwards, derivatives have been a valuable economic tool.

It is important to view the size and growth of the derivatives market in context. The U.S. securities firms meaningful over-the-counter derivatives activity has been concentrated in six firms, which are the most highly capitalized in the securities industry. Their counterparty credit exposure is primarily confined to investment grade entities in short-term and is generally not concentrated with any particular counterparty. Their balance sheets tend to be highly liquid.

The discipline demanded by the marketplace is a positive force, which tends to foster credit consciousness and strong risk management. At the same time, we must recognize that the complexity and leverage inherent in these instruments require very special scrutiny. There is risk that an individual firm or investor might mismanage its derivatives activities and incur significant losses.

There is risk also of a systemic nature in that losses at one firm could spill over to other firms. Market liquidity could deteriorate and the cash markets could be disrupted.

Recent losses announced by major U.S. companies raise questions about whether the directors and senior management of the end-users of over-the-counter derivatives products understand fully the risks inherent in these instruments, as well as possible questions about the sales practice standards used by dealers in selling these products.

I am here today to address recommendations made last week by the GAO in its study of the derivatives market. I commend Charles Bowsher and his colleagues at the GAO. The report contains a thoughtful assessment of the derivatives marketplace and accurately identifies a broad range of goals and objectives for the regulatory community.

There is obviously a great deal to be done. We need to understand this market better, and we are going to have to go to the industry to do that.

The question for all of us here today is not whether this market is going to have more regulatory oversight but how it will get done. From the SEC's perspective, I believe the first step is not legislation but a careful evaluation of the market and an assessment of

the level of cooperation we, as regulators, will receive from the industry in designing a sensible regulatory structure.

In addition, we are going to work closely with our colleagues, both domestically through the working group on financial markets and, importantly, internationally. We will need to keep Congress continually informed of our progress and stand ready to ask for additional authority should we require it.

As Chairman Markey and the members of this committee are aware, the SEC for a number of years has been actively pursuing many of the goals identified by the GAO report.

My written testimony, which I would like to submit for the record, elaborates on the Commission's initiatives in developing accounting, disclosure and capital standards tailored specifically to derivative products. In my opinion, the Commission's actions to date have been responsive to the needs of a dynamic market, while at the same time being responsible in trying to ensure the protection of investors, those that invest directly in derivatives as well as investors in the cash markets.

I am not going to attempt at this time to go through my entire written statement, but I would like to touch on several specific points.

First, it will be critical for regulators and the industry to move ahead quickly with improvements to the accounting and disclosure standards applicable to derivative transactions. The Financial Accounting Standards Board issued an exposure draft last month that I anticipate will apply to the preparation of 1994 year-end financial statements.

In addition, the Commission will publish additional guidance for its registrants on disclosure for derivatives and risk-management activities in time for use in preparing 1994 annual reports.

Second, we agree with the GAO that clear risk management policies and controls, including those governing the use of derivative instruments, defined and overseen at the highest level of an enterprise, are critical to a sound risk management system.

We believe that, given existing audit requirements, there should be more transparent disclosure and accounting for derivative activity, including management policies, instead of public auditor reports on internal controls. Such enhanced public reporting will not only better inform investors but will help assure that auditors as well as management carefully review the information provided and that adequate controls are in place.

Third, the Commission will continue to focus on the use of derivatives by mutual funds. Although the use of derivatives by stock and bond funds appear to be limited, the Commission has heightened its examination of disclosures made by mutual funds, and we have encouraged the industry to identify areas of derivatives disclosure that can enhance investor understanding of risk.

The Commission also is inspecting the management controls of these funds and considering whether rulemaking is necessary to encourage better management controls.

The use of derivatives by money market funds has merited our special attention. We are concerned that money market funds may be purchasing new kinds of instruments whose market value in

certain interest rate environments may be unpredictable and thus threatening to the stability of the fund's price.

Fourth, the Commission is continuing to evaluate the programs currently in place pursuant to which the Commission monitors the derivatives activities of securities broker-dealers and their affiliates. The Commission's risk assessment program, adopted pursuant to the Market Reform Act of 1990, requires broker-dealers to report information on their material affiliates within the holding company group.

The Commission receives quarterly and annual financial statements as well as information on the volume, replacement cost and significant counterparty concentrations for interest rate, foreign exchange securities and commodities products. The Commission reviews the risk management policies used by major U.S. securities firms and obtains information regarding the credit exposures to significant counterparties.

While the risk assessment program is a very valuable regulatory tool, I believe the Commission can and should do more to monitor the activity of broker-dealer affiliates. I intend to explore with the industry and others the best methods for accomplishing the Commission's objectives in this area. The time has come for registered broker-dealers and their unregistered affiliates to demonstrate a high level of cooperation with the Commission in designing better oversight programs.

The Commission is also currently engaged in a comprehensive review of its net capital rule, with the goal of developing a net capital treatment that appropriately measures market and credit risk for derivative products. We will revise that rule to reflect modern financial theory and risk management strategies.

And, fifth, the Commission recognizes that the dealer community must take responsibility to ensure that appropriate sales practice standards are followed. Specifically, we will work with dealers and the self-regulatory organizations to make sure that securities dealers consider the suitability of their recommendations.

Regulation of the derivatives market requires a combination of vigilance, flexibility and close coordination among regulators and with the Congress. It is incumbent on the SEC and all financial regulators to assess the evolving market and its participants and to craft a system of regulation that is tailored to its needs and to its risks. This issue is too important to this Nation to simply do nothing, as some would suggest or to construct the wrong regulatory scheme.

The Commission is moving forward. We remain committed to ensuring that our markets continue to be the national resources they were internationally recognized to be.

Thank you.

Mr. MARKEY. Thank you, Mr. Chairman.

[Testimony resumes on p. 232.]

[The prepared statement of Mr. Levitt follows:]

TESTIMONY OF

ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING DERIVATIVE FINANCIAL INSTRUMENTS

BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE
UNITED STATES HOUSE OF REPRESENTATIVES

MAY 25, 1994

Chairman Markey and Members of the Committee:

I am pleased to appear today to testify on behalf of the Securities and Exchange Commission ("Commission" or "SEC") regarding derivative financial instruments and the General Accounting Office's ("GAO") report concerning financial derivatives ("GAO Report").[1]

It is widely recognized that derivative instruments[2] are important financial management tools that, in many respects, reflect the unique strength and innovation of the American capital markets. In fact, U.S. markets and market professionals have been the global leaders in derivatives technology and development.[3] When used properly, derivatives provide significant benefits to corporations, financial institutions, and institutional investors

in managing the risks of their business exposures or financial assets. Derivatives permit corporations and local governments to lower their funding costs and, in many instances, can be a cheaper and more liquid way of attaining desired exposure than a position in the cash market. OTC derivative products frequently are preferred by investors because such contracts can be structured to match their particular portfolios or investment strategies and their flexibility enables businesses to control ancillary risk in their commercial and investment transactions. Indeed, properly used, such products can facilitate the ability of an institution to undertake a variety of investments, expand credit availability, and help absorb or dampen market shocks.

At the same time, it is acknowledged that the complexity and leverage inherent in these instruments require special scrutiny of their usage.[4] As others have noted, even though these instruments may serve to reduce risk in many situations, in an aberrant, stressful market the leverage, complexity, liquidity risk, and global nature of OTC derivatives may make dealing with exigent circumstances more difficult. This is because derivatives, both listed and OTC, tend to link different market segments. Thus, a failure in one part of the system, such as the insolvency of a major intermediary or a sharp fall in a specific market, potentially could reverberate throughout the financial markets. Although these concerns may not be unique to derivatives, this is an area where we are concerned that a difference in degree becomes a difference in kind.

Broadly speaking, there are two types of risks regulators are addressing regarding derivative instruments. The first is firm-specific risk. This is the risk that an individual firm might mismanage its derivatives activities and incur significant losses. Such losses could be incurred by a dealer subject to the Commission's financial responsibility and oversight rules, a corporate end-user that may be subject to the Commission's disclosure

rules, or a mutual fund subject to the Commission's disclosure and substantive regulation. The second risk is systemic risk, or the risk that losses at one firm could spillover to other firms, that market liquidity will deteriorate if many market participants try to liquidate their positions at the same time, or that cash market trading activities, designed to adjust derivatives exposures, could unduly disrupt the cash markets.

While the Commission cannot, and should not, try to eliminate the consequences of mismanagement by an individual firm, we can, and will, try to ensure that investors and counterparties are not unwittingly exposed to the risk of a firm's error. In continuing its efforts to address both the firm-specific and systemic risks associated with derivatives activities, the Commission is working on revised capital rules for derivative dealers, enhanced suitability standards, improved disclosure standards for public companies engaging in derivatives activities, and improved disclosure and management controls for mutual fund derivatives activities.[5] In addition, we are working with banking regulators and the Commodity Futures Trading Commission ("CFTC"), both separately and in the context of the President's Working Group on Financial Markets ("Working Group"), to identify those areas where systemic risk could be present in order to evaluate the ability of the financial system to withstand market shocks and to improve it where appropriate. Two such potential areas are in the clearance and settlement system and the enforceability of netting provisions in OTC derivative contracts.

Concerns about derivative instruments reflect the size and growth of the derivatives marketplace. The GAO Report estimated that the total global derivatives volume expressed in notional or contractual amount as of the end of fiscal year 1992 was at least $12.1 trillion. Information filed by registered broker-dealers with the Commission indicates that

derivatives activity expressed in notional or contractual amount (including exchange-traded futures and options and OTC instruments), as of 1993 year-end, for the major U.S. non-bank affiliated broker-dealers and their affiliates had increased 38% to $5.1 trillion from $3.7 trillion at fiscal 1992 year-end. More importantly, the aggregate replacement cost associated with these contracts, or the estimated exposure undertaken by securities firms, surged 70% to $30.9 billion from $18.2 billion in 1992.

This growth is significant, but it must be seen in its proper context. We have found that for U.S. securities firms, meaningful OTC derivatives activity has been concentrated in six firms, which are the most highly capitalized in the securities industry. Moreover, the overall replacement cost of their derivatives transactions, while growing, still reflects a small percentage of the total notional amount of those contracts. Furthermore, although the Commission has no formal examination authority over the unregistered affiliates of broker-dealers, our risk assessment data relevant to the credit risk underlying securities firms' replacement cost indicates that counterparty credit exposure is primarily confined to investment grade entities, is short-term, and is generally not concentrated with any particular counterparty.

Further, the balance sheets of broker-dealers registered with the Commission tend to be highly liquid, as do the balance sheets of those broker-dealer affiliates transacting an OTC derivatives business that have obtained a "AAA" rating from a rating agency. In addition, the discipline demanded by the marketplace is a positive force which tends to foster credit consciousness and strong risk management. Generally, we believe that the largest broker-dealers have systems in place to assess the market and counterparty risks attendant to their derivatives portfolios. For example, broker-dealers monitor their positions and value them at fair value ("mark-to-market") on a daily basis. With regard to broker-

dealer affiliates, we have found that they have systems in place to monitor the market and credit risk of OTC derivatives on a frequent basis.

Nonetheless, concerns remain. Recent losses by U.S. companies, such as Procter & Gamble, Air Products & Chemicals Inc., Gibson Greetings and Marion Merrell Dow, and losses incurred by the ARCO pension fund,[6] raise questions about whether the directors and senior management of the end-users of OTC derivative products understand fully the risks inherent in these instruments, as well as possible questions about the sales practice/suitability standards used by dealers in selling these products. These recent losses also underscore the pressing need for improved accounting and disclosure standards applicable to the derivatives activities of end-users, as well as dealers. I expect that the Financial Accounting Standards Board ("FASB"), as well as the Commission, will take action this year to enhance both the accounting and disclosure guidance applicable to derivatives transactions.

In light of these concerns, the GAO Report contains a thoughtful assessment of the derivatives marketplace and accurately identifies a broad range of goals and objectives for the regulatory community. As my testimony will indicate, we have been working actively to pursue many of the goals set forth in the GAO Report's Recommendations to Regulators. These items reflect, we believe, important areas for us, as regulators, to address in n timely and effective manner. We look forward to working through the particulars of each Recommendation to Regulators and we are firmly committed to working internally and together with our counterparts in addressing the complex problems arising in the derivatives market.

COMMISSION'S PROGRAM FOR REGULATION OF DERIVATIVE PRODUCTS

The Commission has devoted resources in many areas to address the risks of derivative products. I would like to discuss the Commission's efforts to date and the areas where additional study, and possible improvement, is needed.

A. Disclosure and Accounting Issues

Clearly the dramatic proliferation and increasing complexity of derivatives has outdistanced the development of accounting and disclosure standards that govern the issues of recognition, measurement, and information reporting. The need for substantially enhanced disclosure and more transparent accounting has been recognized by all who have considered this market.[7] Thus, one of the highest priorities for regulators and the industry must be improving the accounting and disclosure for derivatives transactions.

The Group of Thirty's recommendations[8] in this area exemplify the basic thrust of most recommendations with respect to accounting and disclosure, including:

- The need to develop international accounting standards for financial instruments so as to harmonize accounting treatment and thereby enhance the relevance of both dealers' and end-users' financial statements;
- The need for information about management's attitude toward financial risk, how instruments are used, and how risks are monitored and controlled;
- Disclosure of accounting policies;
- Analyses of derivatives positions at balance sheet date; and
- Analyses of credit risk inherent in those positions.

I fully concur in the need for enhanced disclosure and accounting for financial instruments including derivatives transactions. In fact, a number of initiatives already are

underway, including a broad ranging project by the FASB to address accounting issues raised by the use of varied financial instruments. Standards already resulting from that project include:

- Statement of Financial Accounting Standards ("SFAS") No. 105, Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk (March 1990);
- SFAS No. 107, Disclosures about Fair Value of Financial Instruments (December 1991);
- SFAS No. 110, Reporting by Defined Benefit Pension Plans of Investment Contracts (August 1992);
- SFAS No 114, Accounting by Creditors for Impairment of a Loan (May 1993); and
- SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities (May 1993).

Recognizing the pressing need to address the accounting and disclosure issues raised by derivatives activity in the near term, the FASB, in November 1993, added a new "fast track" disclosure initiative to its agenda. That initiative resulted in the publication last month of an exposure draft entitled, "Disclosures About Derivative Instruments and Fair Value of Financial Instruments."[9]

The exposure draft would require new disclosures by traders in financial instruments and by parties that are end-users of such contracts, such as financial institutions and industrial companies. The exposure draft on derivatives disclosure is in addition to, and is not a substitute for, the development of standards that are needed to address important recognition and measurement issues. In particular, the FASB's project on hedge accounting

will address when hedge accounting, pursuant to which accounting recognition of the fair value of the instrument, and related gains and losses, is deferred, is appropriate. Where hedge accounting is not appropriate, a derivative position is recognized on the balance sheet at fair value, and current increases or decreases in value run through the income statement.

We agree with the GAO that it is critical that these issues be addressed expeditiously. We have expressed the need for prompt action to the FASB, and the FASB expects to have a final standard on disclosure of derivative products in place by the end of this year that would apply to the preparation of 1994 year end financial statements. While the FASB has not yet scheduled the publication of an exposure draft on hedge accounting, I expect, given the critical importance of this issue, that the FASB will have as its highest priority publication of the exposure draft by year end.

The FASB's disclosure exposure draft would make a distinction between derivatives activities undertaken for trading purposes and those undertaken for purposes other than trading. The disclosures required for derivatives held for trading would include:

- The average, minimum, and maximum fair value of derivatives during the reporting period, reported separately by class of derivative instrument; and
- The net gains or losses from derivatives trading activities.

For derivatives held for purposes other than trading, the exposure draft would require the following disclosures:

- A description of the objectives of holding derivative instruments;
- A discussion of the context needed to understand those objectives;
- The strategies for achieving those objectives;
- A description of the financial reporting of the derivatives activities; and

- A description of the derivatives used to hedge anticipated transactions and disclosure of deferred gains and losses.

In addition, the exposure draft encourages the disclosure of quantified information about interest rate or other market risks in a manner that is consistent with the way the entity manages risks and would be useful in examining the success of the entity's strategies for holding and issuing derivative financial instruments. The exposure draft recommends that similar information, classified by type of risk, also be disclosed about the risks of other financial instruments or nonfinancial assets and liabilities to which derivative financial instruments are related by a risk management strategy.[10]

While the exposure draft is a good first step, we firmly believe that quantified disclosure of derivatives activity is essential. Our review of recent reports by registrants disclosing significant derivatives activity has made clear the need for quantified disclosure to provide a clearer understanding of the derivative and risk management activities of the registrant. The Commission staff, through the review and comment process, has been working with registrants reporting significant derivatives activities to expand their disclosures to obtain textual and quantified information that will provide a better understanding to investors of the type, extent, and potential effects of registrants' derivatives activities. Information sought through the comment process includes, depending on the nature of the activities:

- Revenues from derivatives trading, including a breakdown of revenues derived from foreign exchange, interest, equity, and other major types of derivative products quantified and separately identified;
- A description of the registrant's significant end-user activities indicating the specific risk being managed and the type of instrument and strategy used to

manage that risk (e.g., foreign currency swaps used to manage exchange rate risk in designated foreign currency denominated transactions), including quantified information related to the on balance sheet position (if any) being managed and the related derivative positions;

- A summary of open derivatives positions at period end that includes for each major category of derivative instrument the notional amount, carrying value, fair value, gross unrealized gains and gross unrealized losses for each category;
    - For interest rate swaps, the summary should include categories for year of maturity, major swap terms and average interest rates for each of the receive fixed/pay variable, and the pay fixed/receive variable categories, and other information to enable investors to understand the interest rate exposure of the instruments;
    - For futures, forwards, and options, including puts and calls, the period end summary should distinguish between contracts written and contracts purchased, and should aggregate instruments with similar risk characteristics such as interest rate, foreign exchange, commodity and equity price risk.
    - For complex instruments which contain several risks, disclosure of each instrument and its terms and attributes.
- Quantified information concerning terminations of derivative positions accounted for as hedges including the amounts of gross realized gains and gross realized losses from terminations prior to maturity, including the amounts of any such gains and losses where income statement recognition is being deferred. For such deferred gains and losses, disclosure of the fiscal year in which recognition in income is expected; and

- Management methods and quantified parameters used to monitor and control risk management strategies, including stress testing and sensitivity analysis.

Based on the results of the staff's review of 1993 annual reports, the Commission will publish additional guidance on the disclosures expected regarding derivatives and risk management activities in time for use in preparing 1994 annual reports. In the event the final FASB standard on derivatives disclosure does not require end-users to disclose quantitative/numerical information about their derivative contracts or positions, as I hope it will, the Commission will develop its own guidance on the type of quantitative information needed to inform investors adequately.

Accounting issues need to be addressed on an international basis as well. The International Accounting Standards Committee is developing an international accounting standard for financial instruments that would address, among other items, the accounting for equity and debt securities, loans receivable, forward contracts, options, interest rate swaps, hybrid instruments, and hedge accounting. A draft standard has been published twice for comment. The Commission staff has commented on both versions of the proposed standard and has recommended a number of significant changes to the proposal that would, among other things, provide more transparent reporting of derivatives activity.

I also would like to discuss the GAO's recent recommendations in the accounting and disclosure area. The GAO recommends that the Commission establish criteria for independent audit committees and for public reporting on entities' internal control systems. As discussed below, we do not concur in the specific proposals to mandate under federal law the establishment of independent audit committees or financial statement disclosure of

auditors' reports on internal controls. These are issues that the Commission has given extensive consideration during the past 15 years.

B. Audit Committees

Since the 1940s, the Commission has been among the strongest advocates for, and a driving force behind, the use of audit committees by public companies.[11] In 1972, the Commission endorsed the establishment by all public companies of audit committees composed of outside directors.[12] In the following years, principally at the urging of then-SEC Chairman Williams, the use of audit committees spread and gained acceptance in the business community.[13] The SEC has acted in its disclosure, enforcement, and oversight programs to promote the use of independent, effective audit committees.

Over the years, the SEC has required substantive disclosure regarding audit committees. Disclosure of information concerning an audit committee's members, functions, and number of meetings is required in connection with the solicitation of proxies.[14] Further, when a change in independent accountants occurs, issuers must disclose in Commission filings whether a registrant's audit committee recommended or approved the change in accountants, and whether it consulted with the former accountant concerning disagreements with management and certain other matters.[15]

In addition, the Commission has required the establishment of audit committees, with designated duties, as ancillary relief in some enforcement actions.[16] The duties required in such actions generally involve, among other things, the review of a defendant's internal accounting controls, approval of certain filings and press releases, and meeting with the defendant's independent accountants.

Rather than imposing a direct requirement for registrants to maintain audit committees, the Commission has worked with the self-regulatory organizations ("SROs") to require listed companies to have audit committees. The Commission has taken this approach because it believes that the SROs' experience places them in a position to exercise flexibility in the formulation and implementation of audit committee standards. Currently, the New York Stock Exchange ("NYSE") requires listed companies to have audit committees composed solely of independent directors. The National Association of Securities Dealers, Inc. ("NASD") with respect to all national market companies, the American Stock Exchange, with limited exceptions, and the Chicago Stock Exchange, with respect to all companies, require that listed companies have audit committees with a majority of independent directors.

In 1988, the Commission considered the recommendation of the National Commission on Fraudulent Financial Reporting ("Treadway Commission") that the Commission require all public companies to have an audit committee composed entirely of independent directors. The Commission determined that the best course of action was to continue to work with the exchanges and the NASD to encourage independent audit committees and enhance the quality of their operations. The Commission based its decision on its continued belief that the SROs through their listing standards had the requisite degree of flexibility to effectively address standards relating to the independence of audit committee members and the advisability of partial or total exemptions from these requirements for smaller companies. The Commission wrote to each of the SROs (other than the NYSE, which already required independent audit committees), encouraging enhancement of their audit committee listing requirements and encouraging a move to requiring independent audit committees. In response the American Stock Exchange adopted its requirement that listed companies have audit committees with at least a majority of independent directors.

I support the Commission's policies on this issue. Audit committees are key corporate governance mechanisms and, like all corporate governance standards depend on the character, integrity, and diligence of those involved. The training and experience of the committee members are basic factors in establishing an effective audit committee.[17] In this regard, it may be difficult, if not impossible, for some small, local, or regional companies to find qualified individuals who are willing to participate on their committees. Additional SEC regulations likely would not alleviate this problem and probably would not result in significant new disclosures. Such regulations, however, may remove some of the flexibility available in the SROs' requirements and may impose costs that could be significant for smaller companies. Therefore, I am not prepared to endorse a federally imposed mandate governing the composition of audit committees for all public companies.

C. Internal Controls Reporting for End-Users of Derivatives

Critical to a sound risk management system that incorporates use of derivative instruments are effective management controls of the system - understood and evaluated at all levels of management including senior executives and the board of directors. Boards and senior executives should define the fundamental risk management policy of the entity including clearly articulated policies governing the use of derivatives. The board of directors and senior management should provide effective oversight of these activities for consistency with the defined policies and should monitor the continued appropriateness of the policies in light of business and market developments. Equally essential is a system of internal controls to assure that the risk management program, including use of derivative instruments is properly executed consistent with management risk policies and controls.

The subject of internal controls is one where the Commission has played an active role. Certain entities regulated by the Commission, such as investment companies,[18] broker-dealers,[19] and transfer agents,[20] are required to file with the Commission reports from their independent auditors regarding possible material weaknesses or inadequacies in their accounting systems, internal accounting controls, and procedures for safeguarding assets. In addition, the Foreign Corrupt Practices Act ("FCPA")[21] requires issuers with securities registered under section 12 of the Securities Exchange Act of 1934 ("Exchange Act") or that have sold securities under the Securities Act of 1933 ("Securities Act") to devise and maintain a system of internal accounting controls. Under the FCPA, internal controls must be sufficient to provide reasonable assurance that (1) transactions are executed in accordance with management's authorizations, (2) transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles or other applicable criteria and to maintain accountability for assets, (3) access to assets is permitted only in accordance with management's authorization, and (4) the recorded accountability for assets is compared at reasonable intervals and appropriate action is taken with respect to any differences. Thus, public companies that are end-users of OTC derivatives already are subject to certain internal control standards.

The Commission has proposed on two separate occasions a requirement that management of a public company be required to report on the effectiveness of its internal control systems relating to financial reporting and that the registrant's independent accountant report on the entity's internal control system relating to financial reporting. The first proposal was withdrawn in 1980 due to voluntary and private sector initiatives in the area and because of commentators' concerns about the costs of the proposed rule and whether the proposal, in effect, required a report on compliance with the internal control provisions of the FCPA.[22]

In 1988, the Commission again published for comment proposed rules that would have required a report from management on its responsibilities for the registrant's financial statements and internal controls to be included in annual reports and certain other documents.[23] A majority of the commentators supported the requirement for a statement by management concerning its responsibilities for the establishment and maintenance of a system of internal controls for financial reporting. Commentators, however, expressed concerns regarding: (1) the management assessment of the effectiveness of such controls; (2) disclosure of how management would respond to significant recommendations concerning the registrant's internal controls by its internal auditors and independent accountants; (3) the requirement that the report be signed by the registrant's senior officers; and (4) the potential for over reliance by investors on the proposed report. As in 1980, commentators questioned whether a report noting deficiencies in a registrant's internal controls would constitute an admission of a violation of the FCPA. Further, most commentators addressing whether independent accountants should be required to report on either the registrant's internal controls or the proposed management report, opposed such auditor reporting, principally on the basis that the costs would exceed the benefits. On April 16, 1992, the Commission withdrew this proposed rulemaking.[24]

Other federal legislation addresses internal controls for certain regulated entities. Under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), certain banks and savings and loans are required to file with bank regulators management reports containing management's assessment of the effectiveness of the entity's internal control structure and financial reporting procedures. The entity's independent auditor is required to attest to, and separately report on, management's assertions.[25] In supporting the need for such reporting, the GAO indicated that it could aid in ensuring that accounting

principles were applied properly in call reports and financial statements, and could act as an "early warning" of breakdowns in banks' corporate governance systems.[26] A private sector study has been completed that is intended to provide guidance in conducting assessments of entities' internal control structures.[27] In implementing the FDICIA requirement, the FDIC did not develop separate criteria for internal controls. Instead, the FDIC stated that each institution should determine its own standard for an internal control structure and procedures for financial reporting, and that the auditor's attestation should be in accordance with generally accepted standards for attestation engagements.[28]

Where federal regulators are responsible for overseeing on a substantive basis the financial condition of an enterprise as in the case of banks and savings and loans reports on internal controls may be an important tool in such oversight. Where, as in the case of public companies, federal regulation is focused on full and fair disclosure to investors, the issue is whether a public report by a company's auditors on internal controls will materially improve disclosure to investors. Under generally accepted auditing standards, independent auditors currently are required to design their audits to provide reasonable assurance of detecting misstatements that are material to the financial statements.[29] As discussed above, the FCPA requires maintenance of a system of internal controls. The likelihood of an auditor's reporting on management's assessment of an entity's internal control structure being substantially more effective than an audit of the financial statements in preventing and detecting management fraud is open to question. Likewise it is unclear why or how the management of a registrant will understand better the risks inherent in derivative and cash instruments if it is required to report publicly on the effectiveness of the registrant's internal controls and its independent auditor is required to examine and publicly report on management's assertion about the registrant's internal controls.

Investors will be better served by improved disclosure and accounting of a registrant's derivative and other risk management activities. Such enhanced public reporting will not only better inform investors, but also help assure that auditors, as well as management, carefully review the information provided, and assure that adequate controls are in place with respect to the activities required to be disclosed.

D. Mutual Fund Use of Derivative Instruments

Mutual funds, other than money market funds, use derivative products for a wide variety of purposes including, for example, to hedge interest rate, currency, and other market risks, to substitute for a direct investment in the underlying instrument, or to increase potential yield and risk. Fund disclosures indicate that many funds have the authority to use derivative instruments, but our inspections to date suggest that the actual use of derivatives by most stock and bond funds is limited. There are exceptions, however, to this general observation. Funds dedicated to mortgage-backed securities, for example, generally have significant investments in derivatives, ranging from relatively straightforward securities issued by the Government National Mortgage Association and the Federal National Mortgage Association to more complex, riskier collateralized mortgage obligation tranches. Longer-term municipal funds also use derivatives for the purpose of seeking increased tax-exempt return. In addition, funds investing internationally may use certain derivative investments to lessen currency risks.

A recent industry survey of long-term (non-money market) funds suggests that mutual fund use of derivatives is limited. The survey reported that the total market value of all derivatives held by participating funds was $7.5 billion, representing 2.13% of the total net assets of all funds reporting derivatives holdings and 0.78% of the total net assets of the fund complexes participating in the survey. The total notional amount of these derivatives

was $54.3 billion, representing 15.51% of the total net assets of all funds reporting derivatives holdings and 5.67% of the total net assets of the fund complexes participating in the survey. The survey also indicated that the level of use of derivatives varied by fund type, with fixed income funds accounting for 84% of the total market value of all derivatives held by reporting funds and 62% of the total notional amount.[30]

Notwithstanding that the use of derivatives by mutual funds generally appears to be limited, in recent weeks there have been reports of significant losses by some investment companies from investments in derivative instruments.[31] For example, one short-term government bond fund investing in mortgage securities was reported to have declined 4% in value in one day this month,[32] and another was reported to have lost 23% in 1994.[33]

Months before these reports surfaced, the Commission was concerned about investor protection issues raised by mutual fund investments in derivatives. In the past year, the Commission has taken a multi-faceted approach to mutual fund use of derivative instruments, focusing on a broad range of issues, including disclosure, risk management, pricing, leverage, and liquidity. A staff task force has examined the derivatives disclosures of 100 investment companies, representing a broad sample of complexes and fund types, and the Commission's fund disclosure review staff has given heightened scrutiny to derivatives disclosure in prospectuses and registration statements. In addition, our inspection staff is examining and reporting on the derivatives activities of each fund inspected. We are considering whether our inspection process should be augmented by periodic reporting to the Commission of fund portfolio holdings.

