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Remarks Of

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Derivatives: Regulatory Concern, Not Panic

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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I. Introduction

I appreciate the opportunity to participate in this conference. As the use of derivative products has increased, the concern of financial regulators everywhere, both domestically and internationally, has increased as well. Hardly a day goes by without some statement from a financial regulator pertaining to the topic of derivatives. For example, in the last several weeks, the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Chairman of the Securities and Exchange Commission, the Comptroller of the Currency, and at least one member of the Commodity Futures Trading Commission, among others, have issued statements concerning derivatives.

This interest is not limited to domestic regulators. During the first week of February, I had the privilege of representing the SEC at the most recent meeting of the Technical Committee of the International Organization of Securities Commissions ("IOSCO"). At the meeting, the Deputy Governor of the Bundesbank delivered a stern presentation on the subject of, you guessed it, derivatives. In fact, a large portion of the IOSCO meeting was spent groping unsuccessfully for a global securities regulator consensus statement with respect to derivatives activities.

Regarding the explosive growth in the use of derivative products, I noticed recently that the International Swaps and Derivatives Association reported that the notional value of all U.S. dollar-denominated interest rate swaps, the most common derivative instrument, outstanding with its members grew to $783.8 billion in the first half of 1993 from $653.9 billion in the first half of 1992.[1] I recognize that the notional value of swaps is not as useful for regulatory purposes as the replacement value, which is usually only a tiny fraction of the notional value, but the notional value is ordinarily the most available number from an informational standpoint. Obviously, one of the more aggravating problems in the over-the-counter derivatives area from a regulatory standpoint is the lack of solid, up-to-date statistical information.

On the tax-exempt side, which is where I have focused a good bit of attention during my Commission tenure, derivatives activities have grown by leaps and bounds as well. It was reported a couple of weeks ago that in 1993 about $9.5 billion of municipal derivatives were sold on 328 issues, up considerably from the estimated $6.8 billion sold on 110 issues in 1992.[2]

I anticipate that derivative products will continue to grow in use. The ability to tailor an investment product to suit the investor has made the derivative instrument a valuable commodity. This customization trend that has emerged in the early 90s should continue throughout the decade. If used properly, derivatives are an important risk management tool. Although much more speculative, investments in derivative instruments can also be very beneficial from a return standpoint.

I do not consider derivatives to be the latest market rage, subject to disappearance such as portfolio insurance when the market changes directions. Thus, it is incumbent upon all regulators to adjust their regulatory systems, where applicable, in recognition of the continued presence and growth of derivative financial products in the capital markets. Along these lines, it is my intention today to discuss some SEC regulatory developments that are relevant to derivatives activities. All of these developments fall within the adjustment category mentioned previously. I will limit my discussion to SEC matters.

At the outset, though, I do wish to mention a couple of extraneous matters. First, although this is a bank derivatives conference, I will attempt to avoid dwelling on my usual incendiary securities regulatory view of the banking community. Suffice it to say that I still support functional regulation; I still prefer the investor protection and fair and orderly market securities regulatory scheme over the depositor protection and systemic safety and soundness banking regulatory scheme; I still believe that bank securities or mutual fund activities should be limited to a separate SEC registered

nonbank holding company subsidiary; and I still believe that interest rate swaps are securities. Secondly, while I see ample reason for regulatory concern with the explosion in the use of derivative financial products, I see no reason for panic yet.

The vast bulk of derivatives activities conducted by domestic securities firms has been limited by market forces to the largest, most sophisticated, best capitalized securities firms. The significant derivatives related shocks delivered to the U.S. securities regulatory system to date, Drexel Burnham Lambert, Olympia & York, and the Bank of New England, were absorbed without undue systemic stress. The derivatives portfolios of these large organizations were ultimately transferred or liquidated successfully. However, my "no reason for panic yet" comment is not meant to infer complacency. Some regulatory adjustments are presently in order, as are general vigilance and alertness for future developments.

II. Coordination

I will begin my discussion by recognizing that no market development highlights the need for more coordination and consistency from a financial regulatory standpoint than the increase in derivatives activities. While this applies internationally as well as domestically, I will focus primarily on domestic concerns.

The need for enhanced coordination between financial regulators and for more regulatory consistency in the derivatives area has been stressed by Congressman Leach and the CFTC derivatives study, among others. I expect that this point will be emphasized as well by the GAO derivatives study expected to be released this spring.

