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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. Last month, we issued our derivatives report which was prepared in response to the requests of this committee and others. In my testimony today, I will briefly summarize our major conclusions and recommendations, provide our views on H.R. 4503, 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, which is called hedging. They also provide opportunities to profit from anticipated movements in market prices or rates, which is called speculating. Derivatives activities had 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 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, 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 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.

In this regard, the committee's bill, H.R. 4503, is a step toward improving the regulation of certain financial institutions that are dealers and end-users of derivatives. The committee should be commended for addressing this difficult and controversial issue and producing a constructive piece of legislation. The bill would require regulators to establish consistent standards for accounting, disclosure, capital, and examinations; could result in better call report data, including information on revenue gains and losses by class of product; would provide regulators greater access to information in an emergency; and would encourage international cooperation to harmonize derivatives regulation. These provisions are consistent with the recommendations in our report.

Our recommendations also include other types of information that need to be disclosed and would improve the timing of routine information collected by regulators. Information on concentrations of counterparty risk could help regulators anticipate and respond to a financial crisis at a particular institution, as well as recognize potential problems from concentrations of risk across many institutions. We also recommend better reporting about the purposes of derivatives use, such as hedging or speculating. The timing of information is also important as the values of an institution's positions can change quickly. Call report data that is reported quarterly or less often is not frequent enough for regulators to know whether an institution is having financial difficulty. We recommend that the regulators work with the industry to develop methods for the regulators to obtain more timely information.

The bill's requirement for financial institutions that are derivatives dealers and end-users to have written management plans for their boards of directors would help improve their corporate governance. We would also recommend that these plans include the roles and responsibilities of the boards, audit committees, management, and internal and external auditors. This would be consistent with our recommendations that major over-the-counter derivatives dealers and end-users have independent, knowledgeable audit committees and have internal control reporting by boards of directors, managers, and external auditors that includes assessments of derivatives risk management systems.

Because of the committee's jurisdictional boundaries, the proposed bill does not include major derivatives dealers that are the affiliates of securities firms and insurance companies. Important regulatory gaps still remain for these nonbank dealers. We have recommended that your committee work with the other committees of jurisdiction both to craft appropriate legislation to bring major nonbank dealers under some regulatory supervision and to begin to systematically address the need to revamp and modernize the entire U.S. financial regulatory system. Filling these regulatory gaps and addressing how the U.S. regulatory system should be restructured to better reflect the realities of today's rapidly evolving global financial markets are among the most important activities of these committees. In the interim, we encourage you to proceed with your proposed legislation. It is a valuable step toward improving derivatives regulation for major derivatives dealers and end-users.

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

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