We believe it is important that investors receive understandable disclosure about the manner in which a mutual fund uses derivatives and the associated risks. To address this

problem, last February, the Commission staff issued a letter to all registered investment companies, noting that in many cases fund disclosures regarding derivative instruments are unduly lengthy and technical. The letter encourages funds to identify areas of derivatives disclosure that can be modified to enhance investor understanding of the risks associated with derivative instruments.[34]

The Commission continues to work to improve derivatives disclosure through our review of prospectuses filed by mutual funds. We also are considering whether rulemaking is appropriate to enhance risk disclosure to mutual fund investors, perhaps through requiring some form of standardized, quantitative risk disclosure.

Adequate management controls are critical to a mutual fund's ability to monitor the risks associated with derivatives. Adequate management controls also are important to accurate pricing of derivative instruments, which may be a difficult task in the case of certain OTC derivatives. In our inspections, we have found that a number of funds appear to have strong management controls in place, but we remain concerned that these funds may not be fully representative of the industry. We will continue to inspect funds' management controls and will consider rulemaking, as appropriate, to encourage better management controls.

We also are reviewing the regulatory limitations on mutual fund investments in derivatives. In general, the Investment Company Act of 1940 ("Investment Company Act") does not contain broad prohibitions on a mutual fund's investment in any particular type of instruments, including derivatives. The Investment Company Act does, however, contain limitations on a fund's use of leverage,[35] which the Commission staff has interpreted as restricting fund investments in certain derivative instruments that create fund obligations to

someone other than fund shareholders -- for example, a put option written by the fund that obligates the fund to purchase securities from the option holder.[36] The staff also has taken the position that mutual funds must not invest more than 15% of their net assets in illiquid assets,[37] and certain derivative instruments are illiquid. We are reviewing these leverage and liquidity restrictions in the context of derivative instruments to determine whether they continue to reflect appropriate regulatory policies and whether they should be supplemented by other forms of regulation.

The use of derivatives by money market funds is another area that has merited our special attention.[38] Over the past two and one-half years, we have been looking at money market fund use of financially engineered instruments that may be able to achieve their intended results only in a stable interest rate environment. In particular, we are concerned that money market funds have purchased new types of adjustable rate instruments whose market value may not return to par at the time of an interest rate adjustment, with the result that fund share price stability could be threatened.[39] Most recently, we raised the issue in proposing amendments to Rule 2a-7 under the Investment Company Act, our money market fund rule.[40] Money market funds form a particularly important segment of the industry because, despite the disclaimers, individual investors often perceive these funds as the functional equivalent of insured bank accounts.

We have acted, and will continue to act, to enhance investor protection in the area of mutual fund derivative investments. I also have urged fund directors to exercise meaningful oversight of fund derivative investments, involving themselves in portfolio strategies, risk management, disclosure and pricing issues, accounting questions, and internal controls.[41] While the Commission's resources are sufficient to permit it to scrutinize the derivatives activities of individual mutual funds on only a periodic basis,[42] the directors of each fund are

positioned and obligated to promote the interests of the fund's shareholders on an ongoing basis.

E. Dealers' Activities

Broker-dealers in securities and their affiliates have been involved in the OTC derivatives business since its inception. Generally acting as intermediaries, these firms principally undertake a dealer or market making function. Within this context, dealers attempt to create so called "matched books" in derivatives by utilizing offsetting derivatives contracts or by hedging their exposures with securities or other types of financial instruments, such as futures. These dealers play a significant role in the OTC derivatives market; in relation to banks, however, as the GAO Report points out, the amount of activity undertaken by securities firms is relatively small. Moreover, as noted earlier, the aggregate replacement cost of derivatives contracts by securities firms is a small percentage of the total notional amount of these contacts.

Significant trading by securities firms in OTC derivatives has been confined to six highly capitalized institutions. These firms tend to be sophisticated global conglomerates whose activities cross financial products and international borders. Although expanding, the client base of these firms also tends to be large, sophisticated institutional counterparties, sensitive to credit exposures and attentive to sound risk management. The sophistication and credit sensitivity of the marketplace, together with the discipline imposed by the rating agencies, has led to the development of a generally well-managed and capitalized dealer community.

Moreover, the derivatives activities of securities firms are not conducted in the dark. To the extent derivatives are transacted in the broker-dealer registered with the Commission,

the entity and the products are subject to the entire panoply of Commission regulation, including capital standards, suitability requirements and strong examination and enforcement programs. To the extent OTC derivatives products are booked in an affiliate of the broker-dealer, not only does market discipline demand a high degree of creditworthiness and sophistication, but the Commission's risk assessment program provides us with substantial information concerning the activities and exposures of unregistered OTC derivatives dealers.

We view the information gathered under the risk assessment program as a significant complement to the Commission's existing broker-dealer regulatory authority. The risk assessment rules developed based upon the Commission's need for information about the activities of broker-dealer affiliates within holding companies. Several years ago, the Commission petitioned Congress for, and received under the Market Reform Act of 1990 ("Market Reform Act"), broad authority to require information concerning the activities of broker-dealer affiliates.′ Pursuant to the Market Reform Act, the Commission adopted rules establishing a risk assessment program[43] that requires broker-dealers to report information on their material affiliates within the holding company group. In this way, the Commission monitors the activities of unregistered OTC derivatives dealers.[44]

Under the risk assessment program, the Commission receives sufficient information to assess the nature of the business transacted by derivatives dealers, their exposures, and the potential risk affiliates may cause to registered broker-dealers. Specifically, the Commission receives quarterly and annual financial statements, including profit and loss information, from material affiliates engaged in derivative financial activities, together with information on the volume, replacement cost, and significant counterparty concentrations for interest rate, foreign exchange, securities, and commodities products. Additionally, the Commission receives and reviews the risk management policies employed by major U.S.

securities firms. Such policies include the broker-dealer's methods for monitoring and controlling market, credit, and funding risk. To enable the Commission to monitor significant credit exposures, the rules require broker-dealers to furnish for OTC derivatives a counterparty breakdown where credit risk exceeds a defined materiality threshold. The GAO Report suggests that the Commission's threshold is too high to obtain sufficient information for detecting potential credit risk problems among OTC dealer affiliates of securities firms. This is an area I expect will be reviewed in connection with the staff's ongoing review of the risk assessment program.

Beyond formal reporting requirements, the Commission works closely with representatives of the major dealers to gain an in-depth understanding of their OTC derivatives activities based on the information contained in the filed reports. Commission staff routinely meets with the major U.S. securities dealers and reviews, in some detail, the nature and extent of dealer exposures. Particular attention is paid to a review of the controls employed by the major U.S. securities firms to manage credit risk. These reviews generally include an examination of credit functions, such as the capability to perform credit analyses, approve and set counterparty credit limits, approve specific transactions, recommend credit reserves, and manage overall credit exposure. Reviews also typically include an evaluation of whether standards requiring that senior management approve transactions involving extensions of credit above authorized levels are being followed.

It is extremely important that derivatives activities be undertaken in entities that operate under a broad umbrella of risk management policies, commensurate with the level of risk involved, that include adequate systems of risk management controls. Adequate risk management policies, for example, must include the maintenance by derivatives dealers of

independent risk management functions, such as the establishment of credit and internal audit committees separate from the trading functions of the firm.[45]

Moreover, the role of chief executive officers and board members cannot be overlooked. While the board and senior management may not work in the trenches of the trading room, ultimately they are responsible for the direction of the firm, and its "appetite for risk." I believe it is important that they be fully aware of the nature and extent of risk inherent in the derivatives activities undertaken by the trading operation. Optimally, the board should promulgate clearly articulated policies concerning derivatives, and work actively to update those policies as business and market climates change. I applaud boards that have taken such active roles in derivatives risk management and encourage all boards and CEOs to strive to do more in this area.

In order to assess the state of dealer risk management controls, I recently instructed the staff to survey the major U.S. securities firms to determine the extent to which the major derivative broker-dealers and their affiliates are utilizing or implementing the 20 risk management control recommendations contained in the Group of Thirty Report.[46] The responses to our survey of risk management controls indicate substantial conformity to the Group of Thirty Report's recommendations among the top-tier of U.S. securities firms. The firms surveyed account for virtually all of the OTC derivatives activity undertaken by U.S. securities firms. Although this is positive news, we also believe that risk management policies must continue to evolve and adapt to changes in business practices and technology.

In addition to this effort to examine the risk management systems of derivatives dealers, the Commission's existing financial responsibility rules provide a check on the internal controls of broker-dealers registered with the Commission. Specifically, the

Commission's rules require the independent audit of a broker-dealer's internal controls, and the auditor's report to management, or the Commission, if necessary, of any material inadequacies in such internal controls.[47]

We do not believe it is appropriate at this time for the Commission to mandate specific management policies applicable to dealers in derivatives. One of the strengths of the OTC derivatives market is its flexibility and its ability to change. For this reason, the "state-of-the-art" in management controls can be expected to evolve; to freeze today's standard for the future may prove to be a mistake. We would advocate a more fluid approach, whereby industry representatives and regulators would act together to ensure that risk management systems are up to the complex task of controlling the risks in OTC derivatives trading. Our focus will be on the details of internal and external audit functions, and the operation of audit committees. Our goal will be communication and implementation of the most sound risk management practices.

Currently, we regulate only those entities, including broker-dealers, that are registered with the Commission. The Commission always has advocated a strong broker-dealer regulatory program, which requires strong capital standards. Capital standards should provide protection against market downturns and excessive leverage, while not preventing the flow of capital into the securities industry or unduly diminishing a dealer's return on equity. The Commission's primary financial responsibility standard, the net capital rule, ensures that sufficient net, liquid assets are maintained by broker-dealers and is designed to insulate them against potential market and credit risks.[48]

Under the net capital rule, broker-dealers are required to maintain certain amounts of liquid assets, or net capital, based on the amount and type of business the firm transacts.

Because the net capital rule's existing structure reflects the traditional nature of a broker-dealer's business, which historically was a short-term trading business, the growing importance of OTC derivative products, which tend to be longer term and reliant on credit, has presented new challenges. Currently, the net capital rule discourages broker-dealers from incurring credit risk by assessing a 100% capital charge on unsecured receivables. We have been informed that these charges have contributed to the movement of activities in many OTC derivatives, such as swaps, from registered broker-dealers to their affiliates.

Due to concerns that the net capital rule may not appropriately reflect the risks inherent in derivative products, and in light of the practice among dealers to conduct OTC derivatives activities in unregistered entities, the Commission currently is undertaking a comprehensive review of its capital rule. On May 4, 1993, the Commission issued a concept release regarding the application of the net capital rule to derivative products,[49] which sought public comment on the appropriate net capital treatment of the market risk on options, currency forwards, currency swaps, interest rate swaps, and equity swaps and the credit risk on OTC derivative products. Although the Commission's net capital rule applies only to registered broker-dealers, the concerns raised in the concept release are relevant to all derivatives dealers, as well as end-users transacting business with derivatives dealers.

As a first step in revising the net capital rule in the derivatives area, the Commission, on March 15, 1994, issued a release proposing the use of a theoretical pricing model to set capital charges for listed options and related positions.[50] This proposal is significant because it would incorporate, for the first time, modern portfolio theory into the net capital rule. The proposal only applies to listed options and related positions because the Commission believed it would be appropriate to begin this more sophisticated approach to capital charges under a controlled environment. Commission staff, however, is currently

working with the industry on an objective approach that would extend this theoretical pricing approach to OTC options, including debt options.

As a second step in revising the net capital rule, the Commission staff is developing an approach that would integrate interest rate swaps, futures and forward contracts on debt instruments, government securities, and debt securities into a unified computation of market risk capital charges. This initiative is substantially similar to the international proposal of the Basle Committee on Banking Supervision, and we have been working with our international counterparts in developing it.

Finally, in addition to the market risk proposals discussed above, the staff is developing a proposal that would assess capital charges on the credit risk inherent in certain OTC derivative products including OTC options, interest rate swaps, and foreign currency forwards. As mentioned above, the net capital rule currently assesses a 100% charge on unsecured receivables, or credit risk. The staff is reviewing proposals of various industry representatives in devising a more sophisticated approach that would accommodate broker-dealers trading OTC derivative products in registered entities. Our goal is to revise completely the application of the net capital rule to OTC derivatives transactions in a manner that both reflects modern financial theory and contemporary risk reducing techniques, while still providing the safe capital base necessary to protect our markets.[51] I am confident that working together, the Commission and the industry can, in the near future, fashion capital charges that realistically and adequately address the risks in OTC derivatives.

While our efforts in implementing the risk assessment program and revising the net capital rule have been effective and responsive in ensuring the financial integrity of broker-dealers subject to its rules, we share GAO's concern regarding the activities conducted in

unregulated affiliates of broker-dealers. Specifically, we believe more can, and should, be done to address the following areas:[52]

- Capital standards that deal with market and credit risks and leverage concerns. In particular, such standards should specifically address the ability of a firm to withstand "volatility shocks" and valuation uncertainties in times of market stress;
- Suitability standards that specifically address OTC derivatives transactions;
- Risk management controls that will enable firms to monitor adequately OTC derivatives activities and the risks arising therefrom, including their cash market relationships;
- Approaches for addressing legal uncertainties regarding enforceability of netting arrangements;
- Recordkeeping and reporting requirements, including audits by independent public accountants; and
- Examination and enforcement by the Commission and, if appropriate, a SRO.
- More generally, in addition to issues related to the integrity of individual firms, we also must be cognizant of the potential interaction between the trading activity by derivatives dealers and the cash markets.

Implementation of any such regulatory plan may require legislative or regulatory action, or some combination of the two. At this time, we are not submitting a legislative request to Congress. We believe that the Commission has appropriate tools for existing oversight. The Commission also has experienced a high level of cooperation by both

registered broker-dealers and their unregistered affiliates in discussing how to improve oversight, and we have every expectation that we can work with the industry to develop such a regulatory plan. It, however, may become necessary to come back to Congress with a request for specific legislative action and we will not hesitate to do so. For the time being, I intend to explore with the industry and others the best methods of accomplishing these regulatory goals. I look forward to working through these challenges and call on market participants to join the Commission and others, particularly the CFTC, in a serious, committed effort to tackle these complex issues.

Finally, any effective solution ultimately will require coordination with banking and other domestic regulators, as well as the international community. It is critical, however, to bring the securities dealers under prudent standards quickly, even while addressing the complex task of more harmonized standards across markets and institutions.

F. Netting

Aside from more comprehensive coverage of dealers' activities and improved accounting and disclosure standards, there is a need for further action in several other areas involving derivatives. One of these involves the need for greater certainty and coordination in the bankruptcy treatment of derivative products in order to reduce systemic risk. By reducing settlement risk as well as credit exposure, netting contributes to the reduction of systemic risk in the derivatives market by decreasing the number and value of daily settlement obligations and by permitting participants to execute more transactions before reaching their credit limits.

The Commission has been active in efforts to eliminate uncertainty over the enforceability of netting arrangements. In this regard, the Commission supported the

passage of the netting provisions in the FDICIA,[53] which expressly affirms the enforceability of netting arrangements between financial institutions. The Commission also has worked with the Board of Governors of the Federal Reserve System on a proposal that would expand the pool of institutions qualified to rely on the netting provisions under FDICIA to include swaps dealers meeting certain financial thresholds.

Despite the many efforts that have been made to eliminate uncertainty in this area, there continues to be concern about certain scenarios where there may be questions regarding the enforceability of netting provisions. The Group of Thirty Report identifies certain circumstances where the current regulatory scheme leaves an element of uncertainty.[54] For example, if the transaction is not expressly enumerated under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") or the Bankruptcy Code, such as spot foreign exchange agreements, and FDICIA does not apply, then an element of uncertainty remains in the process. The Commission continues to work with other regulators and with industry representatives, including the Commission's Market Transactions Advisory Committee, toward revising the laws to eliminate this netting uncertainty.

The establishment of a properly structured and regulated clearinghouse could help to reduce the legal, operational, and credit risks for OTC derivatives dealers and end-users. A clearinghouse for swaps transactions, for example, would benefit dealers by improving data collection, trade matching, and risk management, by enhancing the potential for multilateral netting and mutualization of risks, and by providing centralized management of relations with and dissemination of information to regulators, banks, and market participants. In addition, a swaps clearinghouse would help reduce the credit exposure of end-users by shielding them from the default of a particular counterparty. This protection may become

more important as the OTC market expands. Finally, in the Commission's experience, clearinghouses provide dealers and end-users with operational efficiencies that can result in savings to dealers, even if they are not direct participants in the clearinghouse, which could be passed on to end-users.[55] Although many issues need to be resolved before a swaps clearinghouse could be established, the Commission staff will work with other regulators and industry participants to resolve legal or regulatory impediments to the development of a clearinghouse.[56]

G. Suitability

Another area worthy of consideration is the suitability of recommendations in derivative products. The customer base of the derivatives market, which began with only the largest, most sophisticated institutions, will expand over time. The use of derivatives by a wider range of potential end-users raises different suitability concerns depending on the end-user. For example, the concerns created by the use of derivatives by highly sophisticated multi-national companies to manage their business exposures differ from those raised when the end-user is a pension fund or a foundation seeking to protect its financial assets. When retail investors are added to this mix, additional concerns are raised.

Highly sophisticated end-users may understand derivatives products and trading strategies. Less sophisticated institutional and retail customers simply may not understand these products and strategies as well. This situation makes it necessary to ensure that suitability standards take into account the differences among derivatives users. In all cases, however, end-users should have adequate information to evaluate the risks inherent in the product being purchased.

Securities SRO rules already require broker-dealers to make suitability determinations before recommending customer trades. Their rules generally require that broker-dealers have reasonable grounds for believing that their recommendations are suitable for a customer based on information regarding the customer's financial situation and needs. Broker-dealers effecting transactions in options, whether such securities are traded on an exchange or in the OTC market, are subject to additional requirements. For example, NASD rules require specific approval of customer accounts for OTC options trading.

The Commission's staff will work with the SROs to evaluate whether broker-dealers are making suitable recommendations to customers engaging in derivatives transactions. We will request a meeting with a group of representatives of the SROs to hear their thoughts and suggestions on the issue as well as on the development of suitability standards for OTC derivative products. Such discussions are part of the process of implementing the agenda for oversight of the OTC derivatives market specified in the recently issued joint statement by the Commission, the CFTC, and the U.K. Securities and Investments Board ("SIB"). In addition, I think it is particularly important to develop suitability standards that specifically address recommendations in OTC derivatives transactions.

H. Regulatory and International Coordination

Aside from the areas of concern to the Commission's program, we recognize that derivative products and dealers cross product, regulatory, and international boundaries. For this reason, we strongly support interagency -- and international -- cooperation as a means of addressing areas of concern regarding derivative products. Accordingly, the Commission and staff regularly meet with banking and futures regulators to discuss a broad range of structural and policy issues, including developments in, and various risks posed by, the derivatives market. These meetings provide the participants with a valuable opportunity to

draw upon each agency's experience and expertise. The Working Group has been revived and is expressly dealing with the issue of derivative products. Over the past few months, the Working Group has held a number of meetings to discuss a broad range of structural and policy issues concerning OTC derivative markets.

In addition, the Commission coordinates with foreign regulators in the regulation of risks associated with OTC derivative products. Specifically, the Commission is an active participant in working groups and committees of the International Organization of Securities Commissions ("IOSCO") and working groups of the Basle Committee on Banking Supervision ("Basle Committee"). Both organizations have been discussing capital standards for equity and debt securities positions, including derivative positions.

Finally, on March 15, 1994, the Commission, the CFTC, and the SIB issued a joint statement setting forth an agenda for the oversight of the OTC derivatives market. Recognizing the size and the global nature of the OTC derivatives market, the joint statement identifies ways in which these three agencies can cooperate in their respective regulatory approaches to OTC derivatives and is intended to provide a framework for enhanced international regulatory cooperation. The staff of the Commission, the CFTC and the SIB have held discussions on the actions necessary to implement the joint statement, including, among others matters, the development of mechanisms for exchanging information on the operations of significant derivative dealers, addressing the legal uncertainties of netting arrangements, and stress testing major dealers' proprietary models for capital charges.

One of the goals of the joint statement was to promote wider regulatory cooperation by taking the joint statement to other regulators, both domestic and international.

Accordingly, Andrew Large, the Chairman of the SIB, and I sent a letter to Mr. Sohei Hidaka, the Director-General of the Securities Bureau of the Ministry of Finance in Japan, expressing our hope that the joint statement would provide a basis for further multilateral issues in this area. We are happy to say that the Japanese Ministry of Finance has agreed in principle to work with other regulators in the area of OTC derivatives oversight.

The Commission agrees with GAO's recommendation for the U.S. regulators to exhibit leadership in harmonizing international standards for derivative products. We believe that because of the global nature of the OTC derivatives market, any effective regulatory framework must include international cooperation and coordination. The joint statement provides an excellent basis for this type of relationship. Our goal is to involve the Group of 10 countries in discussions regarding the implications of derivatives for the global financial system. It is important to remember, however, that international cooperation and harmonization does not mean lowering regulatory standards to the lowest common denominator.

CONCLUSION

To conclude, I would like to emphasize that the U.S. securities markets remain the most vibrant and healthy markets in the world. One of the assets of our markets is their ability to assimilate technological innovations and new products. The development of the OTC derivatives markets has provided benefits to our marketplace and its participants -- but any new development must be watched closely. We have done so, and under the approach we have set forth today, will continue to move forward. The Commission remains committed to ensuring that our markets continue to be the national resource they are globally recognized to be.

1. United States General Accounting Office, Pub. No. 94-133, Financial Derivatives: Actions Needed to Protect the Financial System (1994) [hereinafter GAO Report].

2. The term "derivative" can be used to refer to any financial product that derives its value from other assets. Derivative products, therefore, encompass not only standardized financial products such as options and futures, which have been traded on exchanges for many years, but also customized products such as swaps and forwards, which are traded by dealers in the OTC market.

3. In response to the growing OTC market for stock index options, the Chicago Board Options Exchange developed an OTC-type of stock index options contract for trading on an exchange. These Flexible Exchange Options, or "FLEX Options," are large-sized, customized index options. In addition, the Philadelphia Stock Exchange has proposed establishing a FLEX framework for foreign currency options. The Commission believes that FLEX Options benefit market participants who effect transactions in the OTC marketplace in numerous ways.

4. In general, concerns expressed regarding the growth of derivatives are directed at the more exotic OTC derivative products, which are sold and intermediated for the most part by the major banks and securities dealers. These concerns arise, in part, because of large exposures created by these products for the major financial institutions. In addition, because OTC derivative products often are complex in design, they can be difficult for dealers and end-users to manage.

5. *Concerning Safety and Soundness Issues Related to Bank Derivatives Activities: Hearing Before the House Committee on Banking, Finance and Urban Affairs*, 103rd Cong., 1st Sess. 103-88 (1993) (testimony of J. Carter Beese, Jr., Commissioner, U.S. Securities and Exchange Commission).

6. Procter & Gamble and Gibson Greetings announced in April 1994 that they had lost $102 million and $19.6 million, respectively, on interest rate swaps. On May 12, 1994, Air Products & Chemicals Inc. announced that it lost $60 million on interest rates swaps. In addition, Marion Merrell Dow announced in April 1994 that it expected to take a charge of between $11.9 million and $13.9 million from investments lost as part of Askin Capital Management hedge funds liquidation. The ARCO pension fund announced in April 1994 that it lost $22 million, which accounts for 5.3% of its principal, from derivatives activities.

7. *See e.g.*, GAO Report, *supra* note 1; Financial Accounting Standards Board, Proposed Statement of Financial Accounting Standards, "Disclosure About Derivative Financial Instruments," (Apr. 14, 1994) [hereinafter Exposure Draft]; House Banking Committee Minority Staff, 103rd Cong., 1st Sess., Report on Financial Derivatives (November 1993); Group of Thirty, "Derivatives: Practices and Principles," (July 1993) [hereinafter Group of Thirty Report].

8. Group of Thirty Report, *supra* note 7.

9. Exposure Draft, *supra* note 7.

10. The exposure draft suggests ways of reporting quantified information including the disclosure of: (1) more details about current positions and, perhaps, activities, (2) the hypothetical effects on equity or annual income of various changes in market prices, (3) a gap analysis of interest repricing on maturity dates, (4) the duration of financial instruments,

or (5) the entity's largest value at risk level during the reporting period and as of the end of the reporting period from derivative financial instruments and from other positions. Exposure Draft *supra* note 7.

11. *See* Accounting Series Release ("ASR") No. 123 (Mar. 23 1972), 37 FR 6850; In re McKesson & Robbins, Inc., ASR No. 19 (December 5, 1940), [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,020.

12. ASR No. 123, (March 23, 1972), 37 FR 6850.

13. *See* SEC Division of Corporation Finance, Staff Report on Corporate Accountability, printed for use by the Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess., 486-510 (September 4, 1980).

14. Item 7(e) of Schedule 14A, 17 C.F.R. § 240.14a-101.

15. Item 304 of Regulation S-K, 17 C.F.R. § 229.304.

16. *See, e.g.*, In re Theodore Hofmann, Accounting and Auditing Enforcement Release ("AAER") No. 513, (January 4, 1994); SEC v. Software Toolworks, Inc., AAER No. 495 (September 30, 1993); SEC v. American Biomaterials Corporation, AAER No. 187 (April 19, 1988); SEC v. Gemcraft Inc., et al., AAER No. 107 (July 31, 1986).

17. *See, e.g.*, The Institute of Internal Auditors Research Foundation, Improving Audit Committee Performance: What Works Best (A Research Report Prepared by Price Waterhouse, 1993).

18. *See* Form N-SAR, Item 77B, 17 C.F.R. § 274.101.

19. *See* Exchange Act Rule 17a-5(g) and (j), 17 C.F.R. § 240.17a-5(g) and (j). The reporting requirements for broker-dealer rules require that any "material inadequacies" be disclosed. A "material inadequacy" would include any condition that has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to (i) inhibit a broker-dealer from promptly completing securities transactions or promptly discharging its responsibilities to customers, other broker-dealers, or creditors, (ii) result in material financial loss, (iii) result in material misstatements in the broker-dealer's financial statements, or (iv) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in one of the three conditions described herein. *Id.*

20. *See* Exchange Act Rule 17Ad-13, 17 C.F.R. § 240.17Ad-13.

21. 15 U.S.C. § 78m(b)(2).

22. Accounting Series Release No. 278 (June 6, 1980).

23. Securities Act Release No. 6789 (July 19, 1988), 53 FR 28009 (July 26, 1988).

24. Securities Act Release No. 6935 (April 24, 1992), 57 FR 18421 (Apr. 30, 1992). In addition, the Commission has since noted that "mandatory auditing of internal controls" could result in "enormous costs with relatively few real benefits." Statement of Richard C. Breeden, Chairman, Securities and Exchange Commission, Before the Subcommittee on

Telecommunications and Finance of the House Committee on Energy and Commerce, Concerning H.R. 574, The Financial Fraud Detection and Disclosure Act (Feb. 18, 1993) at 35.

25. The Federal Deposit Insurance Corporation Improvement Act, Pub. L. 102-242, § 112.

26. GAO, Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD 91-43, April 1991) at 8 and 34.

27. Committee of Sponsoring Organizations of the Treadway Commission, Internal Control - Integrated Framework (August 1992).

28. 12 C.F.R. §§ 363.2(b) and 363.3(b), and FDIC, Guidelines and Interpretations Concerning Annual Independent Audits and Related Requirements of Insured Depository Institutions, Appendix to Part 363, Chapter III, Title 12, Code of Federal Regulations, ¶¶ 9 and 10 (May 1993), which indicate that the internal control policies should include the safeguarding of assets. The American Institute of Certified Public Accountants has adopted relevant guidance in Statement on Standards for Attestation Engagements No. 2, " Reporting on an Entity's Internal Control Structure Over Financial Reporting" (May 1993).

29. AICPA, Statement on Auditing Standards No. 53, "The Auditor's Responsibility to Detect and Report Errors and Irregularities," ¶ 5 (effective January 1989).

30. Investment Company Institute, Derivative Securities Survey, February 1994. Survey respondents included 52 fund complexes with 1,728 long-term funds (52% of industry long-term funds) holding aggregate net assets of $958 billion (76% of industry long-term assets).

31. *See, e.g., Bond Fund Sets Disclosure Pact on Derivatives,* Wall St. J., Apr. 18, 1994, at C1; *Paying the Piper,* Barron's, Apr. 11, 1994, at 15; *Derivatives Undo a Popular Paine Webber Fund, Triggering 4% One-Day Drop in Its Value,* Barron's, May 16, 1994, at MW12; *Sinking Funds,* Barron's, May 16, 1994, at MW12.

32. *See Derivatives Undo a Popular Paine Webber Fund, Triggering 4% One-Day Drop in Its Value,* Barron's, May 16, 1994, at MW12.

33. McGough, Robert, *Piper Jaffray Acts to Boost Battered Fund,* Wall St. J., May 23, 1994, at C1. *The Wall Street Journal* reported that the Piper Jaffray Companies have taken the unusual action of investing $10 million in the fund, the Piper Jaffray Institutional Government Income Portfolio.