To some extent, Secretary Bentsen has filled this void by resurrecting periodic joint meetings between the heads of the various federal financial regulatory agencies. Chairman Levitt has made it clear to me that discussion on derivatives has dominated these meetings. It is my understanding that joint staff meetings on derivatives activities are anticipated in the near future.

I applaud the recent efforts aimed at improving derivatives regulatory consistency and coordination. Derivative financial products connect all markets and thus cut across all regulatory jurisdictional boundaries, domestically and internationally. Derivatives market activities require a collective regulatory response, and I encourage the continuation of the current federal domestic regulatory collective efforts.

III. Capital

No discussion of SEC developments in the derivatives area would be complete without mentioning the ongoing project to adjust the net capital rule to take into consideration derivatives activities by securities firms. This project should impact many banking operations as well. Some banking organizations, such as Bankers Trust and J.P. Morgan, have established large securities broker-dealer subsidiaries subject to the SEC's net capital rule. I understand that these bank securities operations have been very successful to date.

If banks continue to operate more profitably by engaging in securities and currency trading, in asset management, and in derivatives activities than by engaging in more traditional banking operations, then banks will become more like securities firms and will eventually become subject to the SEC's net capital rule. If interest rate swaps are treated as securities, a number of banks may find some of their operations to be subject to the SEC's net capital rule sooner rather than later.

Of course, the SEC addresses the credit and market risks of a broker-dealer's operations through capital charges. As a result of the exponential growth of derivatives activities by securities firms, the SEC embarked on a project to adjust its net capital rule to take into consideration these activities. The current rule is unnecessarily harsh on derivative instruments and should be adjusted accordingly.

As everyone here is probably aware, a concept release explaining the net capital rule project was issued last year. The next step in this project is expected to be for the SEC to propose for comment amendments to the net capital rule that would allow broker-dealers to use a binomial pricing model to determine capital charges for proprietary exchange-listed options and related positions. This would represent a somewhat novel approach since currently the net capital rule requires capital charges based on defined strategies contained in the rule. This Commission action is anticipated to occur in March. Later in the year, SEC staff is expected to tackle the net capital rule amendments necessary to take into consideration the market risk associated with, among other things, interest rate swaps. Sometime thereafter, I would expect the staff to tackle the even more formidable task of credit risk posed by these swaps.

For various operational reasons, a great deal of derivatives activities undertaken by securities firms are apparently being conducted in a subsidiary other than the SEC registered broker-dealer. Although the SEC has not yet answered this question, it appears to me that a strong argument can be made that most of these subsidiaries may in fact be operating as unregistered broker-dealers which should be subject to the SEC's net capital rule.

I understand that the federal banking regulators are also continuing to adjust their own capital rules to take into consideration bank derivatives activities. I hope that eventually the banking and securities regulatory capital requirements for derivatives activities will be fairly consistent.

IV. Risk Assessment

In addition to the net capital project, the SEC is monitoring the risks undertaken by individual securities firms as a result of derivatives activities through the risk assessment information now being filed quarterly. I understand that the federal

banking regulators are engaged in a similar program and that the CFTC is about to embark on the same exercise. So here again a common regulatory theme has emerged providing an opportunity for more derivatives regulatory consistency and coordination.

Through an analysis of the risks imposed on the individual firms, the SEC should be able to determine the systemic risk posed by derivatives activities. My view is that the best protection against this systemic risk would be the adoption by each firm of appropriate risk management policies and procedures. Appropriate controls on interconnected risk positions and controls to address concentration risks should be helpful as well. Of course, policies, procedures, and controls operate as designed only if the risk valuation is accurate. Therefore, I hope that in the coming months, the staff of the SEC, will pay particular attention, through the examination process, to the valuation of derivative products portfolios. Inaccurate valuations can very quickly lead to problems. Accurate derivatives portfolio valuation appears to me to be the cornerstone of sound risk management upon which the policies, procedures, and controls that I mentioned depend to function properly. The risk managers in the audience should keep this in mind.

