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FINANCIAL DERIVATIVES

Actions Needed to Protect the Financial System

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Comptroller General of the United States

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Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss federal oversight of derivatives activities. As you know, we issued our derivatives report yesterday; 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 or the other members may have.

In the past 2 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 major advances in finance, information processing, and communications technology.

Derivatives are financial products whose values are based on the value of an underlying asset, reference rate, or index. We focused on four basic types of derivatives: forwards, futures, options, and swaps. 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. When contracts are not traded on an exchange, they are called over-the-counter (OTC) derivatives.

Derivatives serve important functions in the global financial marketplace. Among their benefits, derivatives provide end-users with opportunities to better manage financial risks associated with their business transactions, called hedging. They also provide opportunities to profit from anticipated movements in market prices or rates, called speculating. Derivatives activities had grown to at least $12.1 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 risks 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, individual firms, investors, and U.S. taxpayers. These concerns have been heightened by recent reports of substantial losses by some derivatives end-users, including losses totaling in the hundreds of millions of dollars by U.S. firms. The largest recent loss reported was by a German firm that involved assistance of more than $2 billion from about 120 banks.

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, end-users, and the exchange-traded markets. For example, as of December 1992, the top seven domestic bank OTC derivatives dealers accounted for more than 90 percent of total

U.S. bank derivatives activity. Similarly, securities' regulatory data indicate 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. securities firms. Substantial linkages also exist between these major U.S. derivatives dealers and foreign derivatives dealers. For example, 14 major U.S. OTC derivatives dealers reported to us that transactions with foreign dealers represented an average of about 24 percent of their combined derivatives notional amounts.

This combination of global involvement, concentration, and linkages means that the 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 the 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 cases of severe financial stress. While federal regulators have often been able to keep financial disruptions from becoming crises, in some cases intervention has and could result in a financial bailout paid for or guaranteed by taxpayers.

Primary responsibility for effective management of a firms' 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 managers could measure their firms' risk-management performance. In 1993 a Group of Thirty-sponsored study identified improvements that were needed in derivatives 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 they oversee.

Regulators and 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 ensuring 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 exist in the regulation of many major dealers. For example, securities regulators have limited authority to regulate the financial activities of securities firm affiliates that conduct OTC derivatives activities. Insurance companies' OTC derivatives affiliates are subject to limited state regulation and have no federal oversight. Yet OTC derivatives affiliates of securities and insurance firms constitute a rapidly growing component of the derivatives markets. The growth rate of OTC and exchange-traded derivatives (only combined data were available) was 100 percent for insurance firms and 77 percent for securities firms, compared with 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 banks' derivatives 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 activity. We found that 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 interest rate and other market risks. Insufficient accounting rules and disclosure for derivatives increase the likelihood that financial reports will not fairly represent the substance and risk of these complex activities. In addition, the lack of rules for certain products makes it likely that accounting for these products will be inconsistent, thereby greatly reducing the comparability of financial reports.

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 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 proper balance between (1) allowing the U.S. financial services industry to grow and innovate and (2) 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 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 major U.S. OTC derivatives 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 the existing federal financial regulators and to ensure that derivatives regulation is consistent and comprehensive across 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 boards of directors and senior managements 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 Congress begin to systematically address the need to revamp and modernize the entire U.S. regulatory system.

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Mr. Chairman, this concludes my prepared statement. We will be pleased to answer questions.

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