34. Letter from Carolyn B. Lewis to Registrants (Feb. 25, 1994).

35. Section 18 of the Investment Company Act prohibits mutual funds from issuing any "senior security" other than a borrowing from a bank. Such borrowings cannot exceed one-third of a fund's assets. Investment Company Act of 1940, § 18, 15 U.S.C. § 80a-18.

36. The Commission staff has taken the position that some derivative investments are, in effect, senior securities because they create a fund obligation senior to the claims of fund shareholders. The staff has permitted such investments if they are "covered" or if fund assets are earmarked to collateralize the fund's obligation. For example, a put option obligates the writer to purchase the "underlying" on exercise. Therefore, a mutual fund

may write a put option only if the fund either covers the position (*e.g.*, sells short the "underlying" at a price no less than the option strike price) or segregates cash, U.S. government securities, or other high grade debt securities in an amount equal to the option strike price. *See, e.g.*, Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979); Dreyfus Strategic Investing and Dreyfus Strategic Income (pub. avail. June 22, 1987).

The Investment Company Act generally does not limit fund use of a derivative unless it creates a fund obligation to a third party.

37. An illiquid asset is any asset that may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment. *See* Guidelines for Form N-1A, Guide 4.

38. *See* Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Remarks at the Investment Company Institute Annual Conference, Washington, D.C. (May 18, 1994).

39. These instruments include capped floaters (whose floating rates will not adjust above a stated level), "CMT floaters" (whose floating rates are tied to longer term rates and which will not return to par if the relationship between short- and long-term rates changes), leveraged floaters (whose floating rates move at multiples of market interest rate changes), dual index floaters (whose interest rates are tied to two indexes and which will not return to par if the relationship between the two indexes changes), and COFI floaters (whose floating rates are tied to the Cost of Funds Index, which substantially lags market rates).

40. Investment Company Act Release No. 19959 (Dec. 17, 1993), 58 FR 68585, 68601-68602 (Dec. 28, 1993). Rule 2a-7 allows the maturity of adjustable rate instruments to be determined by reference to interest rate adjustment dates if the instrument "can reasonably be expected to have a market value that approximates its par value" upon adjustment of the interest rate. The proposed rule would clarify that the board of directors or its delegate must have a reasonable expectation that, upon adjustment of an instrument's interest rate at any time until the final maturity of the instrument or until the principal amount can be recovered through demand, the instrument will return to or maintain its par value.

41. Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Mutual Fund Directors: On the Front Line for Investors, Remarks at Mutual Funds and Investment Management Conference, Scottsdale, Arizona (Mar. 21, 1994).

42. The Commission's resources for mutual fund inspections have lagged far behind the growth of the industry in recent years. *See* Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Appropriations for Fiscal Year 1995, Before the Subcommittee on Commerce, Justice, and State, the Judiciary, and Related Agencies of the Senate Committee on Appropriations (May 5, 1994) at 4-6.

43. Exchange Act Release No. 30929 (July 16, 1992), 57 FR 32,159 (July 21, 1992); Rules 17h-1T and 17h-2T and Form 17H.

44. The Market Reform Act also gave the Commission authority to promulgate rules that would establish an identification, recordkeeping, and reporting system for large trader accounts and transactions. In January of this year, the Commission proposed its Large Trader Reporting System, which will provide us with another information source regarding the relationship between the derivatives and cash markets. *See* Exchange Act Release No.

33915 (Apr. 19, 1994), 59 FR 19685 (Apr. 25, 1994); Exchange Act Release No. 33608 (Feb. 9, 1994), 59 FR 7917 (Feb. 17, 1994).

45. The SEC, CFTC and SIB recently issued a joint statement setting forth an agenda for the oversight of OTC derivatives. The joint statement included an agreement by these three regulatory agencies to work together and with appropriate industry groups and participants to promote the development of sound management controls for the risk management of OTC derivative products by securities and futures firms. Specifically, the joint statement listed the following seven concepts that management controls should embrace:

> (1) Policies about derivative activities should be promulgated by the board of directors and should be reviewed as business and market circumstances change;
>
> (2) Execution of these policies should be supported by valuation procedures and techniques, and risk management and information systems designed to ensure the adequacy of both management information and external reporting;
>
> (3) Responsibility for implementing the policies should be clearly delineated and the board of directors should define appropriate levels of and delegated authority for those responsible for implementing board policies for supervising OTC derivatives activities;
>
> (4) Information systems should be designed to achieve full compliance with the policies and principles, assist in the active management of derivatives activities, and provide an adequate flow of relevant information about the derivatives activities not only of the firm but also of its related entities on a world-wide basis;
>
> (5) Appropriate expertise should be maintained at all levels of a firm;
>
> (6) Internal controls should include units, which are independent of trading personnel and report directly to senior management, dedicated to the evaluation of credit, market, and legal risks; and
>
> (7) Appropriate use should be made of risk reduction techniques, such as master agreements and credit enhancements, including collateralization.

Statement of the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Securities and Investments Board (March 15, 1994).

46. Group of Thirty Report, *supra* note 7.

47. *See supra* note 19.

48. Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1.

49. Securities Exchange Act Release No. 32256 (May 4, 1993), 58 FR 27486 (May 10, 1993). *See* Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Securities and Exchange Commission to Mary L. Bender, The Chicago Board Options Exchange and Timothy Hinkas, The Options Clearing Corporation, dated March 15, 1994.

50. Securities Exchange Act Rel. No. 33761 (March 15, 1994), 59 FR 13275 (March 21, 1994).

51. While I believe these proposals would provide broker-dealers with an objective, and reasonable method of assessing capital charges on derivative instruments, the securities dealers have argued that we should forego fixed standards and instead allow broker-dealers to use their own internal proprietary models to calculate capital requirements. Before such an approach can be approved, the Commission first must be certain that it would be able to rely upon such models to yield consistent and independently verifiable results.

52. As discussed in the text, efforts also are underway by FASB and the Commission in the development of accounting recognition measurement and disclosure standards that will result in financial statements that achieve greater market transparency and adequate information for the users of those statements.

53. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102-242.

54. For a detailed analysis of the issues surrounding OTC derivatives and netting under the Bankruptcy Code, FIRREA, and FDICIA, see "Over-the-Counter Derivatives Transactions: Netting under the U.S. Bankruptcy Code, FIRREA and FDICIA," Memorandum of Law for the International Swaps and Derivatives Association, Inc. prepared by Cravath, Swaine & Moore (June 22, 1993).

55. A swaps clearinghouse also might increase the liquidity of the market.

56. In order for a clearinghouse to manage effectively the risks swaps create, it must be able to obtain accurate historical measures of price and volatility. Currently, however, there is a lack of publicly reported data to permit pricing of rights and obligations to protect against potential price volatility. In addition, it would be necessary to determine whether a sufficient number of OTC derivatives had achieved an adequate level of fungibility to make an OTC derivatives clearinghouse practicable.

Mr. MARKEY. Our next witness is the Honorable Eugene Ludwig, who is the Comptroller of the Currency.

We welcome you back, sir. Whenever you are comfortable, please begin.

STATEMENT OF HON. EUGENE A. LUDWIG

Mr. LUDWIG. Thank you, Chairman Markey and members of this subcommittee. I appreciate the opportunity to testify here today.

As the Federal supervisor of most of the commercial bank assets in this country, the Office of the Comptroller takes the safety and soundness issues surrounding the rapid growth in derivative financial instruments very seriously indeed. As detailed in my written testimony, our office has devoted substantial resources to improving our understanding of these issues and to strengthening our supervision of bank derivatives activities.

In addition, my written testimony provides our comments on the General Accounting Office report issued last week that examines derivatives and our response to the issues raised by your letter of invitation.

In the interest of time I submit the written statement for the record, and this morning I will focus my oral statement on recent initiatives that the Office of the Comptroller has taken to augment supervision of bank derivatives activities. No other area of bank supervision has received more of my attention since I arrived at the Office of the Comptroller.

Soon after I became Comptroller, I recruited Douglas E. Harris as my special policy advisor. Mr. Harris was a Senior Attorney and Managing Director of J. P. Morgan and Co., with substantial expertise in derivatives activities of major Wall Street securities firms as well as commercial banking organizations.

Mr. Harris formed the Office of the Comptroller's Derivatives Task Force. One of the first products of the Task Force was Banking Circular 277, Risk Management of Financial Derivatives, which we issued to the chief executive officers of all national banks in October of last year. We were the first banking agency to issue guidance directly to bank management on managing the risks of financial derivatives.

Among its provisions, BC 277 advises banks to set up and follow appropriate risk limits and to establish appropriate internal controls. We expect all national banks—end-users and dealers—to apply the provisions of BC 277 to all their derivatives activities and, to the extent possible, to all analogous risk activities.

Earlier this month, we issued 23 pages of further guidance to banks in the form of commonly asked questions and answers in this area. The questions and answers cover such topics as the duties of senior management and the board of directors for oversight of derivatives activities, and the responsibility of dealers towards end-users.

We are developing and will soon issue supplemental examiner guidance to accompany BC 277, which will include detailed, comprehensive procedures for examining the derivatives activities of national banks.

Mr. Chairman, the Office of the Comptroller has not been alone in paying supervisory attention to bank derivatives activities.

Among the bank regulators, both domestically and internationally, there has been substantial coordination on derivatives issues.

Last September, the Office of the Comptroller called for the creation of an informal interagency task force on bank-related derivatives issues. This task force, which includes staff from our office, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision, is coordinating derivatives policy among the banking agencies, including accounting and disclosure issues.

Further, the Office of the Comptroller participates in the Working Group on Financial Markets led by Treasury Secretary Bentsen, which has added derivatives and interagency coordination on derivative activities to its agenda.

In addition, the Office of the Comptroller is working with other bank supervisors, both in the United States and abroad, to address bank capital requirements in light of derivatives activities. In this regard, I personally participate on the international committee, the so-called Basle Committee, of bank supervisors, which is in the midst of reviewing international rules, including capital rules, applicable to derivatives.

Mr. Chairman, we have come a long way on this issue. Based on our recent examinations of national banks and the discussions we have had with other market participants, it appears that, for the most part, national banks and especially the dealer banks have committed considerable technological and human resources to managing and controlling the risks from derivatives activities.

However, the Office of the Comptroller continues to have concerns about these activities. First, our examiners have found that at a few national banks the extent of senior management and board knowledge and oversight of bank derivatives activities is not as broad as we would like. Second, we are paying particular attention to bank trading and use of especially new and/or complex derivatives instruments, sometimes termed exotic instruments, including types of collateralized mortgage obligations, some structured notes and some highly leveraged over-the-counter transactions. Third, we are closely scrutinizing the proprietary trading units of some dealer banks. These units actively trade cash and derivative instruments to establish risk positions for the bank that are independent of the bank's other trading and risk management positions.

Finally, Mr. Chairman, I just want to note that, as my written testimony discusses in detail, the Office of the Comptroller, in general, supports—and, in fact, in BC 277 and elsewhere, we have anticipated—several of the recommendations in the GAO's report on derivatives. We particularly agree with those recommendations calling for greater coordination and harmonization among regulators and other groups overseeing bank derivatives activity, and, as I have stressed, we are working with U.S. and foreign regulators to develop coordinated policies.

Mr. Chairman, in conclusion, I just want to underscore that our policies and strategies for addressing bank derivatives activities are sound and appropriate. We are continuing to make progress toward addressing the particular concerns that I have noted and other important issues such as accounting and disclosure. We re-

main committed to participating in joint efforts to adopt and promote regulations and policies that address these evolving markets.

Thank you very much. I look forward to answering your questions.

Mr. MARKEY. Thank you Mr. Ludwig, very much.

[Testimony resumes on p. 262.]

[The prepared statement of Mr. Ludwig follows:]

TESTIMONY OF

EUGENE A. LUDWIG

COMPTROLLER OF THE CURRENCY

Mr. Chairman and members of the Subcommittee. I appreciate this opportunity to participate in today's hearing on derivative financial instruments. As supervisor of national banks, the Office of the Comptroller of the Currency (OCC) believes that the safety and soundness issues associated with bank use of derivatives are of great importance. The recent expansion of derivatives markets has provided banks and the public with important benefits: financial derivatives transactions allow banks and other market participants to manage their financial risks more precisely and efficiently than with other instruments, and they also often provide users with the lowest cost funding alternatives by reducing transaction costs and, in some cases, by exploiting arbitrage opportunities across financial markets. At the same time, the recent growth in derivatives markets has created new challenges: supervisors must ensure that banks using these often-complex instruments clearly understand and properly manage the associated risks and that banks have the financial resources to withstand market volatilities. In response, the OCC has devoted resources to improving our understanding of these issues and to strengthening our supervision of bank derivatives activity.

My testimony begins by describing the OCC's recent initiatives to augment its supervision of bank derivatives activity. Then, as requested by your invitation letter, my statement provides the OCC's comments on the General Accounting Office's (GAO) report examining the development and trading of derivative financial instruments by financial institutions and their customers. Because the final version of the GAO's report was released only last week, my

staff have not had the opportunity to review its findings and recommendations in detail. I therefore confine my remarks to preliminary comments on the report's more general findings.

The remainder of my testimony responds to the issues raised by your letter of invitation: the potential for derivatives to contribute to systemic risk, the nature and adequacy of internal controls and risk management systems at banks and non-bank end-users, the nature and adequacy of existing protections afforded to corporate and other end-users of derivatives, the nature and adequacy of the public disclosures provided to investors regarding derivatives holdings, and the possible need for any changes in the regulatory treatment of derivative financial instruments or the adoption of remedial legislation relating to such instruments.

OCC Supervisory Initiatives

The OCC has taken a number of important steps to increase our supervision of the derivatives activities of national banks. Soon after I became Comptroller, I recruited Douglas E. Harris, a Senior Attorney and Managing Director of J. P. Morgan and Co. with substantial expertise in the derivatives activities of major Wall Street securities firms and commercial banking organizations as my Special Policy Advisor. Mr. Harris formed and leads the OCC's Derivatives Task Force, which has produced additions to and refinements of OCC policy in this area.

One of the first products of the Task Force was OCC's Banking Circular 277 (BC 277), Risk Management of Financial Derivatives, which we issued on October 27, 1993 to the chief executive officers of all national banks. We were the first banking agency to issue guidance to bank management on managing the risks of financial derivatives. The circular states that banks should adopt systems and controls to properly measure and monitor the individual and aggregate risks associated with their derivatives portfolios. It also advises banks to set up and follow appropriate risk limits. BC 277 includes some separate standards for dealers and end-users. (Dealers are banks that take on principal risk and actively provide market liquidity to other dealers; and end-users include banks that use derivatives to actively manage their balance sheet risks.) BC 277 sets forth best practices and safe and sound procedures for managing risk, and we expect all national banks--end-users and dealers--to apply the guidance not only to their derivatives activities, but also to risk management generally, including their non-derivatives activities, to the extent possible.

On May 10, we issued 23 pages of further guidance to banks in the form of commonly asked questions and our answers to them. The questions and answers cover such topics as the duties of senior management and the board of directors for oversight of derivatives activities, monitoring the interconnectedness of risks, and the responsibilities of dealers toward end-users. We are developing supplemental examiner guidance to accompany BC 277, which will include detailed, comprehensive procedures for examining the derivatives activities of national banks. We plan to issue this guidance shortly.

The OCC is also participating in several domestic and international efforts to coordinate regulation of derivatives use. Last September. we helped to create an informal interagency task force to look at supervision of derivatives by bank and thrift regulators. The task force, which includes staff from the OCC, the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS), was organized to develop coordinated derivatives policies and procedures among the agencies. The task force is also working on accounting and disclosure issues. The group has several goals: to share information on the extent of banks' involvement in derivatives activities; to discuss ways of achieving greater cooperation in the examination process; and to review and evaluate procedures for risk valuation, pricing, and stress testing.

The OCC has participated in the Working Group on Financial Markets, led by Secretary Bentsen through his representative, Under Secretary for Finance Frank Newman. The Working Group was originally established in the wake of the 1987 market crash to enhance the integrity, efficiency, orderliness, and competitiveness of U.S. financial markets, and to maintain investor confidence. The group, which includes the chairs of the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, has resumed its regular meetings and has added derivatives, and interagency coordination of derivatives regulation, to its agenda.

In addition, the OCC is working with the other bank supervisors, both in the U.S. and abroad, to modify existing capital requirements to address banks' use of derivatives instruments. We

are participating in the Basle Committee's international efforts to develop new standards for market risk and to recognize legally enforceable bilateral netting in the computation of a bank's risk-based capital. With the FRB, the OCC issued a notice of proposed rulemaking to amend our risk-based capital standards to implement the Basle Committee's netting proposal on May 20.

Based on our recent examinations of national banks and discussions we have had with market participants, it appears that, for the most part, national banks, and especially the dealer banks, have committed considerable technological and human resources to managing and controlling the risks arising from their derivatives activities. The OCC continues to have concerns about these activities, however.

First, our examiners have found that the extent of senior management and board knowledge and oversight of bank derivatives activities at a few national banks is not as broad as we would like. While senior management and the board of directors may rely on inside and outside professionals to manage their derivatives activities, proper knowledge and oversight on the part of senior managers and the board is a critical element of our guidance and of sound risk management. Hence, our examiners have informed the management at those banks that we expect them to correct any deficiencies in this regard.

Second, we are paying particular attention to bank trading and use of certain specialized derivative instruments, including certain types of collateralized mortgage obligations, some

structured notes, and certain highly-leveraged over-the-counter (OTC) transactions. The markets for such instruments tend to be less liquid, their values more volatile when compared with simpler, shorter-term derivatives instruments, and their risks may be less easily understood. The OCC is examining whether further regulatory action on these instruments is appropriate.

Third, the proprietary trading units of some of the dealer banks actively trade cash and derivative instruments to establish risk positions for the bank that are independent of the bank's other trading and risk management positions. These proprietary trading units represent only a small portion of the bank's trading activities, and they are intended to make use of the powerful research capabilities and portfolio management expertise that the banks have in place to serve customer needs. We supervise such trading operations closely to ensure that national banks operating them are adequately controlling the associated risks. Nevertheless, the central role that banks play in the economy, and the fact that federally insured institutions are engaging in these activities, raise public policy issues; and, as a result, the OCC is devoting further attention to this area. We do not believe, however, that requiring banks to confine their proprietary trading activities to separately capitalized subsidiaries would address these issues; and in fact, we have some concerns that doing so could increase the risk these activities pose to the financial system.

OCC Comments on the GAO's Findings and Recommendations

As I have noted, I will limit my comments to the report's major findings and recommendations. In general, the OCC supports and is working to implement several of the GAO's recommendations, including those calling for greater coordination and harmonization among regulators and other groups overseeing derivatives activities by financial institutions.

Recommendation 1: Develop and maintain accurate, current, and centralized information, that is accessible to all regulators, including information on the extent of major OTC dealers counterparty concentrations and the sources and amounts of their derivatives earnings.

Banking Circular 277 states that banks should gather and use such information for their risk management purposes, and certainly the additional reporting requirements that GAO recommends would provide useful information for supervising bank trading exposure. At present, our examiners collect, as part of our regular supervision of bank derivatives activity, information that we require for our supervisory needs. In particular, BC 277 states that a national bank's risk management procedures should include reports to senior management and the board of directors that accurately present the nature and level(s) of risk the bank is taking and document compliance with approved policies and limits. OCC examiners obtain and review such information during the regular examination process, with the objective of focusing on the risks to which banks are exposed. At each of the seven dealer banks and at the largest

end-user banks, there are full-time, resident examiner staffs who continuously monitor the bank's risk, including the risk from its derivatives activities.

However, like many market observers, we believe that the public disclosures made by financial institutions engaging in derivatives activities do not give sufficient information about the extent of those activities and their associated risks. We support the accounting profession's efforts to improve disclosures for all financial institutions. With regard to banks, we note that several major dealer and active end-user banks have made substantial improvements in the level and detail of their disclosure of derivatives activities in their 1993 Annual Reports, and we support the banking industry's efforts to voluntarily improve disclosures. In addition, the OCC is participating in the interagency task force's efforts to improve public disclosures of bank derivatives activity.

In December 1993, the Federal Financial Institutions Examination Council (FFIEC), of which OCC is a member, adopted the task force's proposal to expand regulatory reports to include information on non-performing derivatives contracts and to enhance disclosure about derivatives held in a trading or dealing capacity. These changes were effective in the March 31, 1994 Call Reports.

In March 1994, the FFIEC approved the task force's proposal for additional Call Report disclosures that would provide regulators with more consistent data and improve public access to data on banks' derivatives activities. On March 9, the FFIEC published in the *Federal*

Register a proposal that would require banks to increase their disclosures of derivatives positions and revenues. The comment period for the proposal ended on May 9, and we are evaluating the 39 comments received by the FFIEC.

Specifically, the proposal would expand the current disclosures of notional values by requiring banks to report separately their exchange-traded and OTC derivatives transactions. Such information would provide additional information on new lines of business and concentrations in particular markets or products. The proposal would also require banks with over $100 million in assets to report data on the positive and negative fair values of outstanding derivatives contracts. Those data would allow analysis of gross credit risk exposures from these activities. In addition, in anticipation of the aforementioned possible change in the netting rules for risk-based capital purposes, the proposal would require banks to report, as a single number, their net current credit exposure. In calculating this exposure, the proposal would recognize legally enforceable bilateral netting arrangements across all derivatives contracts, which would provide a more accurate estimate of an individual bank's credit risk.

Also under the proposal, banks with over $100 million in assets would be required to report as of March 31, 1995, additional income data related to off-balance-sheet items. Those banks would be required to report the impact of off-balance-sheet items on their net interest margin and on their non-interest income. The new data would enable bank supervisors and the public to better analyze the nature of such activities and the degree to which they create exposure to the bank's capital.

Recommendation 2: Develop and adopt a consistent set of capital standards for OTC derivatives dealers sufficient to ensure that all of the major risks associated with derivatives as well as legally enforceable netting agreements are reflected in capital.

As described below, OCC's capital standards currently address credit risk associated with bank use of derivatives, and we are working on proposals to amend our standards to incorporate market risk and to recognize legally enforceable netting agreements. However, while the OCC supports the GAO's view that capital standards are an important tool for supervising the risks associated with bank use of derivatives, there are a number of reasons why we do not believe that refining our risk-based capital rules to quantitatively incorporate the operational, liquidity, and legal risks stemming from bank use of derivatives would be necessarily the most productive strategy for supervising those risks.

First, although we rely on our capital standards as a supervisory tool, we place an even greater emphasis on ensuring, through on-site examinations, that the bank understands, manages, and controls the risks arising from its use of derivatives instruments as they interact with the bank's other sources of risk. As we said previously, in each of the seven dealer banks that OCC supervises, a full-time examiner staff continuously monitors risk management information.

Second, when compared with market and credit risk, liquidity, operational, and legal risks tend to be more difficult to quantify. For example, the OCC is not aware of any methodologically sound technique for quantifying operational or legal risk.

Third, banks are required to maintain a minimum capital leverage ratio, which is in addition to the risk-based requirement. The leverage ratio provides a cushion against risks (*e.g.*, legal and operational risk) that arise from the banks' derivatives activities, but are difficult to quantify.

Fourth, because such risks arise in the context of many bank activities, not just derivatives activities, we would address them in the context of capital standards that would apply to risks arising from any bank activity.

In addition, the OCC strongly believes that, given the truly global span of derivatives markets, comparable capital regulations among banking agencies and countries would help to prevent competitive inequalities. Hence, the initiatives that OCC has taken to incorporate risk arising from bank derivatives transactions into our capital standards, which I describe below, have been in conjunction with the U.S. banking and thrift regulators and foreign banking regulators.

Current and Proposed OCC Capital Standards Addressing Risk Arising From Bank Derivatives Transactions

The OCC's risk-based capital requirement (12 CFR 3, Appendix A) imposes an explicit capital charge for the current and potential credit (counterparty) risk exposure in financial derivative products. This capital charge applies to interest rate and foreign exchange (FX) swaps, forward rate agreements, and purchased interest rate and FX options[1] and to newer derivative products, including commodity and equity-index swaps.

The OCC believes that the inclusion of off-balance-sheet counterparty (credit) exposures into capital standards was an important and necessary step in ensuring that banks maintain adequate capital for derivatives activities. The OCC also recognizes, however, that the current standards do not consider explicitly market risk and that, as new products or activities emerge in the derivatives markets, the risk-based capital standards may need to be revised. Hence, we are actively olved in the several initiatives, described below, that would result in modifications and additions to the current risk-based capital treatment of derivatives. The scope of these initiatives includes credit risk, market risk, and foreign exchange rate risk. We are pursuing them jointly with the other U.S. banking agencies (primarily the FRB and the FDIC), and with foreign supervisors through the Basle Committee on Bank Supervision.

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[1] Contracts that are traded on an exchange requiring the daily payment of any variations in the market value of the contract, such as futures traded on U.S. exchanges, are not subject to the capital requirements.

Credit Risk:

The Basle Committee Proposal on Netting would recognize legally enforceable bilateral netting arrangements when computing a bank's counterparty credit risk exposure in derivatives. Currently, only netting by novation[2] is permitted. Although this proposal would have the effect of reducing the current capital charge for certain derivatives initially and in some instances, the OCC believes that this proposal, by encouraging the use of enforceable bilateral netting arrangements, will reduce the level of settlement risk and, therefore, systemic risk in the derivatives markets.

The Basle Committee released a consultative paper on this proposal in April, 1993 and the OCC and the FRB are working to implement the Basle Committee initiatives through the rulemaking process. We have issued a notice of proposed rulemaking, which was published in the *Federal Register* on May 20, to seek public comments on this topic. The comment period will end on June 20.

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[2] Netting is the agreed offsetting of positions or obligations by trading partners or participants in a system. Netting reduces a larger number of individual positions or obligations to a smaller number of positions. Novation refers to the satisfaction and discharge of an existing contractual obligation by the substitution of new contractual obligations. Netting by novation occurs, therefore, when the existing contractual obligation is extinguished by the subsequent new obligations.

Market Risk:

(a) The FDICIA Section 305 Proposal would establish a system for measuring a bank's overall interest rate risk exposure and provide a basis for requiring capital for exposures that exceed a threshold level. Derivatives exposures would be fully incorporated into the risk measure.

The U.S. banking agencies issued a joint Notice of Proposed Rulemaking on this proposal on September 14, 1993. The comment period for the proposal closed on October 29, 1993.

(b) The Basle Committee Proposal on Market Risk for Trading Books would incorporate a capital charge for the market risk of equity and debt derivatives that are part of a bank's trading activities. This charge would be in addition to the current risk-based capital charge for counterparty (credit) exposures. The charge would not be applied to derivatives held outside of trading portfolios, such as those used to hedge structural balance-sheet positions.

The Basle Committee issued a consultative paper on this proposal in April 1993, and the consultative period closed on December 31, 1993. Any proposal to modify the OCC's current risk-based capital guidelines that might result from this consultative paper would be issued for full public comment through the

rulemaking process before being adopted. The OCC would carefully consider these comments before adopting any proposals.

(c) <u>The Basle Committee Proposal on Foreign Exchange Risk</u> would introduce a capital charge on a bank's net open foreign currency and precious metals positions. Any foreign exchange or precious metal derivative instrument would be included in determining a bank's net open position. This charge would be in addition to any applicable counterparty or market risk capital charges that are under consideration by the Basle Committee.

Also in April 1993, the Basle Committee issued a consultative paper on this proposal. The consultative period closed December 31, 1993. As with the market risk proposal, the OCC would seek public comments through the rulemaking process and carefully consider those comments before adopting any change to its current risk-based capital guidelines.

Recommendation 3: Establish specific requirements for independent, knowledgeable audit committees and internal control reporting for all major OTC derivatives dealers. Internal control reporting by boards of directors, managers, and external auditors should include assessments of derivatives risk-management systems.

Prudent management of financial derivatives activities requires that senior management and the board of directors at banks engaged in such activities have timely, accurate, and comprehensive information about the level and nature of the risks inherent in those activities. Hence. OCC policy requires senior management and the board of directors of all national banks engaging in derivatives transactions to establish comprehensive risk management systems. As BC 277 states, those systems should include auditing procedures and timely, accurate reports to senior management and the board on the nature and level(s) of risk taken and compliance with approved policies and limits. The auditing procedures should ensure the integrity of measurement, control, and reporting systems, and compliance with approved policies and procedures. In addition, the circular emphasizes that reports to senior management and the board of directors should be prepared by individuals who are independent of the bank's risk-taking unit. Because we recognize that banks can meet those standards in a variety of ways, we do not require banks to establish a particular structure for such functions, (*e.g.*, we do not require the bank to set up a separate committee to oversee the audit function). Instead, we allow the bank to choose the form that enables it to meet our standards in a manner that is efficient and most appropriate to its circumstances.

BC 277 also states that audit coverage should be adequate to ensure timely identification of internal control weaknesses and/or system deficiencies, and that it be performed by competent professionals who are knowledgeable of the risks inherent in financial derivatives transactions. BC 277 notes that the bank's audit procedures should include: (1) appraisals of the soundness and adequacy of accounting, operating, and legal risk controls and (2) tests for compliance with

the bank's policies and procedures. For end-user banks, audit coverage is likely to be included within the scope of audits of the interest rate, foreign currency, and liquidity risk management functions. BC 277 emphasizes that dealer banks should have audit coverage that is sufficient to assess the nature and increased complexity of the other risks, such as credit, market, and operational risks, associated with these businesses.