There are a couple of risk management experiences in the derivatives position valuation area that are worrisome, at least to this regulator. The first is the difficulty experienced by American International Group ("AIG") when attempting to ascertain the risks in derivatives activities undertaken by one of its subsidiaries, AIG Financial Products. AIG is generally regarded as one of the better managed finance services companies in the world, yet AIG reportedly found it necessary to form a covert group of financial professionals to determine if this subsidiary was engaged in inaccurate accounting or incorrect swap valuations, camouflaged by the complexity of derivatives transactions, in order to subvert the risk controls in place.[5] Subsequently, I understand that AIG established reserves of $215 million to recognize an impairment in

the value of certain instruments of the subsidiary.[4] A related example is the reported experience of ABN Ambro Bank, a large Dutch banking concern, with a runaway currency-options trader who masked large losses of around $70 million in complex derivatives maneuvers by feeding false pricing information into the computers used to keep track of the bank's derivatives portfolio.[5] With examples such as these cropping up, I anticipate that the accuracy of derivatives portfolio valuation will become an increasing regulatory concern.

Derivatives portfolio valuation is already a major regulatory concern in the mutual fund area. Given the growing bank interest in mutual fund operations, this subject should be of particular interest to this audience. Mutual funds have become significant buyers of derivative products, particularly in the tax-exempt area.

In addition to limits on leverage and investments in illiquid instruments, the Investment Company Act of 1940 requires that mutual funds must stand ready to redeem shares daily and to pay redeeming shareholders within seven days of receiving a redemption request.[6] In addition, a mutual fund must compute its net asset value each business day and give purchase and redemption orders the price next computed after receipt of an order.[7]

To compute an accurate net asset value per share, a mutual fund must be able to value each portfolio investment accurately. Mutual funds must use market price to value derivative investments for which market quotations are readily available, and the board of directors must make a good faith determination of the fair value of derivative instruments for which market prices are not readily available.[8]

It is interesting to note that one prominent investment company portfolio manager, representing one of the more active purchasers of municipal derivatives, announced last year that he would stop buying such products due to the lack of adequate secondary market support and the lack of accurate pricing information.[9]

Another prominent fund family has indicated that it does not buy municipal derivatives at all because, among other things, of the lack of liquidity and the lack of seasoning during a bear market of these products.[10]

Again, through the examination process, I expect that the SEC staff will be scrutinizing mutual fund operations to ensure that the liquidity, leverage, and valuation requirements of the Investment Company Act, particularly insofar as investments in derivative instruments are concerned, are adhered to. Financial institutions that sell derivative products to funds, unless agreed to the contrary, should be prepared to supply secondary market liquidity for the product and to provide adequate pricing information for the product. Otherwise, there may be questions concerning the suitability of this investment to the fund.

V. Disclosure

As the flow of derivatives activities information to regulators, to investors, and to other marketplace participants improves, a number of concerns with these activities should diminish accordingly. I suppose this has some relationship to the fear of the unknown. In any event, enhanced disclosure of derivatives activities has become a very important issue.

The SEC is undertaking or is considering undertaking several disclosure projects which involve derivatives activities. I will briefly mention two.

First, in the mutual fund area, the SEC has underway a general review of the current state of investment company disclosure. A part of this review will include scrutiny of investment company derivatives activities disclosure.

It is my view that investment companies should include clearer and more useful information in their prospectus about their derivatives activities. The current disclosure is often of the boilerplate variety and is not very informative. Investment companies should more clearly explain what they are doing, particularly whether the

investments are hedging or speculative in nature, or a combination thereof and roughly what the combination is. An explanation of what constitutes a hedge would be information as well, if the activities are substantial. They should disclose the objectives of their derivatives transactions, should discuss adequately the risks involved (including volatility), and should quantify the percentage level of fund assets invested in derivative products.

Secondly, it is my understanding that the staff of the SEC is reviewing the current disclosure practices of the derivatives activities of companies, particularly financial institutions, which are required to file periodic disclosure documents with the SEC. Certain adjustments to the existing disclosure requirements to address specific derivatives activities may be warranted.

For example, Article 5 of Regulation S-X currently requires disclosure of the general character of each type of short and long-term debt instrument, including interest rate and maturity date. Industry Guide 3, which identifies certain statistical information that must be disclosed by financial institutions, requires disclosure of the average balances of each major category of interest-bearing asset and liability, including disclosure of average and year-end yields on each major class of interest-bearing asset and liability. To the extent that derivatives are accounted for as hedges of on-balance sheet financial instruments, the yield data reported in the Industry Guide should also include the effects of such hedges. While the information required by Regulation S-X and Industry Guide 3 currently provide insight into the market risk to which a financial institution is exposed through its major on-balance sheet lending and investing activities, no doubt the information available can be improved through sharpening these requirements.