Furthermore, BC 277 emphasizes that senior management of each national bank engaging in derivatives transactions should have a unit or individual responsible for measuring and reporting risk exposures that is independent of the trading or sales function. The risk monitoring and control function includes monitoring compliance with policies and risk exposure limits.

Recommendation 4: Perform comprehensive, annual examinations of the adequacy of major OTC derivatives dealers' risk management systems, using a consistent set of standards established for this purpose and including consideration of the internal control assessments performed by boards of directors, management, and auditors.

The OCC supports and is in substantial compliance with this recommendation, as it applies to national banks. Together with the forthcoming examiner guidance, BC 277 provides a consistent set of standards for assessing national banks' risk management systems. A central feature of BC 277 is that it emphasizes the importance of the bank's systems to manage the risks associated with derivatives and other bank activities. Since its issuance, we have begun to ensure that banks comply with BC 277 and have proper risk management systems in place through on-site

examination and evaluation of internal risk management processes and internal controls. As noted above, there are full-time, resident examiner staffs in each of the seven dealer banks and at the largest end-user banks. Those staffs range in size from 3 to 22 examiners at the dealer banks and from 1 to 13 at the largest end-user banks. Most end-user banks are examined once every twelve months, and every national bank is examined at least once every eighteen months.

As with other banking activities, the examiners who are implementing BC 277 receive extensive on-the-job training in examination of bank derivatives activities under the supervision of senior examiners. The OCC also provides formal instruction for its examiners. In July 1992, the OCC created the Capital Markets Training Program (CMTP) in to provide advanced technical training for examiners specializing in bank capital markets activities, including derivatives activities. Currently, 81 examiners are enrolled. In 1993, the program sponsored three seminars to address advanced topics related to the supervision of bank derivatives activities. CMTP participants also receive a newsletter that frequently includes feature articles on derivatives. OCC examiners also receive training on bank derivatives activities through a number of specialized courses, many of which conducted by the FFIEC.

Recommendation 5: Provide leadership in working with industry representatives and regulators from other major countries to harmonize disclosure; capital; legal requirements including netting enforceability; and examination and accounting standards for derivatives.

As noted above, the OCC strongly supports the adoption of uniform capital regulations among banking agencies and countries to prevent competitive inequalities and to ensure prudential banking standards in all major markets. We have participated in developing the previously mentioned Basle Committee proposals to recognize reductions in credit risk resulting from the use of legally enforceable netting arrangements and to incorporate measures of market risk on foreign exchange, precious metal, and traded debt and equity positions, including derivatives positions. We will continue to work with the other banking regulators, both here and abroad, to develop consistent, systematic approaches to the supervision and regulation of derivatives activity in banks.

In another section of the report, the GAO notes that its review of examination reports done by OCC and the FRB and the supporting workpapers has caused it to raise a concern that the banking regulators may not be sufficiently testing internal controls. In fact, the workpapers may not include all of the documentation for the work conducted during an examination; and a review of the workpapers by themselves may not capture all of the work conducted during the examination. For instance, much of the information used during the examination, such as bank policy and procedure manuals, is kept by the bank's resident examination staff or returned to the banks, and examiners may not duplicate all of this information for the workpaper files.

OCC examiners routinely review internal controls during their evaluation of the bank's risk management process. Because of our perception that internal controls are an integral part of the

risk management process, however, examiners may not specifically rate the adequacy of internal controls outside of their evaluation of the overall risk management system.

In addition, as the GAO report states, new regulations the banking agencies have recently adopted pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) require management at banks with $500 million or more in assets to conduct their own evaluations of the effectiveness of the internal controls at their institutions, and to report to their regulators on their evaluation.

When evaluating a bank's internal controls, examiners review the results of any work performed by internal and external auditors--including the auditors' detailed testing of controls--and the supporting workpapers. Guided by examination materials that address internal controls (*e.g.*, the *Comptroller's Handbook for National Bank Examiners* and the OCC's *Source Book*), examiners review the scope of audit work to ensure that the bank has addressed all major control areas. If we find that the bank's audit scope is incomplete, we criticize the audit work and require bank management to address our criticisms by expanding the audit. If the bank's audit reports identify deficiencies in key control areas, we verify that the bank has taken corrective action.

The GAO report also notes that the guidelines which the federal bank regulators have issued on bank use of financial derivatives do not have the weight of regulation, and that it can be more

difficult for the regulators to obtain corrective action when a bank fails to comply with the guidance.

In fact, as noted above, Banking Circular 277 sets forth procedures for the safe and sound management of a bank's derivatives activities. Pursuant to 12 U.S.C. 1818, the OCC has the authority to take enforcement action regarding any unsafe and unsound banking practice arising from a national bank's noncompliance with BC 277 or other regulations or guidelines. If an examiner finds that a national bank is not in substantial compliance with the BC 277, he or she will notify OCC management and inform the bank's board and senior management that we expect the bank to correct the problem. If informal measures fail to address the problem to our satisfaction, we may then commence an informal or formal enforcement action against the bank requiring the bank to take corrective action, on the grounds that the bank is engaging in an unsafe and unsound practice.

Because guidelines are more flexible than regulations, they allow us to respond more quickly to the pressing issues at hand, and to adapt to a quickly changing aspect of this industry, while preserving the ability of banks to respond efficiently and flexibly to new opportunities. Moreover, because the guidelines represent standards for the safe and sound conduct of a bank's derivatives activities, we have all the necessary powers to enforce them.

Additional Issues Raised by the Invitation Letter

Your letter of invitation raises a number of additional important issues related to bank use of derivatives. I will respond to each in turn.

(1) The potential for derivatives to contribute to increased systemic risk in the financial system (including the potential for such financial instruments to contribute to increased levels of volatility or excessive speculation in the stock and bond markets).

The growth of derivatives markets, coupled with rapid changes in technology and telecommunications have brought financial markets closer together, with the result that financial pressure at an individual firm might amplify market dynamics, which in turn could create increased financial pressure at many other firms. As bank supervisors, we at the OCC are attentive to the risks associated with the markets in which banks participate, as well as banks' vulnerability to systemic events in those markets, and we have taken steps to minimize banks' exposure to systemic risk.

In particular, we are concerned about the liquidity of some of the markets in which banks participate. Rapid movements in market conditions could lead to simultaneous efforts by many banks and other market participants to limit their exposures, and some markets may not be sufficiently liquid to allow all participants to execute their desired transactions in an orderly fashion. To address this concern, BC 277 underscores the need for bank managers to establish

effective controls over the market/product and cash flow liquidity exposure arising from financial derivatives activities.[3] For example, the circular states that banks' market risk limits should formally address their exposure to market/product liquidity risk, and that the bank should have liquidity policies to formally govern its exposure to cash flow gaps (from intermediate payments or settlements) arising from financial derivatives activities. The circular also states that banks should manage their liquidity exposures resulting from financial derivatives activities as an integral part of their day-to-day operations, as well as their contingency and liquidity planning processes.

In addition, as BC 277 makes clear, the OCC believes that the a crucial defense against systemic risk is for each bank to implement effective risk management systems. The circular and the forthcoming examination guidance stress the need for all banks to have risk management systems in place that are sufficient to measure, analyze, and control each of the risks arising from derivatives activities. Those systems should ultimately enable the bank to monitor, limit and control its interconnection risk--the exposure resulting from the covariance between one or more risk factors. BC 277 also emphasizes the need for banks to anticipate the market, credit and liquidity risks arising from their derivatives activities through use of stress testing--the evaluation of risk exposures under various scenarios that represent a broad range of potential market movements and corresponding price behaviors, including those that go beyond historical and

[3] As BC 277 states, in the context of financial derivatives products, liquidity risk takes two forms: market/product liquidity risk and cash flow risk. If there is insufficient market activity or prices are not available, a bank risks loss due to inability to exit or unwind a position. The inability to meet cash flow obligations at an acceptable price as they become due may also present a risk of loss

recent market trends. In addition, the circular states that banks should hold sufficient capital to absorb potential losses from those risks.

(2) The nature and adequacy of internal controls and risk management systems at both the financial intermediaries and the corporate or other end-users of derivative financial instruments (e.g., mutual funds, municipalities, pension plans or other institutional investors).

As part of the examination process, the OCC reviews information on the nature and adequacy of internal controls and risk management systems of national banks and their customers. We can consult with the other regulators regarding the systems and controls at other banks. We do not collect data, however, about the nature and adequacy of internal controls and risk management systems found in corporate or other end-users of derivative financial instruments that are not banks or customers of banks, and we are not aware of a system-wide source for such information.

With regard to banks, BC 277 requires banks to adopt proper internal controls as part of their risk management systems for derivatives activities, and for other activities, as appropriate. As I noted previously, the examinations that we have conducted since the circular was issued last October have given rise to concerns about the level of senior management and board oversight at some national banks. Our examiners are working with those banks to resolve our concerns in this area.

(3) The nature and adequacy of existing protections afforded to corporate or other end-users of derivatives from abusive practices in connection with sales of such financial instruments (e.g., the sale of unsuitable investments to customers, inadequate disclosures regarding the risks associated with these products).

BC 277 creates the presumption that, consistent with safe and sound banking practices, a bank dealer will not recommend transactions that it knows, or has reason to know, would be inappropriate for the customer, based on available information. Compliance with section C1 of BC 277 is an important part of the bank's credit risk management. In particular, Section C1 states that credit officers who approve derivatives transactions should be able to determine that a proposed derivatives transaction is consistent with a counterparty's policies and procedures with respect to derivatives activities, as they are known to the bank.

A customer's ability to perform its obligations under a derivatives transaction depends, in part, on the appropriateness of the transactions to the customer's financial situation, business practices, and objectives. BC 277 provides guidance to the bank's credit officers who establish the credit lines of individual customers. In this respect, it is broadly analogous to the responsibility of credit officers to evaluate a borrower's ability to repay before making a traditional bank loan.

Section C1 emphasizes that the credit officers responsible for establishing and monitoring financial derivatives credit lines should understand the applicability of financial derivatives instruments to the risks the bank customer is attempting to manage. If the bank believes that

a particular transaction may not be appropriate for a particular customer, but the customer wishes to proceed, Section C1 states that bank management should document its analysis and the information the bank provided to the customer.

Failure to comply with Section C1 can also expose a bank to reputation risk--the risk that a bank might lose a client, or be unable to compete effectively for new clients, due to perceptions that the bank does not deal fairly with clients or that it does not know how to properly manage its derivatives business.

(4) The nature and adequacy of public disclosures provided to investors regarding the derivatives holdings of public companies, mutual funds, municipal governments, and other end-users of derivative financial products.

U.S. banks currently report more information on their derivatives activities than most foreign banks are required to report, and the proposed Call Report changes will expand those required disclosures. However, the current lack of financial accounting and reporting standards applying to bank derivatives activities continues to be one of the most important issues facing bank regulators in the derivatives area. Until uniform standards are adopted, there will continue to be inconsistent accounting practices among U.S. banks and other institutions that use derivatives. The OCC will continue to work to resolve these accounting and disclosure issues, through its own efforts, by participating in the interagency task force mentioned above, and by working with the Financial Accounting Standards Board.

(5) The need for any changes in the regulatory treatment of derivative financial instruments or the adoption of remedial legislation relating to such instruments.

As my statement discusses earlier, the OCC is addressing a range of issues related to the regulation of derivatives use by national banks, and we will continue to strengthen our supervision of these activities, as appropriate.

The OCC does not believe legislation applying to national banks is necessary in the derivatives area at this time. As the OCC implements BC 277 and the pending examination guidelines, however, we will continue to evaluate the effectiveness of current policy in reaching our supervisory objectives. Should we find current measures to be inadequate, we will consider taking further action to address any areas of concern. Similarly, should we determine that our legal authority is inadequate, we will consider requesting additional authority.

Conclusion

We believe the OCC's policies and strategies for addressing supervisory and public policy concerns arising from national bank use of derivative instruments are sound and appropriate. We are continuing to make progress toward addressing the particular concerns that I have noted in the introduction to my testimony, and that the GAO documented in its report. To that end, we are working unilaterally, with the U.S. banking agencies and other financial regulators, and with our supervisory counterparts abroad. We remain committed to participating in joint efforts to adopt and promote regulations and policies that are appropriate for these evolving markets.

Mr. MARKEY. Our next witness, the Honorable Andrew Hove, is the Acting Chairman of the Federal Deposit Insurance Corporation. Welcome, sir.

STATEMENT OF HON. ANDREW C. HOVE

Mr. HOVE. Thank you very much, Mr. Chairman and members of the subcommittee. I am pleased to have this opportunity to present the views of the Federal Deposit Insurance Corporation on insured financial institutions' activities in the financial derivatives market. My testimony today will address the issues that derivatives raise for systemic risk for the deposit insurance system and the FDIC's direct role in supervising derivatives use. In addition, I will comment on the findings of the recent General Accounting Office report on derivatives.

As the insurer, the FDIC recognizes that the size, complexity and dramatic growth of this global market has demanded increased regulatory scrutiny and concern. I believe we have responded to these challenges appropriately and promptly.

The use of financial derivatives is a natural outgrowth of the normal business activity of a financial intermediary. Financial institutions have traditionally accepted credit, market and liquidity risks, three of the principal risks of derivative instruments. Institutions are accustomed to properly managing and controlling these risks when in the form of assets and liabilities. Unbundling and repackaging these risks as derivatives does not involve the creation of new or inherently unmanageable risks. Derivatives have the same risk characteristics inherent in traditional bank activities. How effectively the risks are distributed throughout the system depends on the ability of participants to understand derivatives and their use. When used appropriately, financial derivatives provide substantial funding, liquidity and risk-management benefits to many segments of the domestic and international economies. However, to the extent that complexities are not well understood or are mismanaged, derivatives can result in losses that may take management, shareholders and regulators by surprise. This potential leads to the current concern over the impact of derivatives on the financial system. This concern is appropriate, and I commend the chairman of this subcommittee for his leadership in this area.

The increasing use of derivatives and the complexities involved require us to consider the potential impact on systemic risk. What do we mean by systemic risk? We can think of it as the potential for problems at one institution or at a small set of institutions to trigger problems at other institutions. The initial problems could result from several possibilities: large, unmatched positions, flawed models, inability to access markets to limit losses, or the default of a large participant. The initial problems could spread two ways: First, a mechanical transmission of actual credit losses from institution to institution. Second, and more troubling, involves the reaction of numerous market participants in the face of considerable uncertainty as to the implication of initial problems. These reactions could create disorder and loss of liquidity in markets.

As discussed in my written statement, the Continental Illinois experience in 1984 serves as a useful example of the potential for systemic risk and the measures taken to combat it. What lessons

can be learned from the Continental Illinois experience? First, even before the widespread use of derivatives, the financial system had considerable potential to transmit risks. Second, Continental is a good example of the banking regulators working together to avoid or contain systemic risk. Third, the steps necessary to address a crisis may leave an undesirable aftermath, such as having to extend the safety net beyond the insured depositors, and it is far better to take the necessary precautions to prevent the crisis in the first place.

The FDIC has had a dual role during times of potential systemic problems. We must protect the Federal deposit insurance funds against losses and coordinate with other financial regulators to stem the contagion and maintain orderly financial markets activity and payment system integrity.

The FDIC, as insurer, is also concerned with whether bank activities represent an appropriate use of insured deposits. Derivatives involve traditional banking risks so, by and large, they seem appropriate for insured depository institutions. While the FDIC is concerned about the potential risk presented by off-balance sheet activities to the insurance funds, the controlled use of derivatives by well-managed, appropriately capitalized institutions is within the context of the normal business activity of such entities.

The primary means for determining the degree of risk in these activities and the appropriate supervisory response continues to be the examination process. Examination of these activities includes review of management background, policies, practices and performance, measurement and reporting of risks and exposures, strategic goals and objectives, credit analysis, operations, profitability and audit coverage.

The institutions for which the FDIC is primary Federal regulator do not presently serve as dealers or principal providers of these instruments but are the end-users of these products. While the principal focus of the FDIC's examination efforts has been the extent and degree of involvement in derivatives by State nonmember banks for which the FDIC is the principal Federal regulator, we are working with all the Federal banking regulators to carefully monitor the condition of dealers and the examinations conducted by their regulators.

The FDIC continues to develop and refine existing examination and supervisory guidance, both independently and in cooperation with domestic and international bank regulators, in particular the Basle supervisory committee. Because the vast majority of derivatives activity in the U.S. banking system is concentrated in national banks or State banks that belong to the Federal Reserve System, the FDIC relies heavily on the supervisory efforts of the Comptroller of the Currency and the Federal Reserve.

Mr. MARKEY. Mr. Hove, if you could, could you please try to summarize the rest of your statement?

Mr. HOVE. Yes. Let me turn now quickly to the GAO report.

We concur with the GAO recommendations regarding the need for additional cooperation among regulatory agencies. The GAO report recommends the development and adoption of a consistent set of capital standards for derivatives dealers. Existing capital requirements for derivative activities are subject to continuous study

and review. And, currently, derivatives are subject to capital requirements consistent with the internationally developed standards agreed to in the Basle Accord. We continue to work with other banking regulators and the international regulators on developing standards for requiring capital against market risk, and we expect to issue a proposal for comment in the next few months. In addition, we are working on revising our capital requirements to account for concentration of credit risk.

The FDIC is also in general agreement with the recommendations regarding the need for reporting and disclosure of information.

Mr. MARKEY. Mr. Hove, if you could please summarize.

Mr. HOVE. Let me conclude by reiterating that the use of financial derivatives is a natural outgrowth of normal business activity of the financial intermediary. Derivatives allow institutions to manage traditional financial risks, and, as with traditional banking activities, sound management practices, good information and coordination among regulators are essential to prevent widespread financial interruption.

I would be pleased to respond to your questions.

Mr. MARKEY. We will include your written statement in the record in its entirety.

[Testimony resumes on p. 286.]

[The prepared statement of Mr. Hove follows:]

TESTIMONY OF

ANDREW C. HOVE, JR.
ACTING CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Chairman and members of the committee, I am pleased to have this opportunity to present the views of the Federal Deposit Insurance Corporation (FDIC) on insured financial institutions' activities in the financial derivatives market. My testimony today will address the relation between derivatives and systemic risk, the issues that derivatives raise for the deposit insurance system, and the FDIC's direct role in supervising derivatives use. In addition, I will comment on the findings of the recent General Accounting Office (GAO) report on derivatives. The text of my testimony addresses the questions outlined in your letter of invitation.

As the insurer, the FDIC recognizes that the size, complexity and dramatic growth of this global market has demanded increased regulatory scrutiny and concern, and I believe we have responded to these challenges appropriately and promptly. The FDIC applauds the release of the GAO report on derivatives and is in general agreement with many of the report's recommendations. However, we must reserve some judgment until we have more carefully reviewed their only recently issued report.

FINANCIAL DERIVATIVES AND THE DEPOSIT INSURANCE SYSTEM

A derivatives transaction is defined as a contract whose value depends on, or derives from, the value of an underlying asset, reference rate, or index. Financial derivatives are

principally designed to transfer price, interest rate and other market risks without involving the actual holding or conveyance of balance sheet assets or liabilities. The use of financial derivatives is a natural outgrowth of the normal business activity of a financial intermediary. Financial institutions have traditionally accepted credit, market and liquidity risks, three of the principal risks of derivative instruments. Institutions are accustomed to properly managing and controlling these risks when in the form of assets and liabilities. We want to reiterate that unbundling and repackaging these risks as derivatives does not involve the creation of new or inherently unmanageable risks. Insured financial institutions for years have dealt in the derivatives market in various forms.

When used appropriately, financial derivatives provide substantial funding, liquidity, and risk management benefits to many segments of the domestic and international economies, including insured depository institutions. The benefits arise as risks are parcelled out to those parties more willing and able to bear particular risks.

Derivatives have the same risk characteristics inherent in traditional bank activities, which are not always easy to measure or analyze. How effectively the risks are distributed throughout the system depends on the ability of participants to understand derivatives and their use. Many derivatives are straightforward,

"plain vanilla" instruments that can be analyzed in the same way as traditional instruments. Others are more exotic and require heavy dependence on sophisticated computer modeling to understand and price properly.

To the extent that dealers and users understand the complexities of both individual instruments and the distribution of risks throughout the system, the use of derivatives will be a beneficial and essential component of the financial system. However, to the extent that these complexities are not well understood or are mismanaged, derivatives can result in losses that may take management, shareholders, and regulators by surprise. This potential leads to the current concern over the impact of derivatives on the financial system. This concern is appropriate, and I commend the Chairman of this Subcommittee for his leadership in this area.

Perhaps the most fundamental purpose of bank supervision is to safeguard against widespread financial disruption. The increasing use of derivatives and the complexities involved require us to consider the potential impact on systemic risk. What do we mean by systemic risk? We can think of it as the potential for problems at one institution or a small set of institutions to trigger problems at other institutions.

The initial problems could result from several possibilities: large unmatched positions, flawed models, inability to access markets to limit losses, or the default of a large participant. The initial problems could spread in two ways. The first is a mechanical transmission of actual credit losses from institution to institution. The second and more troubling potential problem involves the reactions of numerous market participants in the face of considerable uncertainty as to the implication of initial problems. These reactions could create disorder and loss of liquidity in markets.

The Continental Illinois experience in 1984 serves as a useful example of the potential for systemic risk and the measures taken to combat it. Continental had purchased energy loan participations from Penn Square Bank in Oklahoma. When it became apparent that Penn Square loans had considerable losses, Continental had a difficult time rolling over funding from domestic sources. To counter this, Continental turned to overseas funding. As problems continued to mount, these foreign sources withdrew and the bank was faced with a severe liquidity crisis.

How did this situation create the potential for systemic risk? First, there was the potential for the direct transmission of credit losses. Two other reasonably large banks had purchased loan participations from Penn Square and a number of smaller

banks had funding exposure to Continental Illinois. Second, and more importantly, there were other large banks that depended heavily on purchased funding from both domestic and international sources. The problems at Continental created uncertainty as to how the United States would handle a large bank that was unable to fund itself.

The problem was resolved through the concerted efforts of the FDIC, the Federal Reserve Board, the Office of the Comptroller of the Currency, and a number of large banks. In order to stabilize the situation, the Federal Reserve supplied liquidity to Continental and the FDIC injected capital and gave assurances to creditors of the bank. In short order, a permanent solution was crafted and any potential problems were averted. While the solution restored order, it did require the extension of the safety net beyond insured depositors.

What lessons can be learned from the Continental Illinois experience? First, even before the widespread use of derivatives, the financial system had considerable potential to transmit risks. Second, Continental is a good example of the banking regulators working together to avoid or contain systemic risk. Third, the steps necessary to address a crisis may leave an undesirable aftermath, and it is far better to take the necessary precautions to prevent the crisis in the first place.

As seen in the Continental example, the FDIC has a dual role during times of potential systemic problems. First, we must protect the federal deposit insurance funds against losses. Second, we coordinate with other financial regulators to stem the contagion and maintain orderly financial markets activity and payments system integrity. With the passage of the Federal Deposit Insurance Corporation Improvement Act, Congress recognized that situations may arise in which the need to avoid market disruption might outweigh the narrow "least cost" rule. When the FDIC, the Federal Reserve and the Treasury determine that such a situation exists, the FDIC has the authority to act in a more flexible manner.

Another issue with respect to deposit insurance and derivatives is how the FDIC fulfills its obligation to protect the insurance funds from losses attributable to the use of derivatives. As many others have noted, the first line of defense must be the management of banks that use derivatives. Federal supervision of the banking system is designed to ensure that management is capable of understanding and controlling the risks of bank activities, including derivatives. Because the vast majority of the derivatives activity in the United States banking system is concentrated in national banks or state banks that belong to the Federal Reserve System, the FDIC relies heavily on the supervisory efforts of the Comptroller of the

Currency and the Federal Reserve to monitor and control the use of derivatives in federally insured institutions.

It is important to note that there are both regulatory and market safeguards that help to prevent a derivatives induced default at a large institution. As the condition of a financial institution deteriorates, both market discipline and regulatory action serve to limit risk taking and participation of that institution in the derivatives markets. As a financial institution's credit-worthiness decreases, counterparties usually exercise market discipline by shortening the average maturity of contracts they are willing to enter into with that institution, reducing their credit lines, requiring collateral, and possibly eliminating new transactions with that institution.

A number of those who have testified before this Subcommittee have stressed the desirability of industry self-regulation with respect to derivatives. This seems particularly relevant to the deposit insurance system, for the insurance funds represent capital that banks and thrifts have put up to protect depositors and taxpayers. As a result, the industry has a direct financial interest in how the FDIC manages the risks posed by derivatives. I would call on the banking industry to work together with the regulators to ensure an approach that protects the insurance funds without stifling the legitimate benefits of derivatives.

The FDIC as insurer is also concerned with whether bank activities represent an appropriate use of insured deposits. As mentioned earlier, derivatives involve traditional banking risks, so by and large they seem appropriate for insured depository institutions. While the FDIC is concerned about the potential risk presented by off-balance sheet activities to the insurance funds, the controlled use of derivatives by well-managed, appropriately capitalized institutions is within the context of the normal business activity of such entities. In addition, the risk control features of derivatives enable banks to extend credit to a broader base of borrowers.

Let me turn now to the FDIC's role as primary federal regulator of state-chartered nonmember banks.

SUPERVISION OF DERIVATIVE ACTIVITIES BY THE FDIC

The FDIC studies and monitors derivative activities throughout the banking industry. This is accomplished by frequent contacts directly with the industry and, as mentioned earlier, by working through the primary federal regulators of national and state member banks. At the same time, the principal focus of the FDIC's examination efforts has been the extent and degree of involvement by state non-member banks for which the FDIC is the primary federal regulator.

The primary means for determining the degree of risk in these activities and the appropriate supervisory response continues to be the regular examination process. Examination of these activities includes reviews of management background, policies, practices and performance; measurement and reporting of risks and exposures; strategic goals and objectives; credit analysis; operations; profitability; and audit coverage. The more significant the degree of the institution's involvement, the more comprehensive will be the scope of review.

Examples of internal control review procedures conducted by examiners include determining whether dollar risk limits have been documented and are appropriate in relationship to the capital level and are complied with. In addition, examiners assess the institution's business strategy and follow-up through observation and examination to determine if performance is functioning as represented by the senior management of the institution. These procedures are consistent with recently developed guidance issued to FDIC examiners entitled, "Financial Derivatives." This guidance also has been sent to the Chief Executive Officer of all institutions where the FDIC is the primary federal supervisor.

In response to the potential risk exposure to insured institutions resulting from increasing involvement in this expanding market, the FDIC continues to develop and refine

existing examination and supervisory guidance both independently and in cooperation with domestic and international bank regulators (in particular, the Basle Supervisory Committee). The FDIC has recently distributed additional examination guidelines to assist in the review and supervision of institutions involved in derivatives activity. This guidance supplements existing examination reference material maintained by our Regional Offices and by our cadre of capital markets specialists distributed throughout the country. The FDIC has approximately 30 examination specialists, located in each of our eight supervisory regions, who receive technical guidance and support from the FDIC's Office of Capital Markets in Washington. Supplemental training and assistance in the examination of derivative instruments is provided to the field staff by these specialists as part of ongoing examiner training. Among other training, these specialists attend seminars twice a year which are conducted by the Office of Capital Markets, and themselves conduct training for examination personnel in their Regions.

Risk management procedures and controls generally relate to the measurement, monitoring, review and audit of the principal risks of financial derivatives. In this context, the methodology for controlling these risks must be viewed as part of the overall structure of the institution and varies from institution to institution. The FDIC assesses the individual risk control environment during the examination process.

The institutions for which the FDIC is the primary federal regulator do not presently serve as dealers or principal providers of these instruments, but are the end-users of these products. However, we are working with all of the federal banking regulators, through an Interagency Task Force, on disclosure of the risk and, as insurer, we carefully monitor the condition of dealers and the examinations conducted by their regulators. The specificity of these fundamental principles would be in the context of the level of sophistication of the prospective counterparties, with more stringent requirements for dealings with non-institutional customers. The FDIC believes that irrespective of any degree of responsibility, legally or otherwise assumed by, or required of the dealer, it remains incumbent on the end-users of derivative instruments to fully understand the nature and risks of these contracts and to determine the suitability and appropriateness of their involvement in the transaction.

The FDIC expects to see reflected in the bank's board of directors' minutes, a full discussion of the costs, benefits, and especially the risks of an institution's planned or ongoing involvement in derivative activities, much the same as for any new business venture. Appropriate management personnel should prepare an executive document, in language suitable for the technical knowledge and awareness of the full board, which

details the exact nature of the planned involvement and the levels of risk that can be incurred. Risk parameters should be expressed in terms of most likely and worst case scenarios, with specific board and management approvals for these levels clearly delineated. An acceptable program would also have to incorporate appropriate controls and audit procedures.

State non-member bank risk management systems have generally been found appropriate for the level and extent of participation of these institutions, which, as I have indicated, are primarily end users in the financial derivatives market. The few exceptions have prompted examination criticism generally on the basis of inappropriate management understanding or control of the accepted risks. In these cases, our concerns have been promptly addressed and corrected. The FDIC has available the option to pursue enforcement actions should derivative activities at individual institutions raise safety and soundness concerns.

The FDIC believes that regulation of derivatives activities is most effective when conducted on an institutional rather than on a product basis. The use of financial derivatives varies substantially by institution. A practice which may constitute inappropriate activity, unsuitable instruments or excessive volume for one institution, may be well within the range of acceptable behavior by another. The FDIC has the ability in the present regulatory framework to review the derivatives

involvement of institutions in the context of their overall financial capacity, capital levels, and risk management environment as well as in the present market environment. This flexibility allows for a suitable response to an unsafe or unsound situation, without adversely affecting the overall market for instruments which have a fundamental benefit for the banking industry as well as borrowers. The examination process is central to this ability to appropriately regulate an activity in which product innovation occurs so rapidly.

GAO REPORT RECOMMENDATIONS

We concur with the GAO recommendations regarding the need for additional cooperation on capital requirements and other supervisory issues among regulatory agencies domestically and internationally. As mentioned earlier, the financial institution regulators formed an Interagency Task Force on Financial Derivatives, which continues to work to harmonize the regulation, supervision, reporting, disclosure and treatment of these instruments. The GAO appears to recognize the efforts of the financial institution regulators to institute comprehensive industry mechanisms to ensure the following or acceptable risk management practices.

Capital Standards

The GAO Report recommends the development and adoption of a consistent set of capital standards for derivatives dealers. Existing capital requirements for derivative activities are subject to continued study, review and revision. Currently, derivatives are subject to capital requirements consistent with the internationally developed risk-based standards agreed to in the Basle Accord. United States banks are required to hold capital equal to at least eight percent of their total assets, including derivatives, adjusted for the relative counterparty risk of the transaction. The amount of capital a bank must hold for a derivative contract is based on current exposure (or market value) and a factor of its potential future exposure due to rate or price changes. A maximum credit conversion factor of 50 percent (due to the relative high credit quality of the majority of counterparties) is applied to the total current and future exposure. The result is a capital requirement ranging from 4 to 8 percent of the contract's market value. The risk-based requirement addresses credit risk associated with derivatives. The FDIC Board of Directors may consider proposing for public comment a change to the risk based capital rules to allow for the recognition of bilateral netting agreements by financial institutions for purposes of capital determination when the netting agreements are deemed to be legally valid.

In addition to the risk-based requirement, banks are also required to maintain a minimum capital leverage ratio. Leverage ratios cushion against other risks such as operational risk and legal risk that are associated with derivatives, yet are difficult to quantify.

We continue working with the other banking regulators and the international regulators (Basle Committee) on developing standards for requiring capital against market risk, and we expect to issue a proposal for comment in the next few months. In addition, we are working on revising current capital requirements to account for concentration of credit risk and the risk of non-traditional banking activities, including derivatives. We have issued a proposal that would incorporate such risks into the specific factors evaluated in the assessment of an institution's overall capital adequacy.

Reporting and Public Disclosure

The FDIC is in general agreement with the GAO recommendations regarding the need for reporting and disclosure of information relating to financial derivatives. The FDIC collects information on banks' derivatives activities in the quarterly Call Reports, which are publicly available. Banks have been reporting the notional/contract amounts of derivative activities since 1990. In addition, banks report separate totals

for interest rate and foreign exchange derivatives and a combined total for forwards and futures along with separate totals for options and swaps. Banks also report total derivatives-related credit exposure aggregated for all counterparties. Beginning with the March 1994 Call Report, banks over $1 billion in total assets, or over $2 billion in par/notional amount of off-balance sheet derivative contracts, must report the composition of trading liabilities and certain categories of trading account assets. In addition, delinquent derivative contracts will be reported on a confidential basis to regulators.

Call Reports are subject to revisions on a quarterly basis as needed. Additional improvements in this area are proposed for September of this year and are presently out for public comment. This notice of proposed rule, besides containing additional derivatives disclosures for public comment, makes clear that additional disclosures, especially with respect to income sources, are being considered by the agencies. The proposals are designed to allow reporting of information which is consistently and uniformly generated by the affected institutions. Also being discussed are disclosures of information regarding counterparty credit concentrations. However, it does not appear necessary or appropriate to require disclosures of individual counterparty exposure in the context of quarterly reported data. This information is correctly part of the examination process and is

no different than credit concentrations to one borrower or entity.

With respect to disclosure, the FDIC agrees that additional disclosures of methodology, qualitative issues and quantitative information, is desirable. The FDIC continues to work with the other financial institution regulators and the FASB in the design and approval of additional reporting and public disclosure. Other public disclosures for financial institutions, which are available to investors, are largely subject to the requirements of Generally Accepted Accounting Principles in the published financial reports, and the individual requirements of other regulatory agencies, and the FDIC is supportive of the efforts of the entities to add transparency in this regard.

Risk Management and Internal Controls

As indicated previously, procedures relative to the assessment of risk management systems, internal controls, and internal and external audit functions are part of the standard examination methodology. Examination procedures of derivatives activities incorporate the institution's own internal audit and any external audit findings in the scope of the examination. During examinations, risk management systems, internal controls and the audit programs themselves are reviewed. When significant flaws or omissions are detected in the audit programs,

examinations will attempt to replicate the audit function. Examiners will sharply criticize an institution involved in off-balance sheet activities which has failed to institute acceptable risk management, internal control and audit standards, citing violations of law or recommending enforcement actions as applicable or necessary.

The FDIC's regulation implementing Section 36 of the Federal Deposit Insurance Act ("FDI Act"), which requires annual audits of larger institutions and the submission of management assertions and auditor attestations on various matters, does not delineate detailed criteria or standards for determining the effectiveness of internal controls. The GAO appears to support adoption of a level of specificity that would address individual institution activities by name or product type. We continue to believe that this degree of specificity would result in excessive micro-managing and a failed attempt to impose a "one size-fits-all" solution.

Rather, full consideration of the corporate governance imperatives of FDICIA is moving in tandem with the implementation of safety and soundness standards presently being developed on an interagency basis in the implementation of Section 39 of the FDI Act. Regulations have been issued for comment which would set general standards that can be tailored to individual operating environments. The proposed standards on internal controls and

information systems establish goals to be met, such as providing for an organizational structure with clear lines of authority and responsibility for monitoring adherence to prescribed policies; effective risk assessment; timely and accurate financial, operational and regulatory reports; adequate procedures to safeguard and manage assets; and compliance with applicable laws and regulations. We believe these efforts will address the safety and soundness concerns while not resulting in excessive micro-management or unwarranted intrusion into the operating prerogatives of individual institutions.

We agree with the GAO recommendation for comprehensive annual examinations of the adequacy of major OTC derivatives dealers' risk management systems. While some elements of this process may lend themselves to consistent standards, at the same time, the process should be flexible enough to address situations which may be different or unique from institution to institution.

Accounting

Accounting standards to this point have allowed substantial variation in the form and manner with which financial institutions treat derivatives transactions, resulting in a wide disparity in the recordkeeping methodology of these entities. The recent call report changes, proposed additional call report changes out for public comment, and ongoing discussions between

the banking agencies and FASB concerning disclosures and accounting, will guide participants in this market toward greater uniformity in collecting and recording this data for their own use, resulting in more meaningful information for regulators and other users of financial statements.

CONCLUSIONS

The use of financial derivatives is a natural outgrowth of the normal business activity of a financial intermediary. Derivatives allow institutions to manage traditional financial risks. The complexities and growth associated with derivatives have led to the current concern over the impact of derivatives on the potential for systemic problems. As with traditional banking activities, sound management practices, good information, and coordination among regulators and the industry are essential safeguards against widespread financial disruption.

Supervision by institution rather than by product or activity provides the most substantial protection for the deposit insurance funds. As insurer, the FDIC relies heavily on the supervisory efforts of the Federal Reserve and the OCC with respect to the vast majority of derivatives activity in the banking system. As the use of derivatives has grown in recent years, the FDIC has stepped up its supervisory efforts in this area. Furthermore, we assure the Subcommittee of our commitment

to ongoing cooperative efforts with other banking agencies and international groups to provide appropriate policies, standards, and guidance for this evolving market.

The existing supervisory rules and guidelines can be broadly interpreted, are routinely updated, and are rigorously enforced. The FDIC believes that appropriate supervision and risk control over participation in the financial derivatives market by insured institutions can be achieved without significant additional legislation. We will, however, continue uniform efforts to refine or make other needed changes to the regulatory treatment and disclosure of financial derivatives activities as discussed in our testimony.

Mr. MARKEY. We will now turn to our final witness, the Honorable Barbara Holum, who is the Acting Chairman of the Commodities Futures Trading Commission.

We welcome you, and whenever you feel comfortable, please begin.

STATEMENT OF HON. BARBARA P. HOLUM

Ms. HOLUM. Thank you, Chairman Markey and members of the subcommittee.

The CFTC welcomes this opportunity to discuss the issues raised in the General Accounting Office's report on financial derivatives, to discuss the report's recommendations and to respond to the questions contained in your letter of April 26th, 1994.

Certainly, the issues relating to the regulation of OTC derivatives are an important topic for discussion among regulators and legislators. Indeed, this debate on whether derivative risks are being properly evaluated, priced, managed and regulated is particularly timely in light of the recent press accounts of trading losses in these instruments.

We believe that the fundamental governmental interest in, one, protecting the financial system from disruption and economic displacement and, two, protecting customers from inappropriate marketing and fraud, requires a closer look at these instruments.

It is important that the debate not lose sight that, properly used by a knowledgeable end-user, derivative products can constitute a valuable and legitimate risk-reducing financial tool. Like any financial activity, however, they cannot be made riskless. Therefore, we should not give the impression that the Federal regulators can protect companies from their investment excesses or misjudgments.

As you know, the CFTC regulates the largest derivative markets in the world. Most transactions subject to our jurisdiction are required to occur on exchanges. We do, however, have authority over options on commodities, whether on or off exchange, and we apply our anti-fraud and anti-manipulation prohibitions to those swaps which the Commission, at the direction of Congress, has exempted from the exchange trading requirements of the Commodity Exchange Act. Such transactions can be conducted largely off exchange only between defined eligible participants.

In 1974, with the creation of the CFTC as an independent agency, Congress recognized the national public interest in the comprehensive regulation of derivatives. The CEA is designed to regulate all risk shifting and price discovery transactions in contracts for the sale of a commodity for future delivery and to assure market integrity, customer protection and the economic validity of the contracts themselves.

The act defines commodity broadly. Included within the definition are, among other things, foreign currencies and interests in exchange rates, interest rates and certain indices. The act provides for licensing of intermediaries, capital requirements, customer funds protections and other requirements and authorities intended to achieve transparent, fair and competitive markets, and to protect such markets from the adverse consequences of unwarranted price volatility and disruption.

Our primary concerns as regulators regarding exchange derivative markets—prevention of fraud and systemic risk—are similar to those which have been raised in connection with the over-the-counter dealer markets. U.S. futures exchange markets are structured to avoid the valuation issues resulting from the opacity and complexity of OTC markets, and to reduce the credit exposure common to dealer markets by requiring the valuation and settlement of market gains and losses daily, or more frequently during periods of extreme market volatility.

Futures brokers also must fully collateralize credit risk. The CFTC well understands that regulations designed for exchange traded and cleared standardized futures contracts may not be appropriate for individually negotiated OTC derivatives products. Accordingly, we believe that, in the current deliberations, we should be careful to distinguish between exchange-traded products and OTC derivatives.

Nonetheless, risk management techniques currently in use in the exchange-traded environment for handling market risk and preventing systemic effects, may be instructive for OTC dealer markets. These techniques include obtaining information on exposures, marking-to-market, and stress simulations to assess the consequences of projected severe market moves.

Mr. MARKEY. Could you try to summarize, please?

Ms. HOLUM. Yes, I will.

Let me address some of the recommendations of the GAO as it relates to improved accounting disclosures.

We believe, as noted in our own report, that adequate financial disclosures by end-users, dealers or intermediaries is vital. To this end, the CFTC endorses improved quantitative and qualitative accounting disclosures to the extent that the snapshot concept of financial statements is ill-suited to measuring the dynamic risks of over-the-counter portfolios.

Mr. MARKEY. If you could, summarize, please.

Ms. HOLUM. I will, thank you.

Concerning the need for legislation, we are not commenting on the recommendations made to other regulators, except to state that we support the view that each regulator should carefully analyze the scope of its existing authorities to assure that they are used to the fullest extent to address needed protections before seeking broader legislative mandates.

The CFTC asks that this short statement and its long testimony which contains more particularized answers to your questions be received for the record.

Mr. MARKEY. Without objection, we will include the longer statement in the permanent record.

[Testimony resumes on p. 326.]

[The prepared statement of Ms. Holum follows:]

STATEMENT OF BARBARA P. HOLUM
ACTING CHAIRMAN
COMMODITY FUTURES TRADING COMMISSION

before the
SUBCOMMITTEE ON TELECOMMUNICATIONS
AND FINANCE
COMMITTEE ON ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES
May 25, 1994

Mr. Chairman, members of the Subcommittee. The Commodity Futures Trading Commission ("CFTC" or "Commission") is pleased to have the opportunity to testify on the occasion of the release of the General Accounting Office report on derivatives (GAO Report).

Summary

As you know, the CFTC oversees the United States futures markets under a regulatory structure specifically designed to address the risks created by potentially volatile derivative products used by hedgers to shift risk and speculators to seek monetary gain. This regulatory structure has functioned effectively and efficiently -- and has done so without a government-sponsored insurance fund -- for seventy years. The CFTC, like the other federal financial regulators represented here today, has worked diligently to identify and address the potential risks and implications of over-the-counter ("OTC") derivative products.

The CFTC's efforts in this area are supplemented by the cooperative efforts of the federal financial regulators represented in the President's Working Group on Financial Markets. The interagency, coordinated nature of the financial regulators' activities reflects the reality of the derivatives marketplace, which encompasses a wide array of products that combine conven-

tional economic interests into new configurations that implicate multiple regulatory structures. Thus, it becomes of paramount importance that efforts by federal financial regulators be coordinated.

The President's Working Group on Financial Markets is uniquely equipped to coordinate the agencies' efforts in this area, to consider whether new regulatory approaches or authorities are needed, and to formulate recommendations to Congress concerning any necessary legislative actions. The Working Group has undertaken initiatives in the OTC derivatives area that address many of the important issues presented to date and are essential to determining how best to frame any legislative approach to such instruments. Although we believe that legislative action at this juncture would be premature, the CFTC believes that each regulator should explore the full extent of initiatives which can be undertaken under its own authority and stands ready to contribute information from its data systems and its extensive expertise in addressing the oversight of derivative markets to the process.

My testimony will address four main subjects: (1) the federal regulatory structure for futures and commodity options transactions, the largest organized derivative markets in the world, as that structure bears upon the current debate concerning OTC derivative transactions; (2) recent CFTC actions relevant to OTC derivatives; (3) the CFTC's views concerning the findings and

recommendations of the GAO Report; and (4) the CFTC's responses to the specific questions posed by the Subcommittee.

I. The CFTC Regulatory Framework for Derivatives

The CFTC oversees the world's largest derivative markets -- the United States commodity futures and commodity option markets. The federal regulatory structure under which these markets have grown and prospered requires, with limited exceptions, that all futures transactions occur on regulated exchange markets. Further, such transactions are required to be effected through regulated intermediaries, subject to risk disclosure, minimum capital, segregation of customer funds, reporting, recordkeeping, supervision of accounts and other requirements. The exchange-trading requirement was designed to foster both customer protection and market integrity by creating a centralized auction market for open and competitive trading by open outcry or similarly competitive means, protected against price manipulation and abusive trade practices. These markets serve as a price discovery mechanism for those involved in the markets as well as cash market participants and the general public. Furthermore, hedgers use these markets to meet their changing risk-shifting needs.

In 1974, with the creation of the CFTC as an independent agency, Congress also assured that the Commodity Exchange Act ("CEA" or "Act")) would provide a comprehensive regulatory structure for all futures transactions. The Act vests the CFTC with exclusive jurisdiction over futures contracts (and commodity options) not only on traditional agricultural commodities but

also on interest rates, exchange rates and other financial interests, including "all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[1/] During the past twenty years, banks, insurance companies, pension plans and other institutions have found that futures contracts on financial products, properly used, can be employed to hedge cash market price exposures and thereby stabilize revenue flows, as has long been the case for agricultural producers and processors using futures contracts on agricultural products. In addition to these direct benefits obtained by financial institutions, other market participants can benefit from the price discovery functions of futures markets.

I mention the Commodity Exchange Act regulatory model because it is a regulatory structure specifically designed to manage the risks created by derivative products, and it is a regulatory model of proven effectiveness.[2/] Further, because of certain common risk characteristics of the transactions and linkages between OTC and exchange markets, the existing structure for centralized futures and commodity option transactions may provide a useful point of reference for evaluating the potential risks and regulatory implications of OTC derivative transactions.

1/ Section 1a of the CEA.

2/ The CFTC's exercise of its recently granted authority to exempt from this regulatory structure certain OTC transactions, such as swaps, that have some characteristics of future contracts, is discussed later in my testimony.

Indeed, one of the tasks for market participants, and potentially for regulators, is to determine whether application of some of the safeguards and risk management systems of exchange markets is desirable and feasible in the OTC derivatives context.

A. Financial Integrity Protections

The futures markets have been laboratories for the development of regulatory mechanisms intended to reduce the potential for a default by one or more market participants to create spillover impacts upon other market participants or systemic effects. The financial integrity safeguards of the futures markets are designed to assure the integrity of all futures transactions, notwithstanding the potential for significant price volatility and the degree of "leverage" that may be involved in a trader's activities. These requirements apply to intermediaries acting for customers in regulated futures transactions and to the futures exchanges on which the transactions are executed.[3/] Credit risk is removed from all positions on futures markets by daily marking-to-market and payment of gains and losses on all open positions. The integrity of futures transactions effected on the exchange markets is supported by clearing organizations which clear, settle and guarantee performance of obligations to their clearing members. Futures clearing organizations are subject to CFTC oversight, including review of clearing organization rules. Clearing organizations impose their own capital requirements for clearing members, generally at significantly

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3/ These requirements do not apply to end-users or customers.

higher levels than minimum capital requirements established by the CFTC. The futures exchanges also maintain a database that compiles aggregate settlement gains and losses and margin surplus and deficits on a cross-market basis that enables clearing organizations to assess risks to their members at other exchanges.

The futures margin system is a key financial protection, under which both sides to a trade, the long and the short, make initial performance bond margin deposits. The futures exchanges' clearing organizations, in addition to requiring standing (original) margin for each futures contract, also make daily mark-to-market settlements, collect variation margin on losing positions and distribute daily all profits. Most futures exchanges, including the largest exchanges, collect such variation margin on an intra-day basis and all exchanges have authority to do so in volatile markets.[4/]

FCM minimum capital requirements, financial reporting requirements, including early warning procedures triggered by declines in firm capital and other specified events, and customer funds protections help to assure that customer funds and property deposited with a broker or accruing as a result of transactions effected by a broker are secure. FCMs are required to maintain

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4/ The proportion of margin called for and collected on an intra-day basis is very substantial. The Chicago Mercantile Exchange, for example, on which the largest volume of stock index futures trading occurs, routinely collects 80% of the variation margin due for that day's trading on an intra-day basis.

internal controls that meet minimum performance standards and to obtain independent audits on at least an annual basis to determine whether there are any material inadequacies in such internal controls. For example, FCMs' internal systems must be sufficient to prevent certain types of violations of the law, such as non-current books and records or insufficient funds to meet customer obligations. The Commission is in the process of reviewing comments on proposed rules to implement recently received risk assessment authority relating to affiliates of regulated intermediaries.

B. Market Integrity Protections

The CFTC employs a comprehensive market surveillance system which is designed to maintain competitive markets by detecting and preventing threats of price manipulation or other market disruptions. This system collects data concerning large trader positions (that is, positions that exceed specified thresholds) in all futures and commodity option contracts and enables the Commission to identify promptly the significant traders in each market and the size of their positions.[5/] This is important not only for our own market surveillance but may also help to identify large participants in OTC markets since large OTC derivatives participants are likely to make use of the futures markets to manage their risks. In addition, for many designated contract markets, the Commission establishes and enforces prophy-

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5/ The SEC received similar large trader reporting authority for securities market participants in the Market Reform Act of 1990.

lactic rules regarding the maximum permitted size of speculative positions. In other such markets, exchanges, subject to Commission approval and oversight, set and enforce such speculative position limits or, alternatively, position accountability rules. Under Commission oversight, the exchanges also enforce daily price limit moves and, with respect to stock index markets, circuit breaker rules to dampen market volatility and facilitate daily settlements. As part of our market surveillance program, Commission staff communicate regularly with staffs of other government agencies and the self-regulatory organizations, as well as directly with market participants, to monitor the markets.

II. CFTC Actions to Address OTC Derivatives

A. Rulemakings Pursuant to the Futures Trading Practices Act of 1992

In the Futures Trading Practices Act of 1992 ("FTPA"), the Commission was granted broad authority to exempt OTC products that might otherwise be subject to regulation as futures contracts from the exchange trading requirement and other provisions of the CEA.[6/] This grant of exemptive authority recognized the "need to create legal certainty for a number of existing categories of instruments which trade today outside of the forum of a designated contract market."[7/] Although these instru-

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6/ This exemptive authority includes the power to put conditions on exemptions and to grant exemptions for stated periods of time.

7/ Conference Report, Futures Trading Practices Act of 1992, H.R. Rep. No. 978, 102d Cong., 2d Sess. at 80 (1992).

ments "may contain some features similar to those of regulated exchange-traded products" Congress recognized that they are "sufficiently different in their purpose, function, design, or other characteristics that, as a matter of policy, traditional futures regulation and the limitation of trading to the floor of an exchange may be unnecessary to protect the public interest and may create an inappropriate burden on commerce."[8/] The Conference Report on the FTPA stated that the Conferees "expect[ed] and strongly encourage[d] the Commission to use its new exemptive powers promptly upon enactment of this legislation in four areas where significant concerns of legal uncertainty have arisen: (1) hybrids, (2) swaps, (3) forwards, and (4) bank deposits and accounts."[9/]

1. Swaps. Pursuant to the Conferees' direction and the exemptive authority granted by the FTPA, in January 1993, the CFTC adopted exemptive rules which provide a safe harbor from most CFTC regulatory requirements for swap transactions meeting specified criteria.[10/] The exemption is limited to swap agreements entered into by "eligible swap participants," which include various categories of institutional and commercial entities and natural persons with substantial assets. Eligible swap participants include, for example: banks; investment companies; commodity pools with total assets exceeding $5,000,000; corporations

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8/ Id.

9/ Id. at 81.

10/ 17 C.F.R. Part 35 (1993).

or other entities which have total assets exceeding $10,000,000 or net worth exceeding $1,000,000 and are entering into the swap transaction in connection with the conduct of their business; employee benefit plans subject to the Employee Retirement Income Security Act of 1974 with total assets exceeding $5,000,000; governmental entities; broker-dealers; futures commission merchants; and natural persons having total assets exceeding $10,000,000.

In addition to restricting the categories of participants eligible to participate in exempt transactions, the CFTC's swaps exemptive rules impose restrictions upon the design and execution of the transactions that distinguish them from exchange-traded futures contracts. To qualify for exemption: the swap may not be part of a fungible class of agreements that are standardized as to their material economic terms; the creditworthiness of any party having an actual or potential obligation under the swap agreement must be a material consideration in entering into or determining the terms of the swap agreement; and the swap agreement may not be entered into or traded on a multilateral transaction execution facility (a physical or electronic transaction execution facility in which participants can simultaneously effect or offset transactions and bind both parties).

The CFTC swaps exemption does not exempt swaps from all statutory antifraud and manipulation prohibitions. However, no prescriptive, affirmative requirements as to the conduct of the transactions, other than the participant, design and execution

criteria of the exemptive rules, apply to qualifying swaps.[11/]

2. Hybrid Instruments. Also pursuant to the Conferees' direction and the new exemptive authority granted by the FTPA, the Commission amended its Part 34 rules, "Regulation of Hybrid Instruments," in January, 1993.[12/] Under the revised rules, a hybrid is defined as a financial instrument that combines characteristics of commodity futures or option contracts, or both, with equity, debt or depository instruments. Eligibility for exemption under the revised rules is based upon measurement of the commodity component of the instrument as compared to the instrument's commodity-independent component. If the commodity independent component of the instrument, that is, the portion of the instrument that is subject to regulation under the securities or banking laws, is of greater value than the commodity component and the other criteria of the rule are satisfied, the instru-

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11/ Although the CFTC's swaps exemptive provision preserves the applicability of statutory antifraud and manipulation prohibitions, these prohibitions are limited to specified types of conduct involving futures and options contracts or the cash market. There is no statutory or regulatory antifraud provision expressly designed to cover swaps. For example, CEA Section 4b, the general antifraud provision applicable to futures contracts, prohibits, among other things, any person from cheating, defrauding or attempting to cheat or defraud any person "in or in connection with any order to make, or the making of, any contract with any commodity for future delivery . . . for or on behalf of any person." Liability under this provision thus would arise from a swap transaction only to the extent that a futures contract under the CEA were shown to be involved.

12/ 58 Fed. Reg. 5580 (January 22, 1993). This rulemaking is responsive to the Conferees' direction with respect to hybrids and bank deposits and accounts.

ment is exempt from CFTC regulation. The Commission limited the availability of the Part 34 exemption to hybrid instruments that are issued or sold: (1) subject to applicable federal or state securities or banking laws; and (2) to persons permitted under such laws to purchase or enter into the hybrid instrument.[13/] The exemption is based on the concept that a hybrid instrument should be subject to regulation in accordance with the regulatory framework applicable to its dominant component.[14/]

3. Energy Contracts. By order issued April 13, 1993,[15/] the CFTC exempted certain contracts for the deferred purchase or sale of specified energy products from regulation

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13/ Further,

> (i) the issuer must receive full payment of the hybrid instrument's purchase price, and a purchaser or holder of a hybrid instrument may not be required to make additional out-of-pocket payments to the issuer during the life of the instrument or at maturity;
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> (ii) the instrument may not be marketed as a futures contract or a commodity option, or except to the extent necessary to describe the functioning of the instrument or to comply with applicable disclosure requirements, as having the characteristics of a futures contract or a commodity option; and
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> (iii) the instrument may not provide for settlement in the form of a delivery instrument that is specified as such in the rules of a designated contract market.

17 C.F.R. § 34.3(a)(3) (1993).

14/ 58 Fed. Reg. at 5580, 5581 n.2.

15/ 58 Fed. Reg. 21286 (April 20, 1993).

under the CEA. The order applies to contracts for the deferred purchase or sale of crude oil, condensates, natural gas, natural gas liquids, or their derivatives that are used primarily as an energy source. The contracts must be entered into between commercial participants meeting specified requirements. These requirements relate to, among other things, the capacity to make or take delivery and regulated status, minimum net worth or total assets, which evidence the commercial status of the parties and distinguish the exempted transactions from those required to be effected on approved exchanges. Under the order, qualifying contracts are exempted from all provisions of the CEA except Section 2(a)(1)(B), the so-called "jurisdictional accord" between the CFTC and SEC, and the provisions prohibiting price manipulation.

B. CFTC OTC Derivatives Report

The FTPA directed the Commission to conduct a study to determine, *inter alia*, the size, scope, activities and potential risks presented by the markets for swaps and other off-exchange derivative financial products, the need for additional regulatory controls applicable to these products, and whether a single federal regulatory agency should regulate such products. The Commission's October 1993 report, *OTC Derivatives Markets and Their Regulation* ("CFTC Report"), describes the various legal frameworks applicable to OTC derivatives transactions and stresses the "cross-regulatory" nature of the issues raised by OTC derivatives. The Report notes that these products "are not

readily cabined within any single regulatory structure" and that their systemic and public policy implications also transcend regulatory boundaries.

Although the Report does not recommend any fundamental changes in the current regulatory structure for OTC derivatives, the Commission supported the establishment of an interagency council to foster regulatory coordination in this area and to identify and consider common regulatory issues raised by OTC derivative products. The Commission cited the President's Working Group on Financial Markets, originally established to address intermarket issues raised by the October 1987 market break, as a model for such an interagency council. The CFTC's Report sets forth a number of suggested agenda items for the recommended interagency group, including the following.

1. Information Access. The Commission cited the difficulty of obtaining comprehensive information as perhaps the most pressing issue in this area. The Commission recommended that an early focus of the federal financial regulators' efforts should be the identification of information gaps and needs, including what information is available and where it is located; how information currently collected under risk assessment, capital or other authorities held by the various regulators could be made more standardized; whether better arrangements for the collection, exchange and review of information could improve its usefulness; and the extent to which existing authority is suffi-

cient as to unregulated end-users and unregistered or foreign entities performing intermediary functions.

2. Pricing, Disclosure and Risk Valuation Issues. The Report identifies as an issue for interagency consideration the relative lack of transparency in OTC derivatives markets, including the potential impacts of price opacity upon risk management and the adequacy of financial disclosure concerning OTC derivatives.

3. Internal Controls. The CFTC Report recommends that federal regulators discuss how best to cooperatively reinforce the importance of sound internal risk controls. By way of example, the Commission suggested that regulators could recommend that existing self-regulatory organizations ("SROs") for financial intermediaries under their supervision consider adopting guidelines or principles of conduct that encourage best internal control practices on the part of such SROs' member intermediaries and end-users. In addition, members firms could be encouraged to assure that the counterparties with whom they elect to do business maintain adequate internal controls.

4. Clearing Facilities for OTC Derivatives. The Report recognized that proposals for clearing systems for various types of OTC derivatives raise many issues that are of common interest to federal financial regulators and suggested interagency consideration of these cross-market issues.

5. Scope of Regulatory Oversight Over Dealers. The Commission suggested that the interagency council consider issues

raised by the presence of OTC derivative dealers that are not otherwise subject to federal oversight.