Additionally, Item 303 of Regulation S-K, Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), currently

requires companies to discuss information about liquidity, capital resources, and results of operations that the company believes are necessary to an understanding of its financial condition, cash flows, and results of operations. This very broad requirement is intended to elicit disclosure about transactions or other factors which are not required by GAAP, and while not evident from the financial statements or other disclosures, are necessary to an understanding of the financial statements both from a historic perspective, as well as with respect to continuing operations.

Specifically, Item 303(a)(3)(ii) requires companies to "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[11] This provision would require a company to disclose the existence of derivatives activities which are reasonably expected to have a material impact on future income. In fact, I understand the SEC staff has observed instances in which companies have used MD&A to disclose the existence of derivative positions that have had, or that will have, a material impact on the results of their operations.

In light of the recent misfortunes of a certain large German company in the derivatives hedging area, however, the MD&A disclosure requirements may need modifying.[12] These requirements may need to be adjusted, among other things, to reflect adequately the risks posed by substantial derivatives hedging to a company's finances, such as the risks posed by a timing mismatch.

It appears to me that financial institutions, or other companies involved in substantial derivatives transactions, should include better and more useful information about their derivatives activities.[13] At a minimum, companies should disclose the objectives of their derivatives transactions and should explain the value of these activities to their operations. If derivatives are being used in a risk management or hedging program, the company should consider discussing the risks involved and the

strategy used to compensate for the risks. Again, a description of what constitutes a hedge may be informative. Financial institutions should also attempt to quantify their derivatives activities by providing the dollar impact on revenues and expenses for trading and hedging activities for each type of product or risk.

VI. Conclusion

Unfortunately, time does not allow me to mention two other very important areas where the SEC is working which will have an impact on derivatives activities. These are the accounting and sales practices areas. I encourage each member of this audience to pay particular attention to regulatory developments in both of those areas.

Where there exists complexity, illiquidity, and leverage, regulators will remain concerned. Derivative products have provided a great deal of flexibility to investors, allowing them to structure a portfolio and to manage risks in a certain manner. I believe that it is important to allow market participants the freedom to meet customer needs with new and innovative financial products. However, I also believe it is necessary to adjust our securities regulatory system to provide investors with reasonable and cost-effective investor protection safeguards in this complex and innovative market environment.

ENDNOTES

1. See Pressman, "Municipal Derivatives Volume Took Flight in 1993, So Did Secondary Market Ratings by Moodys', S&P," The Bond Buyer (Feb. 16, 1994), at 6.

2. Id.

3. See Straus, "The Shadow War at AIG," Investment Dealers' Digest (Sept. 6, 1993), at 14.

4. See Loomis, "The Risk That Won't Go Away," Fortune (March 7, 1994), 40.

5. See Rees and Effinger, "Dutch derivatives scam unmasks financial nightmare," The Denver Post (Nov. 21, 1993), at 31.

6. Section 22(e) of the 1940 Act [15 U.S. C. 80a-22(e) prohibits a mutual fund from suspending the right of redemption or postponing the date of payment or satisfaction upon redemption for more than seven days after the tender of such security to the mutual fund.

7. Rule 22c-1(a) [17 C.F.R. 270.22c-1(a)].

8. Rule 2a-4 [17 C.F.R. 270.2a-4].

9. See Pressman, "Major Buyer of Derivatives Leaves Market, Cites Disclosure," The Bond Buyer (Sept. 9, 1993), at 1.

10. See Pressman, "Fidelity May Ease Derivatives Restrictions, Officials at the Firm and on Wall Street Say," The Bond Buyer (Feb. 22, 1994), at 1.

11. 17 C.F.R. §229.303.

12. See e.g., Taylor and Sullivan, "German Firm Finds Hedges Can be Thorny," The Wall Street Journal (Jan. 10, 1994), at 1; and Gilpin, "A Metallgesellschaft Temblor Rocks Radnor, PA. The New York Times (Jan. 15, 1994), at 37.

13. See Hume, "Firms Should Improve Disclosure About Derivatives in 1993 Reports, FASB Officials Say," The Bond Buyer (Jan. 12, 1994), at 7.