C. Participation in the President's Working Group on Financial Markets

Following the CFTC's recommendation for coordinated interagency consideration of OTC derivatives issues through a vehicle such as the President's Working Group on the Financial Markets, on January 3, 1994, Treasury Secretary Bentsen wrote to the members of the Working Group requesting that the Group consider new developments in the financial markets, including the growing OTC derivatives markets.[16] Secretary Bentsen's letter noted that this initiative would be consistent with the CFTC's recommendation for an interagency coordinating group to address OTC derivatives issues.

The Working Group members, the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System and the Chairmen of the SEC and the CFTC, as well as staff representatives from each agency, have been meeting on a regular basis pursuant to Secretary Bentsen's request. The Working Group has undertaken a number of projects relevant to OTC derivatives that relate to issues identified in the CFTC's Report, the GAO Report and the issues posed by the Subcommittee. In addition, a series of presentations has been made by staff members of the various agencies which address internal control, risk assessment, and other issues relevant to OTC derivatives under each agency's

16/ The Comptroller of the Currency had also previously called for interagency action on this issue.

area of responsibility. Since its reactivation, the President's Working Group on Financial Markets has provided an important mechanism for the collective consideration by the federal financial regulators of such issues as access to information concerning OTC derivative transactions, internal management controls, technical improvements in legislation designed to give greater certainty to netting arrangements, the development of clearing facilities for OTC derivatives, systemic risk, disclosure, and customer protection.

D. Risk Assessment Rules

In response to a Commission request in 1989, Congress in the FTPA granted the Commission new authority to obtain information concerning activities of futures commission merchant affiliates that could pose material risks to such regulated firms. The risk assessment provisions of the FTPA provide the CFTC with authority that closely parallels that granted to the SEC in the Market Reform Act of 1990, which the SEC implemented in July 1992. This statutory authority was granted in recognition of the fact that the operations of regulated FCMs may be materially affected by, and are best understood in the context of, the activities of their affiliated entities, many of which may be unregulated. Concomitantly, the effectiveness of ongoing financial oversight programs may depend upon access to information concerning risks to the FCM created by affiliate activity, and the efficacy of regulatory responses to financial problems at the

regulated entity may be enhanced by access to information concerning relevant affiliate activity.

The Commission has proposed rules that would require futures commission merchants to maintain and report to the Commission certain information concerning their organizational structure, risk management policies, and affiliate activities which may pose material risks to the financial or operational condition of the FCM.[17] The proposed rules are designed to facilitate financial oversight of FCMs that are part of holding company groups whose activities may affect the FCM's overall financial condition or in which the group maintains control of funding outside of the FCM.

For example, under the proposed rules FCMs would be required to maintain and report information related to their own holdings and those of material affiliates that present off-balance sheet risk such as swaps and over-the-counter securities options, with breakdowns of swaps by type (e.g., interest rate, foreign currency) and maturity, since the risk of such holdings may not be adequately reflected under existing financial rules. FCMs would also be required to maintain and report quarterly on open exchange-traded futures positions carried in accounts on behalf of affiliates. Large positions in such accounts may represent a significant exposure of the FCM to risks created by its affiliates' trading activities relative to cash flow or financing shortages. Such positions are not subject to the haircuts

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17/ 59 Fed. Reg. 9689 (March 1, 1994).

applicable to an FCM's own positions nor do they affect an FCM's minimum adjusted net capital requirement since they are not treated as customer positions. Consequently, additional scrutiny of such positions may be necessary to develop a full risk assessment of the FCM's condition.

E. International Activities

The CFTC concurs with the GAO that the market for OTC derivative products is a global one. The size and scope of international activity in such products, particularly at market centers, reflects the ease with which such products can cross borders. In the exchange-traded futures markets alone, during the 1980's, forty-six new non-U.S. futures and options exchanges in twenty-four different countries commenced derivatives trading and in 1993 more than one-half of the total number of futures exchange transactions occurred outside of domestic markets. This being so, international coordination and harmonization of minimum requirements, as well as international agreement on the availability and legality of bilateral close-out netting, are increasingly relevant not only to the adequacy of U.S. prudential supervision, but also to the maintenance of the U.S.'s competitive posture internationally.

The problems at Metallgesellschaft ("MG"), which required a massive debt restructuring which is still ongoing, are ample evidence that the interface between regulated futures and over-the-counter markets is an international cause for concern. The Commission worked with the exchange, certain international

regulators and the regulated entity through which MG non-financial affiliates cleared futures trades in addressing the potential for the firm's problems to have spill-over effects. More remains to be known about the nature and scope of that trading.

The Commission has made effective use of existing information-sharing arrangements and has the capacity to exchange information about firms regulated in other jurisdictions that are key-related affiliates of U.S. firms from certain jurisdictions. However, the Commission believes that more can be done to facilitate the flow of information for supervisory purposes among financial regulators, and it is currently discussing new expanded Financial Information Sharing Memoranda of Understanding with the United Kingdom and the Netherlands, respectively. The CFTC also participates actively in the International Organization of Securities Commissions ("IOSCO") working parties on derivatives comprised of members of the Technical Committee and the Development Committee. Working Party 3, which previously developed principles for financial supervision of conglomerates, currently is examining OTC derivatives, addressing, among other things, data collection, lead regulators, and a map of the existing regulatory structures which pertain to these transactions.

The Commission is drafting a consultative paper on internal control performance objectives for that Working Party. The purpose of this paper, if adopted by IOSCO, will be to seek comment by regulators and OTC derivatives market participants on the extent to which, and the methods whereby, regulators may wish

to encourage or require the use of specified internal control mechanisms by regulated intermediaries and nonregulated dealers and end-users to manage the risks of OTC derivative products.

Under the auspices of the Development Committee, the Commission participated in a Task Force which is identifying the elements of the regulatory infrastructure to be considered in emerging markets which seek to establish exchange derivative markets.

The Commission also joined with the SEC and the U.K. Securities and Investments Board (SIB) on March 15, 1994 in issuing a Joint Statement setting forth an agenda for action concerning oversight of the OTC derivatives market. This is the first international understanding among futures and securities regulators for developing and coordinating an approach to the OTC derivatives market. The seven point program includes:

* improving international oversight of OTC derivatives trading through enhanced information sharing;

* improving risk management by promoting the use of legally enforceable netting arrangements;

* addressing concerns about excess leverage by promoting the establishment of prudent risk-based capital charges and increased use by firms of stress simulations of severe market conditions;

* promoting the development and use of sound management controls as part of an effort to monitor and control firms' activities and risk;

* encouraging strengthened standards for customer protection;

* examining the regulatory framework for multilateral clearing arrangements; and

* promoting improved standards for accounting recognition, measurement and disclosure.

The authorities pledged to work actively with other domestic and international futures, securities and financial regulators to promote wider regulatory cooperation and are also committed to taking further action in each of the areas specifically mentioned. The Japanese authorities have commented favorably on this plan of action.

III. <u>GAO Findings and Recommendations</u>

Although the Commission has not had an opportunity for extensive study of the recently released GAO Report, I am prepared to convey our preliminary views on the GAO's recommendations to the financial regulators and to Congress. We do not comment on the recommendations made to other regulators but we support the view that each should carefully analyze the scope of its existing authorities to assure that they are used to the fullest extent to address needed protections before seeking broader legislative action.

A. <u>Principal Findings</u>

GAO cites the various types of risks posed by derivatives and correctly notes that these general types of risk exist for many financial activities. GAO also finds that the specific risks in derivatives activities are relatively difficult to manage, in part due to the complexity of the products and the difficulty of measuring their risks. The CFTC generally agrees with these comments as they apply to OTC derivative transactions but not as to exchange-traded derivatives, which have effective

credit and market risk protections, and generally do not give rise to legal risk. With respect to OTC derivatives, however, the CFTC's Report discusses various types of risks, including those cited by the GAO. Like the GAO Report, the CFTC Report stresses the importance of internal controls and improved disclosure. GAO's finding that some OTC derivatives dealers are not regulated is also consistent with the CFTC Report, which cited the existence of unregulated OTC derivative dealers as a subject for further review on an interagency basis. The Commission concurs in GAO's general findings concerning the need for improved accounting standards to ensure adequate disclosure of derivatives activity and for coordinated international efforts to harmonize international regulation of derivatives.

B. Recommendations to the Financial Regulators

The GAO Report includes several recommendations to all federal financial regulators. These recommendations relate to the development of centralized information on OTC derivatives, capital standards, audit committee requirements, reporting concerning internal controls, annual examination of major derivatives dealers' risk management systems, and providing leadership to harmonize disclosure, capital, examination and accounting standards for derivatives.

1. Centralized Database. The GAO supports the concept of reporting essential transactional and exposure data on OTC transactions to a central database. The Commission currently has electronically transmitted day-to-day position information on all

traders in the markets it regulates and is pursuing risk assessment information on activities of affiliates that pose material risks to regulated entities. As I have mentioned, in its own report, the CFTC stressed the importance of an interagency inventory of available data and urged that this subject be made an early priority for interagency review. The Working Group has initiated a project that is designed to evaluate the extent of the various agencies' access to OTC derivatives data, including the specific types of information reported, the extent to which such information can be shared with other regulators, and areas in which additional data are desirable or necessary. The vast variety of types of OTC products and participants makes the subject of data collection complex and the construction of an inventory of data availability in itself an ambitious undertaking. Consequently, while development of a centralized database (or readier access to existing databases) may be desirable, there remains substantial work to be done to determine how such a database can be constructed and data collected in a manner that would make a centralized repository useful.

2. Capital Standards and Other Requirements for Major OTC Derivatives Dealers

The GAO recommends that the financial regulators work closely with industry representatives to develop consistent capital standards for OTC derivatives dealers, establish specific requirements for independent, knowledgeable audit committees and internal control reporting for all major OTC derivatives dealers

and perform comprehensive annual examinations of the adequacy of major OTC derivatives dealers' risk-management systems.

The Commission has expressly endorsed the improvement of internal controls and risk management practices at dealers and end-user firms. It also believes that any effort to harmonize capital standards or other risk management approaches should take into account that the risks of OTC derivatives may require treatment that draws on more than one regulatory scheme and that the credit risk and pricing risks related to these products may require particularized management techniques.[18]

18/ The Commission is aware of the ongoing domestic and international debate on capital standards generally. See, e.g., the SEC Concept Release, 58 Fed. Reg. 27986 (May 4, 1993), relating to the appropriate treatment of credit risk, options pricing models and capital treatment of so-called derivative product companies, and the subsequent SEC proposal permitting the use of theoretical pricing models for calculating capital charges on proprietary positions in listed options and related positions (SEC release No. 34-33761) for which the comment period closed May 16, 1994, 59 Fed. Reg. 13275; and the April 1993 proposals of the Basle Committee on Banking and Supervision (formed under the auspices of the Bank for International Settlements) on netting, market risk, and an interim approach to interest rate risk. See also, paragraphs II and III of the Joint Statement among the SEC, CFTC and U.K. SIB issued March 15, 1994 which state:

II. Netting Arrangements

> Appropriate netting arrangements that are legally enforceable in a bankruptcy proceeding are a critical component of risk management by enabling financial market participants to control and manage their credit exposure to counterparties. The Authorities will promote the use by securities or futures firms of appropriately designed netting arrangements which the Authorities are satisfied are legally enforceable. Accordingly, the Authorities agree that applicable capital standards should reflect, to the extent appropriate, the risk-reduc-

(continued...)

3. Coordination and Harmonization

The GAO's recommendation that federal regulators provide leadership in working with industry representatives and regula-

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18/ (...continued)
ing characteristics of legally enforceable netting arrangements. The Authorities will promote efforts to achieve mutually acceptable recognition of netting by financial regulators. The Authorities also will advocate, as appropriate, amendments to domestic (and, in the case of SIB, EC) insolvency and other relevant legislation.

III. Capital Standards

The Authorities recognize that regulatory capital is a critical element in the prudential regulation of securities or futures firms and helps to address concerns regarding excessive leverage within such firms. Regulatory capital charges should address in particular, market and counterparty risks, and the risks involving concentrated exposures. In this context, the Authorities believe that regulatory capital standards should encourage incentives for good risk management, for example, by reflecting the risk-reducing characteristics of legally enforceable netting arrangements and of appropriate risk management techniques which satisfy standards set by the regulators. The Authorities also recognize that prudential supervision of the regulated activity must address in an appropriate way the risks to the regulated entity posed by related entities, for example by the reporting of information on material related entities by the regulated entity.

The Authorities have been engaged in work to review and (in the case of SIB, in order to implement the EC Capital Adequacy Directive) to modify, as appropriate, their capital standards. The Authorities will work to promote the establishment of prudent risk-based capital charges for securities and futures firms, taking into account prudential policies on customer funds. The Authorities also recognize that it is important, for prudential reasons, for securities and futures firms using proprietary models to incorporate and to undertake stress simulations approximating severe market movements.

tors from other major countries to harmonize disclosure, capital, legal requirements, and examination and accounting standards for derivatives is consistent with ongoing regulatory efforts domestically and internationally. In advocating such efforts, the GAO joins a long list of commenters who have stressed the need for harmonization of regulatory efforts in this area, both among domestic regulators (including securities, futures, banking and insurance regulators) and among international regulatory authorities in order for any approach to derivatives, which readily cross borders and are traded by institutions subject to different regulators within most jurisdictions, to be effective.

The CFTC Report on OTC derivatives also singled out the need for coordinated efforts to achieve sensible, effective "institutional" regulation without unnecessary duplication; supported the notion of functional regulation tailored to the markets and participants to which it applies; and indicated our view that structural changes to the markets should be carefully conceived to assure that they improve existing protections and do not unnecessarily hamper innovation or impede prudent uses of risk-shifting instruments. Not only does the CFTC agree that further harmonization and coordination is desirable, the CFTC spearheaded reinvigoration of the President's Working Group on Financial Markets, which we believe is well-suited to coordinate federal agencies' efforts in this area. The CFTC has also played a leadership role in the international community.

C. Recommendations to Congress

The GAO recommends that Congress take action directed toward regulation of OTC derivatives dealers and to reconstruction of the entire U.S. financial regulatory system. The Commission believes, however, that at this juncture the regulatory community should cooperatively explore how existing regulatory authorities can be used to address the issues relating to OTC derivatives, that the Working Group is an appropriate forum in which to consider these issues, and that it would be premature to seek legislation.

For example, to the extent the entities in question are affiliates of SEC or CFTC registrants, they are already subject to those agencies' risk assessment authorities. Moreover, better internal controls and risk management practices among all dealers can be encouraged through end-user regulation. The CFTC has in recent months taken steps to promote better disclosure of OTC derivatives transactions by collective investment vehicles active in the futures markets (commodity pools).[19]

Finally, all market participants must comply with the access and design restrictions contained in exemptions the CFTC has granted for swaps and other types of OTC derivative transactions. The CFTC's power to reevaluate and impose conditions on exemptions for OTC derivative transactions could always be drawn upon

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19/ As discussed infra, the Commission has recently proposed amendments to its rules governing commodity pool operators and commodity trading advisors which would assure disclosure of risks such as counterparty creditworthiness risk relevant to OTC transactions. See 59 Fed. Reg. 25351 (May 16, 1994).

if additional regulation in this area were determined to be warranted. Alternatively, this authority is an important regulatory tool which could be used in consultation with other regulators to encourage private sector initiatives.

D. Recommendations to FASB

The CFTC believes, as noted in its OTC Report, that adequate financial disclosures by end-users, dealers and intermediaries is vital. To this end, the CFTC endorses improved quantitative and qualitative accounting disclosures to the extent that the "snapshot" concept of financial statements is ill-suited to measuring the dynamic risks of OTC portfolios. Such improvements should be directed to all off-balance sheet instruments regardless of the nature of the underlying right of interest. Additionally, the CFTC believes that it should be made clear that existing fiduciary and regulatory disclosure obligations for its registrants require disclosure of risks by intermediaries that takes account of the complexity of the product and the sophistication of the user.

IV. Questions Posed by the Subcommittee

A. Systemic Risk: the potential for derivatives to contribute to increased systemic risk in the financial system (including the potential for such financial instruments to contribute to increased levels of volatility or excessive speculation in the stock and bond markets).

Concerns about the potential for derivatives to contribute to increased systemic risk in the financial system appear to be

based on a number of factors, including the size and complexity[20/] of the derivatives markets, the extent of concentrations of activity in unregulated dealers, lack of transparency, the potential for fluctuations in market liquidity, and potential interconnections between OTC markets and regulated markets. As discussed in the CFTC OTC Report and in the GAO Report, it is important to note that many of the risks discussed in connection with OTC derivative products are not unique to those products but are common to other financial products. Although the empirical evidence does not support the view that derivatives cause volatility, it is true that the complementarities and dependencies among OTC derivatives and central markets are complex. For example, many OTC dealers and end-users participate in both OTC and central market transactions.

Exchange derivative markets are structured to remove the risks of measurement and pricing characteristics of certain OTC transactions. Such markets also have clearing facilities and settlement and payment regimes which are designed to materially limit the credit risk characteristic of OTC transactions. It should also be noted that exchange-traded derivatives may permit market participants to rebalance or adjust the degree of equity and/or interest rate exposure in their portfolios without immedi-

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20/ Although the volume of derivatives activity has grown rapidly over the past ten years by any standard of measurement, the widespread use of notional principal amounts to measure the OTC derivatives market grossly overstates total risk exposure. This is because, for many common OTC derivatives transactions, notional principal is used only to calculate payments between counterparties and is never exchanged.

ately adjusting their cash market positions and with less potential market impact than through the exclusive use of the cash market.

B. Internal Controls and Risk Management: the nature and adequacy of internal controls and risk management systems at both the financial intermediaries and the corporate or other end-users of derivative financial instruments (e.g., mutual funds, municipalities, pension plans or other institutional investors.)

The second issue raised by the Subcommittee is the nature and adequacy of internal controls and risk management systems at both financial intermediaries and the corporate or other end-users of derivative financial instruments (e.g., mutual funds, municipalities, pension plans or other institutional investors). In the exchange-traded area, with respect to the financial intermediaries under our jurisdiction that handle customer funds (FCMs), these intermediaries are required to meet certain performance standards concerning internal controls and obtain third-party audits on at least an annual basis to verify whether there are any material inadequacies in such internal controls.[21/] FCMs are also subject to segregation and capital requirements to protect against loss of customer funds.[22/] All commodity professionals who act as intermediaries or who render advice on commodity futures and options must be registered and must supervise the accounts they handle and the personnel they em-

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21/ Commission Rules 1.12 and 1.16, 17 C.F.R. §§ 1.12 and 1.16 (1993).

22/ 7 U.S.C §§ 4d(2) and 4f(b) (1988 & Supp. IV 1992); 17 C.F.R. §§ 1.17, 1.20-1.30, 1.32 and 1.36 (1993).

ploy.[23/] In addition, the National Futures Association (NFA), the only registered futures association,[24/] requires its members, which include FCMs, introducing brokers, commodity pool operators and commodity trading advisors, to perform a comprehensive self-audit annually.[25/] We further note that the CFTC's proposed risk assessment rules would require the FCMs to whom they apply to review their existing internal controls and risk management systems and procedures with a view towards assuring that those systems are sufficient in light of the potential risks created by their own and their affiliates' activities.[26/]

The Commission examined internal controls with respect to OTC derivatives as part of its OTC derivatives study. Although the Commission found that there are no regulatory requirements for OTC markets participants that correspond to those applicable in the exchange-traded derivatives environment, regulators and private organizations have devoted increasing attention to the importance of firms' internal control and risk management procedures as the first line of defense against OTC derivative risks.

23/ 7 U.S.C. §§ 6d, 6e, 6k and 6n (1988 & Supp. IV 1992).

24/ Section 17 of the CEA, 7 U.S.C. §21 (1988 & Supp. IV 1992) and Parts 170 and 171 of the Commission's rules, 17 C.F.R. Parts 170 and 171 (1993), govern the activities of registered futures associations.

25/ NFA Interpretative Notice to Compliance Rule 2-9: Self-Audit Questionnaires, NFA Manual, Vol. 1 ¶ 9020 (WGL) (October 6, 1992).

26/ 59 Fed. Reg. 9689 (March 1, 1994).

Basic risk controls include: marking of open positions to market on at least a daily basis; separation of risk management, credit assessment and trading functions; and prevention of deferral of loss reporting to management.[27/] Generally, the data collected by the CFTC concerning the risk management procedures of OTC derivatives participants are consistent with the conclusions of other OTC derivatives studies that participants in such markets recognize the importance of devoting substantial resources to the evaluation, monitoring and management, on a global basis, of the risks incurred in such activities. However, although most OTC derivative transactions currently may occur in firms with sophisticated evaluation and management systems, many have expressed concerns about the level of risk control in the less expert community. Mutual funds, pension plans, banks and insurance companies are subject to specialized regulatory frameworks, including internal control guidelines.

As the Commission recommended in its OTC derivatives report, federal regulators could discuss in an interagency forum how best to cooperatively reinforce the importance of such internal controls. For example, regulators could recommend that existing self-regulatory organizations (SROs) for financial intermediaries under their supervision consider adopting guidelines or principles of conduct encouraging best internal control practices on the part of such SROs' member intermediaries and end-users. Member firms could likewise be encouraged to assure that the

27/ CFTC Report at 134.

counterparties with whom they elect to do business also maintain adequate internal controls.

C. Protections Afforded End-Users: the nature and adequacy of existing protections afforded to corporate or other end-users of derivatives from abusive practices in connection with sales of such financial instruments (e.g., the sale of unsuitable investments to customers, inadequate disclosures regarding the risks associated with these products).

The Subcommittee has also inquired concerning the nature and adequacy of existing protections afforded to corporate or other end-users of derivatives from abusive practices in connection with sales of such financial instruments (e.g., the sale of unsuitable investments to customers and inadequate disclosures regarding the risks associated with these products). With respect to regulated futures accounts, the CFTC requires that each customer be furnished with a basic, single-page risk disclosure statement and, if applicable, a separate risk disclosure statement for exchange-traded commodity options before an account can be opened for the customer. These exchange-traded products are offered and sold to a wide range of users without any CFTC-imposed limitations on access. Consequently, CFTC-mandated disclosure statements are designed for all types of market participants. FCMs and other commodity professionals are required to disclose all material information to customers in addition to the prescribed risk disclosure statements.

The exemptions which the CFTC has granted with respect to off-exchange instruments have been premised either upon the applicability to the instrument of another regulatory framework or upon limitations upon the nature of the transactions and their

participants that establish minimum financial levels or other requirements, e.g., registration status, which provide a foundation for waiving otherwise applicable requirements under the CEA and CFTC rules.[28] These access restrictions may serve some of the same purposes as suitability rules. We also generally have reserved fraud jurisdiction under the Commodity Exchange Act and CFTC rules when granting such relief. Of course, under the authority granted to the Commission in the FTPA, it would be possible for the Commission to revisit previously granted exemptions for off-exchange instruments if additional protections were determined to be needed.

D. Public Disclosure: the nature and adequacy of the public disclosures provided to investors regarding the derivatives holdings of public companies, mutual funds, municipal governments, and other end-users of derivative financial products.

The Subcommittee has also requested our views concerning the nature and adequacy of the public disclosures provided to investors regarding the derivatives holdings of public companies, mutual funds, municipal governments, and other end-users of derivative financial products. Although this issue is more appropriately addressed by other regulators, I note that we have encouraged the efforts of the Financial Accounting Standards

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28/ For example, to be an eligible swap participant, a natural person must have total assets of at least $10 million, and an entity must have a net worth of $1 million and use the swap in the conduct of its business or otherwise have a net worth of $10 million, or be a governmental entity or an entity that is otherwise regulated, such as a bank, insurance company, broker-dealer or investment company. See 17 C.F.R. § 35.1(a)(2)(1993).

Board to assure that it addresses commodity as well as financial derivatives in developing appropriate reporting rules for financial statements.

I also note that the CFTC does regulate one type of frequent end-user of OTC derivatives -- commodity pools, the futures counterpart of mutual funds. The Commission has recently proposed amendments to its rules governing commodity pool operators and commodity trading advisors which would expressly require as part of the disclosure provided to customers a discussion of the principal risk factors of the investment, including risks such as counterparty creditworthiness risk relevant to transactions in off-exchange instruments.[29/]

E. Regulatory or Legislative Changes: the need for any changes in the regulatory treatment of derivative financial instruments or the adoption of remedial legislation relating to such instruments.

Finally, the Subcommittee has requested our views as to the whether there is a need for any changes in the regulatory treatment of derivative financial instruments or for the adoption of remedial legislation relating to such instruments. We do not believe that there is such a need at this time.

I have discussed above several aspects of the CFTC's activities with respect to OTC derivatives. Implementation of the CFTC's risk assessment authority, which is designed to address some of the risks for regulated FCMs created by OTC transactions, is a high priority on the CFTC's agenda. Working Group initia-

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29/ See 59 Fed. Reg. 25351 (May 16, 1994).

tives to improve access to information about OTC derivatives, enhance the enforceability of netting arrangements, improve accounting disclosure, and explore customer protection issues in the OTC derivatives context are also underway.

As discussed in the CFTC's Report, OTC derivatives transactions generally are conducted beyond the scope of most securities and futures regulatory requirements because of the nature of the participants involved, i.e., their financial resources, registration status or legal status based upon which they are deemed to be sophisticated or otherwise not in need of protections accorded the general public, and because they occur in a privately negotiated context outside of a public offering or auction context. Relevant regulatory exemptions exist under the securities laws as well as under exemptive rules adopted by the CFTC pursuant to the FTPA and the directives set forth in the legislative history of the FTPA. As I have noted above, the Commission believes that each regulator should explore the full extent of the initiatives which can be undertaken under its own authority to assure that the risks and implications of OTC derivatives are addressed appropriately. In this regard, the Commission has the authority to reevaluate the exemptions which it previously granted. For instance, the CFTC's power to impose conditions on exemptions for OTC derivatives transactions could be drawn upon in consultation with other regulators. Alternatively, this authority could be used as a tool to encourage private sector initiatives.

The Commission also believes that in the event that new statutory authority to address OTC derivatives issue is determined to be necessary, that authority should be designed with the benefit of the expertise of the various existing financial regulators. In light of the fact that OTC derivatives combine multiple types of financial interests as well as physical commodities, for certain types of instruments, such as commodity swaps, the most appropriate regulatory structure for these types of products may involve aspects of more than one existing regulatory structure. The Commission therefore believes that the appropriate regulatory treatment of OTC derivatives may not be that of any single existing structure, such as the current bank-regulatory approach, but rather a new framework with elements drawn from various regulatory approaches. The Working Group provides a forum for development of new regulatory approaches of this nature.

Mr. MARKEY. That completes the time for opening statements by witnesses.

We will now turn to questions by the subcommittee members.

The Chair will recognize himself and begin with you, Chairman Levitt, if we could.

On page 28 of your prepared testimony, you state that, quote: "We share GAO's concern regarding the activities conducted in unregulated affiliates of broker-dealers." And on page 289, you say that: "More can and should be done to address the need for capital standards, suitability standards, risk management controls, recordkeeping, and reporting, examination and enforcement by the Securities and Exchange Commission and the SRO's and the interaction between derivatives and the cash market."

I would like to ask a few questions about the nature and extent of the SEC's current legal authorities to take action in these areas, and I would like you to give brief responses, a simple "yes" or "no" if possible, so that we could get through each of the various areas and understand, first, what legislative power has been given to you at this point to deal with any of these issues.

First, if the SEC wanted to subject the unregulated derivatives affiliate of a securities firm to a routine inspection or examination of its internal controls and risk management systems and the firm said no to the SEC—we don't want you to do that—would you, the SEC, have the legal authority to go in and conduct such an inspection?

Mr. LEVITT. No.

Mr. MARKEY. The SEC's risk assessment form 17-H states, on the very first page, that intentional misstatements or omissions of fact may result in civil and criminal penalties.

Does the SEC have the legislative authority to go into the unregulated derivatives affiliate of a securities firm and check to see if any such misstatements or omissions have been made?

Mr. LEVITT. No.

Mr. MARKEY. Wouldn't you first require there to be some evidence of a potential violation or other probable cause before you could initiate such an inspection?

Mr. LEVITT. Would you repeat that question, please?

Mr. MARKEY. Would you have to first require there to be some evidence of a potential violation or other probable cause before you could initiate such an inspection?

Mr. LEVITT. Well, under our antifraud authority, if that fraud pertained to a securities derivative, we might be able to act upon that.

Mr. MARKEY. OK. Isn't it true that the SEC often uncovers evidence of problems with internal controls or even fraudulent or manipulative activities during routine inspections or examinations of registered broker-dealers?

Mr. LEVITT. Yes.

Mr. MARKEY. In fact, isn't that just what happened during the course of your recent World Broker Study where you ended up with about 40 referrals to enforcement?

If you are prevented from conducting routine examinations or inspections with respect to derivatives dealers affiliated with securi-

ties firms, doesn't that eliminate the prospects for any wrongdoing at such firms to be detected in that fashion?

Mr. LEVITT. No, I don't believe so. I think that under the risk management policies which have been recently enacted, we receive fairly regular reports from firms about the activities of their broker-dealer unregulated affiliates. We are not totally without resources with respect to those derivatives that deal with securities.

Mr. MARKEY. If the SEC wanted to mandate that an unregulated derivatives affiliate of a securities firm set aside a certain amount of capital as a cushion against loss and the firm said no—we don't want them to do that—would you be able to compel them to set aside more capital?

Mr. LEVITT. No, we would not.

I would like to say, though, that the affiliates of broker-dealers are subject to Commission oversight under the risk assessment program, and we do receive detailed information from the broker-dealer concerning affiliates. And I think we should also be mindful of the discipline imposed by the marketplace in rating agencies, which help to ensure that broker-dealer affiliates are adequately capitalized and do have sound risk management systems.

Mr. MARKEY. But you just said that you don't have the authority to verify what they tell you on the risk assessment form; so you don't know for sure that the data is accurate?

Mr. LEVITT. If they wish to defy the Commission and to deny us the kind of information we receive from our regular risk assessment program, they could do so.

Mr. MARKEY. There is nothing you could do about it?

Mr. LEVITT. That is correct.

Mr. MARKEY. If the SEC wanted suitability standards to be developed for OTC derivatives transactions and an unregulated dealer affiliated with a securities firm either did not wish to comply with such standards or failed to ensure compliance, would the SEC or the SRO's be able to take action?

Mr. LEVITT. I suppose if they denied us access, we could rely in general on our risk assessment program. Thus far, we—I can't answer simply yes or no without suggesting to you that we have had excellent cooperation from the firms and we have never been denied access. We have no reason to believe that any of the filing data was fraudulent, and they do have to give us the data under the risk assessment program.

Mr. MARKEY. But if the derivative is not in fact defined to be a security, would you be able to act?

Mr. LEVITT. No.

Mr. MARKEY. OK, thank you.

What Federal agency is empowered to oversee the derivatives affiliates of insurance companies, including conducting examinations, setting capital standards, and requiring comprehensive financial reporting?

Mr. LEVITT. I don't really know.

Mr. MARKEY. Do you disagree with the GAO's testimony that State insurance regulators do not currently regulate these activities?

Mr. LEVITT. Well, yes, I thought you were asking which Federal agency. No, State insurance regulators do regulate.

Mr. MARKEY. No Federal agency now has responsibility?

Mr. LEVITT. That is correct.

Mr. MARKEY. Can you see any reason for exempting derivatives dealers affiliated with insurance firms from Federal regulation, particularly if the Federal regulation is extended to firms affiliated with securities firms as well?

Mr. LEVITT. I am not sure, Mr. Chairman. I haven't really focused on insurance companies and I don't really have an answer for that.

Mr. MARKEY. Thank you.

Mr. Greenspan, if I may, in your prepared statement you said that the board is not persuaded that public policy considerations require regulation of nonbank derivatives dealers. Why do you think the regulatory system is adequate when some dealers are subject to regulation, including examinations, capital standards and financial reporting, and others are not?

Why for the banks and no one else?

Mr. GREENSPAN. Well, Mr. Chairman, I would not acknowledge that these are unregulated institutions. The key question I think that we all have to address is what type of instruments are we dealing with, what type of financial system, what type of risk management systems are we dealing with, and do they pose systemic risk or other problems for national policy?

There is nothing involved in Federal regulation per se which makes it superior to market regulation. Indeed, if one looks into the future, what you can envision fairly readily is that the distinction between dealers and users is likely to diminish. That is, the complexity of these types of risk management systems that are evolving are going to make it very difficult to say this is a dealer and this is an user. We are going to be looking at very complex financial systems.

Mr. MARKEY. In your opinion, would that then make the case for a reduction of Federal regulation of banks in this area in order to make it more consistent with the securities and insurance industry? That is, you are making the case now for less regulation for banks.

Mr. GREENSPAN. Well, let me go further beyond the insurance companies and beyond the unregulated affiliates. A very substantial part of corporate America is going to be involved with these types of instruments. And I think it is mandatory for us as regulators of the system as a whole and those of us who are concerned about systemic risk, to try to ensure that the overall system is regulated, whether that be by the market, or if the market fails, by other regulators.

Mr. MARKEY. Well, our objective clearly is to make sure the market doesn't fail. And if in fact there is a set of regulations that Mr. Ludwig and Mr. Hove now administer, and there is not for the corresponding insurance and securities marketplaces, the question is whether or not there is an interconnection between these marketplaces that could come back to haunt the banking system of the country. And as I think you are saying—I think you are making the correct point, sir, that there is an interconnection. And our point is that if there is an interconnection, do we need less regulation on the banks because the market will discipline them, or do

we need more regulation on the insurance and securities industry, because of the impact that those industries could have upon the banking system?

And I think we are probably drawing different conclusions here. You are going to rely more upon the market. I am of the opinion that we need more scrutiny of the securities and insurance marketplace, as it interacts with the other financial institutions that are taxpayer supported.

Mr. GREENSPAN. Mr. Chairman, I think we need a different type of regulation.

Mr. MARKEY. What is that?

Mr. GREENSPAN. I think that the type of regulation that has been involved over the decades with respect to bank supervision, is clearly increasingly less relevant to the type of complex risk management endeavors that are involved in banks and other institutions. We obviously are having a wholly different type of requirement when you get to market risk with vast portfolios, of which derivatives are only part. And if you are going to appropriately supervise these types of institutions, it is becoming ever-increasingly apparent to those of us who are involved in this that we have to recognize that individual institution, especially the large ones, are going to have very complex systems. Regulation is going to have to make certain that their risk management systems function effectively.

And as I indicated in my remarks a few moments ago, I believe that we have to become increasingly concerned about the question of oversight of the process as distinct from regulation. If you are asking——

Mr. MARKEY. I am sorry, maybe I missed something. I don't quite know what you mean.

Is this the case for a single overarching Federal regulator of all of the financial marketplace?

Mr. GREENSPAN. It is not, Mr. Chairman.

Mr. MARKEY. It is not, OK.

Mr. GREENSPAN. It is an endeavor to recognize the type of financial risks that are emerging as a consequence of very rapid changes in the financial system.

Mr. MARKEY. My point to you is why shouldn't we give to the SEC, why shouldn't we give to appropriate other regulators, the ability to monitor the securities or insurance industries, consistent with what Mr. Ludwig and Mr. Hove are doing?

Mr. GREENSPAN. Let me explain why, Mr. Chairman, very specifically, with respect to this question at this time. We are finding that this whole structure is evolving at such a pace——

Mr. MARKEY. Which structure now?

Mr. GREENSPAN. The structure of risk management.

Mr. MARKEY. Risk management at private firms?

Mr. GREENSPAN. At private firms.

Mr. MARKEY. Not at the government level?

Mr. GREENSPAN. No, at the government level we are moving to address these issues at a very escalated pace, and I can speak for the comptroller——

Mr. MARKEY. Can I ask though, do you have any of the information which has been denied to Mr. Levitt, either about the internal

workings of these insurance or securities firms. Do you have that information?

Mr. GREENSPAN. No, I want to respond to the specific question which you are raising with respect to legislative authorities. Our concern is that we have to be very flexible at this particular stage to be capable of adjusting to the type of changes that are currently in train. If we have complete flexibility, which we do, to essentially cover a number of these areas and to create——

Mr. MARKEY. Who has flexibility?

Mr. GREENSPAN. We, the regulators.

Mr. MARKEY. We, the regulators. You mean stipulating the limitations which Mr. Levitt says he has within his own agency, the insurance regulators——

Mr. GREENSPAN. I am going to try to get to that question as far as we at the Federal Reserve Board see the question. Our concern basically is that legislation can be invoked in this particular area for the purpose of improving the Federal regulators capabilities for overseeing the system. We don't know at this particular point whether or not a specific set of legislative initiatives would have unintended consequences, as indeed previous types of regulation have had such consequences.

Mr. MARKEY. We are handing the authority over to you, though, and over to Mr. Levitt. I mean, what you have to conclude is that after we hand over discretionary authority to Mr. Levitt, if he going to abuse it and he is going to hurt the American economy, we are not going to be mandating any specific solution. We are going to be handing over to the SEC the ability to get information about the dealers that are not now covered. And then the Federal regulators will be able to work in a more coordinated way.

Right now, Mr. Ludwig and Mr. Hove know more things about the banking institutions than Mr. Levitt and insurance regulators at the State level know about their institutions. So how in the world can you have the flexibility which you are touting if in fact half of the regulators are flying blind with regard to what the state of play is out in the financial marketplace?

Mr. GREENSPAN. Well, I don't want to speak for Mr. Levitt who is more than capable of speaking for himself on this question, but as I listen to what he is saying, he expects and is indeed getting the level of cooperation from these institutions which is more than adequate to meet the oversight that we need, and that I suspect——

Mr. MARKEY. No, he is saying he has to rely upon their honesty. Is he not sure of the accuracy of the information. I suppose we could strike Mr. Ludwig and Mr. Hove of their authority and they could rely on the honesty of every banking institution in the country as well. But over here, I don't think I hear them recommending that they are now given too much information, and I don't think that there is any harm being done to those financial institutions.

Mr. GREENSPAN. Well, I don't want to capitalize on this whole issue too much, but let me just quickly summarize by saying this, that as far as the Federal Reserve Board is concerned, as far as I judge the other regulatory agencies, we believe that we are ahead of the curve on this issue as best one can get. Our major concern is the fact that things will be done which will prevent us from ad-

justing. I don't deny that if it turns out that there is lack of cooperation, that there is evidence of dishonesty, that there are elements involved that suggest that we are incapable of overseeing these types of institutions, that under those conditions some form of legislative initiative would be appropriate. I would just argue that I think we are far removed from that at this particular point.

Mr. MARKEY. And I would argue that we are not far removed from it. I think we have identified the problem. I think that right now sufficient information is being given to Mr. Ludwig and Mr. Hove and they are acting quite responsibly. On the other hand, the securities and insurance regulators have to rely upon the kindness of strangers, like Blanche Dubois. They do not have the authority to ensure that this information is accurate in the same way as the banking regulators, and I don't think that you can have a comprehensive and accurate assessment of this marketplace until verifiable information is put into the hands of the other regulators. And then we will trust the regulators to work together with the information they have gathered. It just seems to me that this is the common sense solution that takes the onus off of Congress having to come back here on a regular basis to revisit the issue.

My time has expired.

Let me turn and recognize the gentleman from Texas, Mr. Fields.

Mr. FIELDS. Mr. Chairman, as a courtesy, I would be glad to yield to our full committee chairman, Mr. Dingell. I would be glad to yield to Mr. Dingell if he would like to——

Mr. DINGELL. Mr. Chairman, I have a brief statement which I would ask to have inserted into the record.

Mr. MARKEY. Without objection, so ordered.

Mr. DINGELL. I would like to commend you, Mr. Chairman, and your ranking Republican member, Mr. Fields, for the work you are doing on this issue. In particular, I want to commend you, Mr. Chairman, for your leadership in requesting the GAO report and in scheduling this important series of hearings on issues raised by financial derivatives. I look forward to working with you.

I commend you, and I have no further questions at this time, Mr. Chairman.

[The prepared statement of Mr. Dingell follows:]

STATEMENT OF HON. JOHN D. DINGELL

I commend the chairman of the subcommittee, Mr. Markey, and the subcommittee's ranking Republican, Mr. Fields, for the work that you are doing on this issue, and, in particular, I want to commend Mr. Markey for his leadership in requesting the GAO report and in scheduling this important series of hearings on the issues raised by financial derivatives.

I look forward to working with the subcommittee as well as with our financial regulators and the industry to make sure that appropriate steps are taken to ensure the financial integrity of the dealers, the protection of investors and end-users, and the stability of our financial system. To that end, and pursuant to my commitment to help the subcommittee to write necessary and appropriate legislation, I have asked Secretary Bentsen to convene the Working Group on Financial Markets to review the GAO's recommendations and report back with the Group's outline for accomplishing the regulatory and legislative tasks. I have also written to the SEC and to the Securities Industry Association's Swap and OTC Derivative Products Committee asking for their input on specific issues.

The issues raised by financial derivatives are complex and we need to exercise great caution and care in crafting solutions. This is a process in which we all must work together cooperatively.

I trust that we can count on the cooperation of our witnesses today. And I again commend the subcommittee for its leadership and hard work on this issue.

Mr. MARKEY. OK.

Mr. FIELDS. Thank you, Mr. Chairman.

Mr. Greenspan, let me ask you, last week Treasury Secretary Bentsen warned against overreaction to the GAO report and he said too much of a response can be as bad for a market as too little response.

And I take it from the exchange you just had with the chairman, plus what you said in your statement, that you agree with that?

Mr. GREENSPAN. I do, Mr. Fields. Let me just say that I may not agree with a number of the elements involved in the GAO report, but it is a first rate report. I mean, it is a quality research job and I think that should be stipulated up front.

There are areas here where I think there are legitimate disagreements with respect to achieving goals which we all share, and I think that the chairman and I probably, if we listed our goals, would come out the same way, but I don't think it is obvious from the conversation we just had that we think the means of getting there are the same. But I do think that the Secretary of the Treasury points to an important issue with respect to public policy.

Mr. FIELDS. Also, I can't expect you to be privy to the hearing that we had last week. It was an excellent hearing with the GAO. And one of the points that some of us made, that if we singularly regulate in this area, that there is a possibility, perhaps a high probability, that much of this market will be shifted to London or other financial marketplaces. And if I understood what you said, in fact, you began your opening statement talking about that the international markets have been transformed in the last 15 years, and then when you are talking about disclosure and transparency, you talked about the need to work with our international partners. Chairman Levitt in his testimony talked about working with our international partners.

Should our immediate focus not only be on filling regulatory gaps if there are any, but also the development of standards that are consistent on a global basis?

Mr. GREENSPAN. Mr. Fields, I think it is too soon to make those types of judgments at this point. And let me say why. This is an extraordinary market that has evolved in the last 10 years, which is still undergoing quite important changes.

The fact that it is growing as fast as it is very clearly indicates that it is meeting a fundamental need in the financial system. It is not just a peculiar set of financial concepts which have temporarily taken the fancy of a lot of people.

There is some very fundamentally useful risk dispersion and risk reduction capabilities at low cost in the new instruments that are evolving. And if we inadvertently create some form of regulation which inhibits the flexibility of the system, I think indeed the demand is not going to go away for these instruments. It will, as you point out, merely shift to another venue. And there is reason to expect that other institutions outside the United States with the global communications capabilities that everyone has will merely take the same business. That will not reduce whatever elements exist

of systemic risk and there are always systemic risks in every type of financial transaction.

So I don't see what purpose legislation would serve, unless I were reasonably assured that it would not have unintended consequences. And at this stage, with the degree of momentum that still exists in these markets, I cannot readily make that statement.

I would be concerned that we would not be able to give this committee appropriate evaluations of the possible implications of any statute that was written, largely because we are still in a phase of change which is not stabilized sufficiently for us to get a sense of what appropriate standards would be. That may arrive at some day. It is not here at this stage and I think the risks are very significantly in the direction of reducing the flexibility of the regulatory system through legislation.

Mr. FIELDS. Let me go back, the thrust of my question is if we are going to be looking at this question for the remainder of this year into the next Congress, if we are going to be working with a number of people like yourself, my question is should we approach this in a global sense, realizing that there needs to be global standards? Because if not, we are going to force certain financial products to be shifted to other markets, perhaps outside of our control, and that the world has shrunk.

Mr. GREENSPAN. Yes, as Comptroller Ludwig indicated in his prepared remarks, there is considerable American presence in international fora to create such standards. The problem that we have to be careful about is not to create obsolete standards which by the time they are promulgated the markets have so changed that they are no longer relevant.

Mr. FIELDS. Chairman Levitt, let me turn to you and let me also refer to page 29 of your testimony. Because there was a last paragraph after you made certain recommendations. You said implementation of any such regulatory plan may require legislative or regulatory action or some combination of the two.

At this time, we are not submitting a legislative request to Congress. We believe that the Commission has appropriate tools for existing oversight. The question is, has any information been denied to you?

Mr. LEVITT. No. Broker-dealers are obligated to file with us very comprehensive, very accurate information about their subsidiaries, about their affiliates. We have received excellent cooperation up to this point.

Mr. FIELDS. Based on the information you have been collecting under the Market Reform Act, are you aware of broker-dealer affiliates managing their activities in an unsafe or an unsound manner?

Mr. LEVITT. No.

Mr. FIELDS. Also, going back to page 29 of your statement and then reading into page 30, you say that the Commission has received a high level of cooperation by both registered broker-dealers and their unregistered affiliates in discussing how to improve oversight, and that you have every expectation that you can work with the industry to develop such a regulatory plan. And it is my understanding that you have already received some recommendations, that as an example, the SIE sent a letter to you dated April 7th, 1994, suggesting a framework for supervisory oversight of the de-

rivatives business conducted in the affiliates of broker-dealers. Have you had an opportunity to review that letter, do you have any reaction?

Mr. LEVITT. Yes, I did have an opportunity to review that letter. Let me say that I think a great deal more has to occur. Both you and Chairman Markey have asked me very pointed "yes" and "no" questions, and I suppose those "yes" and "no" questions can prove the points that each of you make are equally correct. And even though you both have very different takes on this, both "yes" and both "no" are right. But they only give a partial picture at this point.

I think Chairman Markey is absolutely right in pointing out that there is a potential danger here and the Commission is mindful of that danger in terms of protecting the interests of the American system and the American investor. But I am satisfied at this point that the industry, too, has acted responsibly and understands that they are dealing with a new and unknown and misunderstood and perhaps even sometimes misapplied product. And they are coming forward to meet with the Commission and to design the kind of oversight and disclosure program which can be responsive to the committee's legitimate concerns about this.

I am not going to sit here and say that, fellows, this is not your province, stay out, do not legislate, we will do it by ourselves and call for some kind of system of economic Darwinism. On the other hand, I am not prepared to say at this moment the sky is falling down, we need the legislation immediately to protect American investors and American systems.

The hour is late, we are pretty far into the game, the risks are well-known and recognized, but a dialogue is taking place and I do believe American directors and management are making correct noises. Now, if that oversight, if that dialogue, if that disclosure does not become available and apparent in a very short period of time, I will be back here and saying, Chairman Markey, this is the time, we need your help in this way, and I would expect, Mr. Fields, that you would assist in that regard.

I am not prepared at this moment on this day to call for a specific piece of legislation, although what each of you say is appropriate and is correct.

Mr. FIELDS. Well, let me just close by saying, I appreciate very much Chairman Markey calling the series of hearings that we have held. This is a very complex subject, requires a great deal of study. And I certainly appreciate the illumination that our witnesses this morning have brought to bear on this particular subject.

Mr. MARKEY. The gentleman's time has expired.

The Chair recognizes the gentleman from Oklahoma, Mr. Synar.

Mr. SYNAR. Thank you, Mr. Chairman.

Chairman Greenspan, Mr. Levitt just told us that we have a potential danger here. You have made an argument in your exchange with Mr. Markey that we don't need legislation at this point to fix this problem because there is massive change and there is no stabilization right now. Could you tell the committee when this thing is going to stabilize and what should we look for to know?

Mr. GREENSPAN. I think I could do the latter, not necessarily——

Mr. SYNAR. The microphone is not on.

Mr. GREENSPAN. I can do the latter, but not necessarily the former. One of the things which is really quite impressive at this stage is a general awareness on the part of the private market participants of the nature and complexity of the instruments with which they are dealing. And they are very rapidly escalating their internal capabilities to evaluate and control market risk in, I must say, a very impressive manner.

We have been through a period in recent months in which we gained a better view of how a lot of these techniques and derivative products behave on the downside of a cycle. We have gone through, up until the beginning of this year, a very considerable expansion of these derivative products in what I would term a very benign environment for that type of product. And you can't really be certain precisely where the stresses and the strains are until you see the other side.

We are seeing the other side, and indeed we have seen a number of instances—I think Chairman Holum made comments on a few of them—of losses and misadventures in this particular area. It has had a very sobering effect on a number of the players, which in my view is very beneficial.

Mr. SYNAR. Well, let me move us beyond that. Not getting into the debate of whether or not we wanted to legislate regulation or market regulation, you argued in your statement that the adequacy of Federal oversight will depend upon a number of factors. Let me go through a list of the ones that you mention and just tell me whether or not they exist today.

Do we have strong internal controls on dealers?

Mr. GREENSPAN. I am sorry?

Mr. SYNAR. Do we have strong internal controls on dealers?

Mr. GREENSPAN. Yes.

Mr. SYNAR. Do we have adequate financial reporting?

Mr. GREENSPAN. Not quite.

Mr. SYNAR. Do we have adequate capital standards?

Mr. GREENSPAN. We are evolving them and I think procedures are going to be required to——

Mr. SYNAR. So the answer is no, not today.

And do we have adequate examinations?

Mr. GREENSPAN. Yes.

Mr. SYNAR. OK.

Mr. Ludwig, on the issue of capital adequacy for national banks participating in derivatives, your office's Banking Circular 277, dated October 27th, 1993, states, quote: "The board of directors should ensure that the bank maintains sufficient capital to support the risk exposures that may rise from its derivative activities."

However, today in your testimony, you say that you continue to have concerns about the national bank derivatives activities, including the fact, and I am quoting here: "Our examiners have found that the extent of senior management and board knowledge and oversight of bank derivatives activities at a few national banks is not as broad as we would like."

There seems to be a disconnect here. On one hand, you don't want to require minimum capital standards for derivatives activities, and you want capital adequacy judgments by a board of direc-

tors which you now claim don't know what they are doing, necessarily.

Mr. LUDWIG. We have set high standards for boards and management in terms of their knowledge of their derivatives activities. To a great degree, they have been complied with. But we have taken a very intensive look at all the institutions that are involved in derivatives activities.

Mr. SYNAR. Now, you say they—how does that fit with your, our examiners have found to the extent the senior management board knowledge of oversight of bank derivatives activities is not as broad as we would like. How can it be complete if you say this?

Mr. LUDWIG. I would worry about our examiners if they gave everybody an A-plus score. They are going in and seriously looking at the management capabilities and internal controls of each of these institutions on a very intensive and individualized manner. In the case of those institutions we have identified as not living up to the standards, we are comfortable that they are changing their standards.

Mr. SYNAR. What percentage of the examinations have that, fit that category?

Mr. LUDWIG. Among the very major participants, we believe they are all meeting the standards.

Mr. SYNAR. Then why did your examiners find to the extent that senior management board knowledge that there had been not the compliance that you would like? I mean, either they found it or they didn't find it.

Mr. LUDWIG. There are 362 national banks involved to any material degree in the derivatives business. Of those, 8 or 10 are very significant actors in the derivatives business. Of the first tier entities, they have a very significant board oversight and management knowledge of the activities and we are comfortable with what they are doing. As you go down the list and as new entrants get involved in the market, one of the reasons we scrutinize so closely, they don't immediately and all the time have the board——

Mr. SYNAR. It is safe to assume, though, second tier and third tier are going to get into this business?

Mr. LUDWIG. Yes, and we are going to be very cautious that their managements and their boards are well aware of these activities and supervise them properly. The fact that we don't give every institution a grade A the first time through doesn't surprise me. I would worry if everybody did get a grade A.

Mr. SYNAR. Let me move to one final question.

Mr. Levitt, how easy is it today for a shareholder of a mutual fund to find out whether their fund is engaging in derivative activity?

Mr. LEVITT. I think that——

Mr. SYNAR. You need to turn on your mike.

Mr. LEVITT. I am sorry.

Mutual funds are required in their disclosure material to discuss the various instruments and vehicles that they use in managing the fund's investments. But I believe that the mutual funds have to go further and become more specific about revealing the differences in the kinds of derivatives.

Mr. SYNAR. Do you have adequate authority to ensure——

Mr. LEVITT. Yes.

Mr. SYNAR [continuing]. Consumer protection?

Mr. LEVITT. Yes, we do.

Mr. SYNAR. What authority is that?

Mr. LEVITT. We have the authority under the act to see to it that adequate disclosure is given by mutual funds.

Mr. SYNAR. Have you exercised that authority in any individual mutual fund case?

Mr. LEVITT. Yes, we have.

Mr. SYNAR. What are those?

Mr. LEVITT. I would have to get back to you with specific instances of the times that we have exercised that authority.

Let me say in response to your question, however, that I believe that the mutual funds have got to do a better job in terms of disclosing the various risk elements involved in using derivative products. Certain kinds of mutual funds, money market funds, for instance, almost by their name, imply a measure of risk that would defy the use of a very exotic kind of derivative product.

On the other hand, some derivative products, some products that are related to the level of current interest rates, are entirely appropriate and secure for those money market funds. And I think it is important that all funds reveal very clearly the kind of risk that is entailed.

But there are also limitations on mutual funds in terms of the amount of leverage that they can have. There are limitations in terms of capital adequacy that bear importantly upon this, and limit the amount of derivative exposure that those funds can have.

Mr. SYNAR. Should they disclose the results of any stress tests on their derivatives portfolio under adverse market conditions?

Mr. LEVITT. I don't know exactly how that would occur. I mean, I am not sure it is appropriate for a mutual fund to disclose a hypothetical situations. I would have to think about the kind of disclosure that would tell an investor that this particular fund has a measure of risk that is greater than a fund which is not using a derivative product.

Mr. SYNAR. What about new players, what about new players, new funds that come into effect, do you have any fears they may not be as competent as those already in the market is this?

Mr. LEVITT. Not necessarily. I am not persuaded that a new fund carries a level of risk that is any greater than an old fund. As a matter of fact, I could give you examples of both.

Mr. SYNAR. But you believe you have the necessary authority to push mutual funds or encourage mutual funds to disclose more of this risk to——

Mr. LEVITT. Yes, yes, I do.

Mr. SYNAR. And you are exercising that, in your opinion?

Mr. LEVITT. I am sorry?

Mr. SYNAR. You are exercising that, in your opinion, your authority?

Mr. LEVITT. Yes, we are.

Mr. SYNAR. And you will provide to the subcommittee a record of how you have been doing that?

Mr. LEVITT. Yes. I share your concern about this, because the mutual fund investor imply a level of sophistication which calls for

greater disclosure and greater specificity. It isn't merely the volume of material that we disclose to them, it is the nature of it and how accurately we describe what level of risk is implied by this.

Mr. SYNAR. Wouldn't you agree that most people who invest in mutual funds, invest on the basis of low risk, that they believe they are entering a low-risk type of situation?

Mr. LEVITT. Not necessarily. The fund business has become so aggressive and so competitive that there are funds for almost every level of risk. And in some mutual funds bear a very great level of risk.

Mr. SYNAR. No, I didn't suggest that there aren't different kinds of risk that each mutual fund takes on, but for the investor, wouldn't you agree that the common perception is the investment in mutual funds is a lower-risk proposition?

Mr. LEVITT. I think of the common perception of an investor in mutual funds is the kind of diversification and overall management that he will obtain that would diminish the risk perhaps over his making his own investment decisions.

Mr. SYNAR. I will take that as a yes.

Thank you, Mr. Chairman.

Mr. MARKEY. The gentleman's time has expired.

The Chair recognizes the gentleman from North Carolina, Mr. McMillan.

Mr. MCMILLAN. I thank the Chair.

Chairman Greenspan, in your testimony, you generally referred to a considerable degree of private regulation that takes place apart from governmental regulation in the area that we are focusing on. Could you elaborate briefly on what you mean by that?

Mr. GREENSPAN. What I mean very specifically is that the self-interest all of those who are involved in financial management is to make certain to the best they can that the counterparties with whom they deal will not default. Their interest is, in certain respects, overwhelming, if I may put it that way. And the only key question that we must ask ourselves, are they capable of obtaining the level of information and have the ability to evaluate it in a manner which reduces the bilateral risk between two parties?

If we have a substantial amount of that type of inter-institution or company regulation, it is very easy to generalize that you have got essentially a safe system. And so what has to be emphasized here, is that our primary, indeed our indispensable level of regulation, is at the level of the firm. We in government cannot substitute for that. We do not have the insights, the capabilities, or in fact the special type of interest a firm does.

What our job is essentially in this area, especially in risk management, is to assure that individuals have the types of information that they need, that they have the capabilities to appropriately function in a manner which keeps risks at prudent levels.

Mr. MCMILLAN. Isn't one of the primary objectives of a bank risk management? Having a loan portfolio involves taking risks. Indeed, I have heard bankers say that if you don't have a loss on a loan occasionally, you are perhaps not taking enough risks. That implies there is an essential risk element in that.

The purpose of the institution is to balance those risks in a way that is profitable to the investors and serves the depositors as well.

Mr. GREENSPAN. That is correct, Mr. McMillan. The basic purpose of the financial institution, its underlying franchise, its contribution to our economy, is the management, the prudent management of risk.

As I indicated in my prepared remarks, risk-taking is a necessary ingredient for economic growth and rising standards of living. The question that we must address is how to ensure that is done prudently. And a commercial bank and indeed all financial institutions are risk-takers by their nature.

And as I have indicated many times in the past, it is not the purpose of bank regulation to assure that there are zero failures. Because that would clearly imply that the system was not functioning in a manner appropriate to its purpose or its function in the economy. We have a special concern, obviously, with respect to banks which differentiate them from the securities firms, in that there is a deposit insurance system which we have, as regulators, a separate purpose in protecting. But leaving that particular purpose aside, our view of the financial system is not to reduce risk to an absolute minimum, because that would essentially neuter these institutions from their very important function in promoting economic growth and vitality in our economy.

Mr. MCMILLAN. We, of course, tend to focus on situations in which the system breaks down, and then try to take action to prevent that from ever happening again in any instance. But we don't focus much on reporting the degree to which derivatives, for example, or hedging, avoids loss or achieves the objective for which it is engaged in, let's say, apart from sheer speculation.

Is there a practical means by which, in a disclosure format, that kind of activity should be a part of normal reporting; and as kind of a counterbalance to those occasions in which it may not work?

Mr. GREENSPAN. One of the issues that is evolving as we examine this in increasingly greater detail in recent years, is the importance of our overseeing the particular processes of risk management that each individual firm, especially the dealer firms, are engaged in. And as I indicated in my prepared remarks, if I had to forecast where we are all, of necessity, going because of the heterogeneity of these products, it is to ensure that the risk management systems are adequate, that they are understood by executives within the firm or institution, that the boards of directors know what the system is effectively doing, and it then enables supervisors and regulators to go into the firm and effectively question them as to whether their existing procedures and existing risk management practices are capable of surviving without insolvency under a certain set of circumstances, which we would specify.

And it is in the "stress testing" as we call it, of these institutions, where I think our greatest oversight and regulatory responsibilities lie, and our ability to assure the stability of the individual firm and have reasonable certainty, to the extent that we can, that an institution's activities and its portfolio will not create systemic risk for the system.

Mr. MCMILLAN. Let me ask this question; for a financial institution that has insured depositors, includes most of the banking system, is it appropriate activity for the bank to engage in speculative

activity with respect to derivatives for the purpose of enlarging profits as opposed to hedging its position to avoid loss?

Mr. GREENSPAN. Well, Mr. McMillan, if you look at the whole question of risk management, virtually every activity of a commercial bank, whether it is making loans on inventories or commercial real estate or engaging in interest rate swaps or involved in any type of activity, is essentially involved in the control and maintenance of risk for profit-making purposes.

From an underlying economic point of view, it is very difficult to distinguish whether certain economic values produced in, say, currency trading that enhances the effectiveness of the underlying markets, is more or less of an economic value than a commercial loan.

We do know that most of the standard so-called "plain vanilla" derivative activities of commercial banks are far less risky than certain types of loans that are made. I mean, term loans, commercial real estate loans, are all fairly risky types of activity, but they contribute, they have a major role in finance and the achievement of economic growth. That is what a commercial bank is there for.

I wouldn't want to argue, because I think the facts clearly are quite to the other side, that the major derivative activities that are taking place in the commercial banks are more risky than the average commitments that banks are making.

Mr. MCMILLAN. Thank you.

Mr. Levitt, you talked a little bit, and there has been talk here about the concentration of derivative markets. Would you say that there is greater concentration in derivative markets than there is in the underlying markets upon which they are based, whether that be commodity, currency, bonds, security, et cetera?

I think we would acknowledge there is a pretty high concentration of the underlying markets anyway, at least that would be my perception.

Mr. LEVITT. I am not sure whether you are asking me whether the derivative trading is concentrated in a relatively small number of firms, or whether you are suggesting that the amount of leverage that derivative trading involves is greater than that of the underlying security. In both cases, the answer would be——

Mr. MCMILLAN. I think those are two different questions. I am thinking more of the concentration with respect to the market-makers or the firms.

Mr. LEVITT. Yes, there are about six market-makers, six major market-makers today, that do the preponderance of the derivative business. That is not to say that that could not expand.

As a matter of fact, I suspect if this business appears to be a profitable business for the firms, it may expand somewhat in the future. But right now, it is fairly well concentrated.

Mr. MCMILLAN. Does that cons—is my time expired?

Mr. MARKEY. Yes. You can ask this question.

Mr. MCMILLAN. I thank the Chair, and thank the panel.

Mr. MARKEY. I said if you wanted to finish that line of questioning.

Mr. MCMILLAN. Oh, I am sorry.

Well, I guess the import of my question was, does that concentration—should we be more concerned about that level of concentra-

tion among derivative market-makers than we are about, say, concentration of markets among bond dealers?

Mr. LEVITT. Oh, yes and no, to the extent to which—yes, in that it involves a greater level of exposure, I suppose, but no, which would be my prevalent answer, in that we are better able to keep a handle on dealers that are identified, are the larger, more prominent, more experienced dealers in this business.

I guess if I had a worry, I would worry more about dealers or users who we didn't know so well who didn't have that experience, who lack the expertise, whose boards may not have been sufficiently well-prepared for this and may have been looking at this in terms of making a quick buck. I think that is it where the danger in any new product is.

And I think that is something we have to be alert to. So the concentration in and of itself doesn't worry me that much.

Mr. MARKEY. The gentleman's time has expired.

The Chair recognizes the gentlelady from California, Ms. Schenk.

Ms. SCHENK. Thank you, Mr. Chairman. It is a good thing you took your chair back. I was beginning to feel comfortable.

I would like to return to some of the basics, if I may, both Chairman Greenspan and Chairman Levitt mentioned in their opening remarks and in answers to some of the previous questions, talked about the systemic risks.

Much of our previous discussions center around the risks of derivative products as they relate to the integrity of our financial markets. I would like to ask each panel member if they would briefly comment on what are the systemic risks, particularly in the event that, say, a large end-user or a dealer fails or suffers enormous losses?

Are there some precedents or historical benchmarks that we might look to for areas of concern?

Chairman Greenspan, if you would start.

Mr. GREENSPAN. It is important to first define what derivatives do in the system. And with very few exceptions, they improve the relation or they tighten the relationships between the primary markets. They arbitrage markets in a manner in which you do not get, as we used to say many years ago, inconsistent market behaviors in various different primary markets.

What happens is that they tighten up the efficiency of the financial system, and accordingly probably reduce the level of overall risk. But in so doing, the very efficiency that is involved here means that if a crisis were to occur, that that crisis is transmitted at a far faster pace and with some greater virulence consequently, because the mechanism is very efficient.

One hundred and fifty years ago, for example, it was quite possible to have a systemic collapse in a market, say, in England, and investors in the United States not know about it for 2 weeks. And you would not get the interaction that we currently experience almost instantaneously today. So in that regard, what we are seeing is a system which because of its increased efficiency if something goes materially wrong, then you do get a much more rapid change.

The October, 1987 stock market crash, was perhaps the best example of how quickly things can occur when something adverse happens. The problem, however, is not in the derivatives them-

selves. A difficulty that is very likely to arise, as you point out, is that major derivative dealers could lose a great deal of the institution's liquidity, mainly because they invested in some bonds or stocks which went badly awry, and they would have difficulty meeting their counterparty obligations in the derivatives markets as a consequence.

One would not say in that instance that the derivatives were the cause of the problem. What you would say is the fact that they increased the efficiency of the system means that the problem would move through the system far more efficaciously, if I may use a word that I am not sure is appropriate.

Ms. SCHENK. It is more like a quickly spreading flu bug; is that what you meant?

Mr. GREENSPAN. Yes.

Ms. SCHENK. Is there some way to insulate the spread of that flu?

Mr. GREENSPAN. There are a number of people who have a degree of nostalgia for what markets were like, say, 50 years ago. And I must admit to being one of them, especially as a central banker. You cannot turn the clock back. Technological change has been extraordinary. It has created irreversible changes in the marketplace. And rather than be nostalgic for times past when things moved much more slowly, it is quite important for us to make certain that we create a regulatory system which is appropriate to the degree of dynamism which has emerged in not only the American financial system, but in the global financial system.

And speaking for the Federal Reserve Board and inferring from conversations I have had with my colleagues at this table, we have all put in far more effort in this whole area of major changes in global finance than I think our counterparts in years past probably put in in four to five times the time.

Ms. SCHENK. Chairman Levitt, would you care to comment?

Mr. LEVITT. There is not much that I can add to Chairman Greenspan's very lucid description of his concept of where systemic risk lies. I would emphasize my own feeling that I am more concerned about areas that I don't know much about because we don't have that information. In particular, the globalization of these kinds of transactions make me concerned about an insurance company in Berlin, a bank in Tokyo, an industrial concern in London that may decide to deal in derivatives and where the netting laws or the bankruptcy laws were insufficient to accommodate the kinds of relationships with U.S. dealers that I think is important to prevent a breakdown in the system.

And I think for that reason, it is essential that the "Group of Ten" address these issues, address the issue of capital standards. But those are the areas of my greatest concern.

Could I devise a system that would reduce the likelihood of a systemic risk? There are probably some things that in my wish list I would include, although for the moment they are not possible.

A clearing facility of some sort, if settlements could be reduced to instantaneous settlements, areas of that kind that the working group is giving consideration to and thought about, would all address the question of systemic risk.

But I think that Chairman Greenspan's description was totally consistent with my own concerns, and I would just add to the notion of international concerns that I have about entities that we may not know as much about.

Ms. SCHENK. Well, let me just follow up in my interest here and what the risks are.

Chairman Levitt, to what extent are public funds or taxpayer funds at risk here within a reasonable realm?

Mr. LEVITT. Well, I think that when any new product comes on the scene, any new device, public pension funds and philanthropic pension funds examine this to see whether they are taking advantage of every opportunity that the marketplace may present. I think that there are limitations that have been placed on various funds by their boards and in the case of public pension funds by their oversight bodies on a State and local level.

I know that to be the case in a number of municipal funds and Taft-Hartley funds, and I served on the boards of several foundations which used derivatives but whose activities were tightly monitored by an investment—by investment committees that knew enough about the risks involved to control the level of risk that was taken by those particular kinds of funds.

Ms. SCHENK. OK.

Chairman Hove, may I turn to you for a moment and just ask very simply to what extent are insurance funds put at risk?

Ms. HOLUM. In the futures exchanges, we don't have insured funds.

Ms. SCHENK. I am sorry, I was referring to Chairman Hove.

Mr. HOVE. Thank you.

The risks in the insured funds are not a lot different than the risks that institutions take from time to time, as Chairman Greenspan mentioned, in the other risks that they take in making loans, and making other types of investments. We monitor very closely the activities of the institutions.

From the supervisory standpoint, most of our institutions are smaller institutions that are in fact end-users and they are using derivatives for a specific purpose of hedging their interest rate risk or other types of risk. We work very closely with the Federal Reserve and the OCC in their monitoring of the larger institutions and supervision of the larger dealer banks.

As we look at it from a supervision perspective, we don't see a large risk to the insurance funds from derivative activities in financial institutions.

Ms. SCHENK. My time is up. All right.

Thank you, Mr. Chairman.

Mr. MARKEY. The gentlelady's time has expired.

The Chair recognizes the gentleman from Illinois, Mr. Hastert.

Mr. HASTERT. I thank the Chairman.

I would like to first of all recognize the chairman for bringing this issue forward. I would also like to recognize him for another issue. You know, he has been a leader in this Congress in nurturing the information services generation by deregulating. We can now move information all over this world, in a instantaneous manner, not only just voice information, but data. These are the tools that we need to have to be able to judge financial markets—what

is happening in Berlin or what is happening in London or what is happening in Singapore, instantaneously.

But to me, it seems like we are talking about apples and oranges, in a sense. To follow up what the gentlelady was talking about, there are different types of risks.

Gentlemen, Mr. Hove and Mr. Ludwig, when you talk about having the information available to make good judgments on what banking institutions are doing, people who make either investments or deposits in banks really have those deposits insured, they are insured with taxpayer money. So the responsibility for you to make sure that those investments, transactions and activities are much more, I guess, I would use the old term "conservative," than possibly somebody who is being speculative, is a different responsibility than monitoring investments made by people who are using commodity trades and other types of instruments, isn't it?

Mr. LUDWIG. Well, we certainly have a very high degree of responsibility for these institutions, not merely for the taxpayer support provided by the FDIC, but the inherent risks to the system by these large financial institutions. In respect of derivatives, I say one word, which I was going to address vis-a-vis systemic risk, and that is that there is a benefit in terms of lowering risk to diversification, a very considerable benefit. Derivatives activity provides some benefits to the system, as well as to these institutions, both in terms of their ability to diversify and manage risk better, and in addition, because derivatives focus the dealer or the end-user on different types of risks that are inherent in traditional transactions, including credit risk, market risk, interest rate risk. It even goes beyond that and begins to focus them on the risks associated in interconnections, what we call covariance.

They actually play a very beneficial role in lowering risk overall. We have to be very, very cautious as in any large growing market, but this is certainly a market that, if handled correctly, can actually result in a lowering overall of risk.

Mr. HASTERT. Exactly. And the role, I am trying to talk about—the apples and oranges role—when people make an investment in a bank, they are usually looking for a much more limited return on their investment than if they are going into more speculative ventures. Therefore, your responsibility controlling, having information, and being able to have a check and balance of the activity of banks is certainly warranted.

If we move away from that and move into the market, so to speak—and the "market" is a fantastic word, because market means that many people are there checking and giving and taking—I would ask Chairman Greenspan is there less need in the marketplace, and maybe this sounds like a simplistic question, but maybe we need some easier answers here, than in the banking realm? Because there is a different setting, a different stage that people are playing on.

Mr. GREENSPAN. Yes. Congressman, there is a statutory lesser need, if I may put it that way, in the sense that we do have a deposit insurance system and that over and above how one would look at relative risk-taking by financial institutions generally, and its systemic characteristics, over and above that in banks or depository institutions, where there is deposit insurance, we have an

overriding regulatory requirement to assure that the deposit insurance system is not at risk. That means that you would expect and indeed we have more regulation in banks than we have, say, in securities firms.

It is true, however, that we have interest in both areas with respect to systemic risk. And as a consequence of that, it is important to try to separate in the commercial banking area our systemic risk concerns, which are largely payment system issues, from the deposit insurance question. And so far as the financial intermediaries other than commercial banks are concerned and the S&L's and credit unions, that is those who do not have deposit insurance, our concern should be related to systemic risk and not to other considerations. And here it does require a somewhat different type of focus and a different degree of supervision.

Mr. HASTERT. Chairman Levitt, in the realm of your oversight and supervision, if a person, an investor, makes an investment, whether or not it is modest into a speculative stock or a commodity transaction, he probably accepts a little higher risk; wouldn't you think?

As a matter of fact, if he expects to make a return of maybe 12 or 14 percent in today's market as opposed to making an investment in a stock or a bank investment of 6 or 7 percent return on that investment, isn't there a higher risk assumed by the investor?

Mr. LEVITT. Well, it has been my experience that there is a correlation between return and risk. Unfortunately, not every investor adequately understands that.

Mr. HASTERT. We understand, we see those situations here all the time. Well, what I am saying is, if that market is going to be viable, companies, banks and trading organizations will try to use the market to hedge their risks. Thus, they probably need to be a little less encumbered by regulation than banks are today. Is that an assumption that should be taken, is it valid or not?

Mr. LEVITT. I am sorry, I couldn't hear the last part of that.

Mr. HASTERT. I am just saying in very simple language, should the whole market be regulated the same way banks are or should there be a little bit more flexibility in the——

Mr. LEVITT. Well, I think——

Mr. HASTERT [continuing]. Market sector?

Mr. LEVITT. I think that banks are different. I think banks are protected by—bank depositors are protected by an insurance fund that goes to the safeness and the soundness of the banks and their different marketplaces in dealing with somewhat different products and different levels of risk. So, you know, this gets into the whole question of regulation, which I believe is clearest and most effective when it is functional. But I guess that is an issue for a different day.

Mr. HASTERT. Well, not necessarily.

You are saying that regulation for regulation's sake is not necessarily good for everybody in the market?

Mr. LEVITT. That is correct.

Mr. HASTERT. And the assumption that Doctor or General Bowsher made the other day is what is good for banking ought to be good for the market system as well, and not necessarily taken as logic by everybody. Is that correct or not?

Mr. LEVITT. Well, I think that we are dealing with a product that, in my judgment, requires a measure of flexibility, because the kind of regulations that we might promulgate or that you might legislate today might be very, very different from what may be called for tomorrow. And I think we have got to create a system which is resilient enough to respond to these changes.

Mr. HASTERT. Even though I have 5 minutes less than anybody else, I will relinquish my time.

Thank you.

Mr. MARKEY. You are at 9 minutes and 45 seconds right now, and everyone else had 10 minutes. I was trying to wind you down for the final 15 seconds, but everyone got 10, and you did as well, sir.

OK, thank you.

The gentleman from Ohio, Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

On page 85 of its report, GAO stated last week that Congress needs to regulate securities and insurance firm affiliates because, and I quote: "These securities firms and insurance companies are large financial firms. As in the case of a major bank failure, a crisis involving derivatives that affects one of these firms would likely affect the financial system and require Federal intervention to resolve," end quote.

I would like to ask both Chairman Greenspan and Chairman Levitt, does the fact that brokers have SIPC insurance and access to the Fed discount window create the possibility of a taxpayer bailout?

And how realistic is that threat of a taxpayer bailout?

Chairman Greenspan.

Mr. GREENSPAN. Negligible. And the reason is that so far as the discount window is concerned, for a noncommercial bank, incidentally, it requires that the Federal Reserve Board have five members voting in the assent for such a loan, but with very rare exceptions, and I can't think of any offhand, these are collateralized, and with good collateral indeed, so that we have never had a loan which has gone bad. We never will, if the type of collateral we request is there.

So I would say that short of a virtually inconceivable situation, so far as the discount window is concerned, one cannot envisage where taxpayer funds would show up. On SIPC, I gather the risk to SIPC is not preventing market risk, but is a risk of fraud and I would pass the baton to someone who is far more knowledgeable on this than I.

Mr. LEVITT. Well, SIPC differs fundamentally from Federal deposit insurance protection for banks and thrifts. It doesn't protect investors from declines in the market for their securities. It does protect them against fraud. And I guess another difference is that the SEC's customer protection rules prevent broker-dealers from using customer securities and funds for proprietary purposes. And by contrast, the essence of banking is that banks use insured deposits to make loans. And the amount that SIPC protects against is $500,000 of which no more than 100 may be a claim for cash, whereas FDIC insurance protects par value of deposits up to $100,000.

Mr. OXLEY. What about the question I asked about the realistic threat of a taxpayer bailout?

Would you care to comment and do you agree with Chairman Greenspan?

Mr. LEVITT. Yes, I would. I think that I point out that broker-dealer failures historically, and I guess most recently Drexel-Burnham, have been able to wind down successfully without any amount of significant loss to the SIPC system or any loss to the taxpayer.

Mr. OXLEY. Thank you.

Chairman Greenspan, on page 55 of the GAO report, it compares the credit exposures on derivatives and on loans at the seven largest U.S. bank derivatives dealers. Did the GAO overstate the credit exposures when they used gross exposure on the charts, rather than net exposure?

Mr. GREENSPAN. I am not familiar with that particular page or reference. I haven't had a chance yet to get that far into the report. If I may, I would like to answer that for the record.

Mr. OXLEY. That would be appropriate, with the chairman's permission.

Mr. MARKEY. Without objection.

[The following information was received from Mr. Greenspan:]

Derivatives dealers typically enter into master netting agreements which, if legally enforceable, reduce the amount at risk in the event of a counterparty default to the net of unrealized gains and unrealized losses on outstanding contracts with the failed counterparty, rather that the gross amount of unrealized gains. For many counterparties, the net amount can be substantially smaller than the gross amount, so that aggregate gross exposure may significantly overstate the size of the aggregate net exposure. For example, a recent survey by the International Swaps and Derivatives Association of the firms on its Board of Directors indicated that, as of year end 1993, net exposures averaged 56 percent of gross exposures. This estimate of the reduction in exposures through use of legally enforceable netting agreements is roughly consistent with figures reported by leading U.S. dealers in their 1993 annual reports.

Mr. OXLEY. Even so, the swap exposures are much smaller than the loan exposures. In derivatives, are we talking about a risky activity, or activity that poses less risk to the banking system than plain old bank loans?

Mr. GREENSPAN. In general, a swap can be a negligible risk. It depends on the maturity that is involved in the instrument and the nature of the instrument involved. But I think one can say in general that there is no presumption that the standard, the major thrust of derivative activities is any riskier. Indeed, the argument could very well be it may well be less risky than standard commercial lending, especially when the maturities of the lending are extended.

It is quite possible that when one gets into what Comptroller Ludwig was talking about, the so-called "exotics," which are very elaborate, complex type of products, that one could envisage a degree of liquidity failure which would make those particular products more risky than certain standard commercial bank products.

But certainly across the board looking at derivatives per se and other commercial bank activities per se, I would not want to venture to the presumption that derivatives were more risky than the rest of the banking system's asset valuation.

Mr. OXLEY. I would like to ask all of you, I listened attentively to the testimony and to your answers to the questions. Am I correct in my understanding that none of you see any particular value to federally mandating the internal management systems that collect and report information for corporate decisionmaking?

Is there anybody that disagrees with that essential premise?

Mr. LEVITT. Well, in general, I would agree with that statement, but we are—again, I would point out that we are in an evolving environment right now, and I don't want to define precisely what kind of reporting mechanism we are going to require. In general, I believe that right now we have sufficient auditor involvement in terms of our risk assessment process, but I think we are going to have to work very closely with the industry, speaking for the broker-dealers and their affiliates, before I can categorically say that we want no outside involvement. I think a mandated involvement would be costly, and I think that we—it appears that we have the kind of controls right now in terms of audit control which would not make that necessary.

Mr. OXLEY. If I could just sum up then, Mr. Chairman, with the last question. I take it all of you believe there is much that can be done to improve derivatives regulation within your own regulatory spheres and there is no reason at this point to legislate in the area of derivatives?

Is that a common agreement among the panel members?

Mr. LUDWIG. I would echo Chairman Levitt's remarks that this is a fast-evolving market. And while I can't conceive, at this time, of a federally mandated scheme for nonfinancial institutions, this is a market you wouldn't want to be categorical about. And similarly, while we certainly believe that we have sufficient authority to deal with the issues that we can conceive developing, I wouldn't want to be categorical about legislation in other areas.

Mr. OXLEY. OK. Thank you.

Thank you, Mr. Chairman.

Mr. MARKEY. The gentleman's time has expired.

I just have another question or two and then we will wrap up the hearing, if that is possible.

Mr. Levitt, if I could, isn't the Achilles' heel of a voluntary system of guidelines as a substitute for regulation the fact that the players that we should be most worried about are least likely to take the pledge that they will cooperate and hand over all information that is accurate and needed by the regulators in order to assess what is going on in the marketplace?

Should we leave behind the 10 percent most venal who prey upon the 10 percent most vulnerable out in the financial marketplace, and by the time we catch up with them 2, 3, 4 years down the line, the damage which they have done obscures the voluntary cooperation of the 90 percent who have been complying with your request or other regulators' requests for their voluntary cooperation?

Mr. LEVITT. I think there is always a risk of venality in a system. And I don't really want to come away from this hearing with the notion that we want some kind of voluntary participation, that we depend upon the graciousness and openness of the regulated to satisfy a public protection standard.

Rather, I would like to suggest to you that using its risk assessment programs and using its efforts to adapt capital standard mechanisms to be responsive to these new products and techniques, we will be able to develop the kind of disclosure that would be responsive to your concerns. If that is not the case within very short order, certainly by the fall, I will be back here or in your office saying that I am sufficiently worried about whether it is 10 percent or 20 percent or 5 percent, that we need something more than this.

Mr. MARKEY. My only concern is that then we won't be able to pass legislation until October of 1996. And that is a long time to leave the window open in a marketplace that is this mature. When a marketplace moves $12 trillion it is not anything that is in transition or still developing. It is a very mature marketplace, and I am just very concerned about the way in which the political process works—we pass legislation in the even-numbered years near the end of the session. And I caution all of you that that is a very risky proposition in an area that has so much potential for damage both to the system and to individuals.

Let me ask, if I could, Mr. Greenspan, just to close in on another point.

Could you explain why a derivatives dealer in trouble that has to go to the Fed discount window for an emergency liquidity injection is not Federal intervention to bailout the firm as the GAO suggested last week?

Mr. GREENSPAN. Well, first of all, remember that the discount window is at the discretion of the Federal Reserve. It is not a right.

Mr. MARKEY. I appreciate that.

Mr. GREENSPAN. And that we fully collateralize those loans. There is no loss to the taxpayer. Taxpayer funds are not exposed in that regard; if the particular loan is appropriately collateralized, which they always are.

Mr. MARKEY. So if a group of securities firms were simultaneously collapsing under the weight of a derivative's induced crises, and they came to the Fed window, you would not extend liquidity to them unless it was fully collateralized at that time; is that what you are saying?

Mr. GREENSPAN. Let me say this: I don't want to comment on hypothetical situations, as how a lender of last resort——

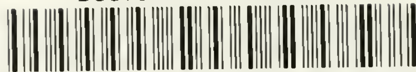
Mr. MARKEY. I am sorry, you just said that there would be no taxpayer exposure. And the way—the only way you could guarantee that is if it is collateralized.

Mr. GREENSPAN. The answer to your question, basically, is that it has always been the case that it has been collateralized. What you are not going to get me to say is that under no conditions, under no conceivable remote circumstances, is it possible that we may have a major systemic problem.

Mr. MARKEY. I think you have answered.

Mr. GREENSPAN. The answer basically is that if that possibility did not exist, the concept of a lender of last resort would not exist.

My own judgment is it is extremely remote, and indeed it is not something which I would suggest that legislation should be focused on in an endeavor to fend off. Because there is no way that we can eliminate all forms of risk from the system.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Indeed, as I said earlier, were we to endeavor to do that, we would end up with a stagnant economy. Risk is part of life. I mean, that is what it is.

Mr. MARKEY. I agree with you, and we want people to take risks. But as you know, the system has changed in the last 50 years, Mr. Chairman. In the old system, the risk ran to individuals. In the modern, telecommunications-driven marketplace—and this subcommittee is quite familiar with that, and we know how much more dramatically this marketplace is going to change in the next several years because we are working on the legislation that is going to open up those new technology possibilities—the risk runs to the system, not just to individuals. And with that change, we have to be cognizant of who is at risk.

And we know now it is no longer just the individual whose name is on that particular investment. It is potentially institutions and the entire financial system.

My problem, I guess, is that back in 1987, in July, a very similar panel sat here, and the hearing was on program trading, and the question given to each person, your counterpart at that time, was whether or not there was any risk. Should we give any additional powers over to the SEC, over to the CFTC, over to other regulators, to be able to just monitor the marketplace in anticipation?

We were told no. We were told we shouldn't anticipate any problems. In fact, everything was fine. I think since we have given those powers over to the regulators, they haven't done any damage with them. In fact, I think they have made it dramatically less likely that there will be a recurrence. That is all that we are suggesting here as well.

We have identified a problem in terms of an information gap which exists. We want to hand over to the regulators the information which they need so they can work with their counterparts.

Back in 1987, the SEC did not have the information the CFTC had. In 1994, the SEC and insurance regulators do not have the information which the banking regulators have. That is all we are really talking about here. And any other interpretation of what this debate is about is a red herring. It is an attempt to really characterize the subcommittee as members who want to ban derivatives, which clearly we don't. Ban technology? Clearly of all subcommittees in Congress this would be the last one that would want to ban telecommunications, computers, software, Internet, spectrum delivered information. We are the prime movers in changing this world, in making it possible. This intermediation is basically made possible by what this subcommittee has done over the last 10 or 12 years on the other side of our jurisdiction.

My only point to you is that when we come back here in October of 1996, with a 2½-year gap that you are recommending, I just hope that we don't have to deal with, ex post facto, a set of conditions that were created and that could have been avoided by giving over to the regulators, the appropriate regulators, just the information and the powers they need to prevent, I think, reasonably anticipatable problems that are going to be created in this marketplace. That is my only point.

Let me turn over to the gentleman from Texas.

Mr. FIELDS. In all due respect to the chairman, let me be clear, I didn't hear anybody recommend a 2½-year gap. In listening particularly to Chairman Levitt, in what he said in his written testimony and then also what he said orally before this subcommittee today, if I heard you correct, Chairman Levitt, you said that at this particular time legislation wasn't needed, that you felt that you had the proper oversight tools that were needed, that you were getting cooperation from industry, you had been requested to form a working group, you responded to one of the questions that I propounded that you are not aware of broker-dealer affiliates managing in an unsafe and unsound manner.

The position of many of us on this side of the aisle is that this is not the time to rush to judgment, particularly on something that is so strategically important, but neither are we the proverbial ostriches with our heads in the sand, that we are going to be very open to recommendations, particularly from you, Chairman Levitt. But I just want to make clear, no one is suggesting that we wait 2½ years if there is a need for Congress to do something.

Is anybody recommending that?

Mr. LEVITT. No. I want to work very closely with this committee in terms of what we need and what we get. And I think I said before that I will discuss with the committee not later than the fall, what progress has been made and what kind of help the committee would be prepared to give us in terms of giving American investors the kind of protection both of us want to give to them.

Mr. FIELDS. And also let me just close by saying so that there is no misunderstanding by anyone at the table or anyone in the audience, this subcommittee has a reputation for working in a bipartisan manner. I feel the chairman has been very open and has been very inclusive, does not mean that we always agree on every issue. But I think this is a very important subject matter area.

I am glad that we are building the record that we are building. And we plan to work with the chairman as much as we possibly can. If we disagree, then we will disagree.

Thank you, Mr. Chairman.

Mr. MARKEY. I appreciate that.

And again, I guess there is a little bit of me that feels like Charlie Brown here with Lucy holding the football. My projections of the time line to pass legislation are based upon past experience.

We had to go all the way from October of 1987 to October of 1990 in order to deal with the aftermath of the problems created at the end of 1987. And this is with the Brady Commission report sitting here by the end of December in 1987, by the way.

Same thing is true in government securities. We had to go from August of 1991, all the way to November of 1993, again, with the stipulated problems already identified by the time Warren Buffet and others had testified here in September of 1991.

So I speak from hard-won experience. My hope is that we won't have to have that ex post facto hearing here, the post-mortem. And we are going to continue, however, this year, to very aggressively pursue this issue and we will begin with oversight hearings into particular instances that might help to illuminate how this issue is affecting those who are out in the marketplace who may not

quite appreciate yet the risks that they are being exposed to by practices that are not well understood.

With that, we conclude the hearing. We thank all of the witnesses for their help.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

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