REMARKS OF

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THE FUTURE OF THE OTC DERIVATIVES MARKET: WHERE DO WE GO FROM HERE

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THE GREAT DERIVATIVES DEBATE:
WHERE DO WE GO FROM HERE?

On July 18, 1963, President John F. Kennedy made a speech to the U.S. Congress concerning the balance of payments deficit that the United States had been running since 1960. In that speech, President Kennedy advocated the adoption of the Interest Equalization Tax, which taxed the value of foreign shares purchased by U.S. citizens. The tax was designed to stem the outflow of capital from the U.S. to foreign private and public issuers who had been raising capital in the U.S. markets.

I think you know how this story ends:

Europeans recognized this as an enormous opportunity to finally break Wall Street's monopoly on underwriting European issues. The tax raised the cost of borrowing by around 1% -- enough of a disincentive that foreign borrowers looked for other markets to tap. The result: The Eurobond market was born.[1]

The way in which the Eurobond market developed is instructive on a number of fronts. It demonstrates how markets ever so quickly adapt to changed circumstances -- even in the dark ages of the early sixties! And it also demonstrates that regulators no longer have the luxury of simply regulating things we don't like out of existence. Today, more than ever, the instrument or practice we seek to ban all too easily simply finds a more sympathetic market.

The interdependence of world markets today suggests that regulatory policy decisions that focus only on the effects in the domestic market, and do not take into consideration the global environment, are destined to fail. Policy makers around the globe realize that previously insulated domestic markets now operate in an environment where capital flows ever so freely across borders. Furthermore, national regulatory structures are beginning to compete among themselves. Some countries are using regulation -- or the lack thereof -- as an economic development tool. National regulators now have another new challenge to deal with: regulatory arbitrage.

Another way to look at it is that, if I and my colleagues don't do our job correctly with regard to the OTC derivatives market, I'll be visiting London a lot more in the future. After all, isn't that how the OTC derivatives market got its start?

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1 Ian M. Kerr, A History of the Eurobond Market, the First 21 Years, 17 (1984). See also, Morris Mendelson, The Eurobond and Foreign Bond Markets, in 1 International Finance Handbook, Chapter 5.1 (Abraham M. George & Ian H. Giddy, eds. 1983.)

When entities such as the Japanese Ministry of Finance decided to ban these instruments from their home marketplaces, overnight, the market moved to Singapore, New York, and, most certainly, London. Although it is possible that national policies could change and inhibit such a free flow of funds, the trend toward interlinked global markets seems unstoppable at this point.

Let's focus for a moment on three other unmistakable trends that are revolutionizing international finance: first, the blurring of functional distinctions among broker-dealers, banks, and other financial intermediaries; second, the growing use of short-term trading strategies by institutions; and last, but certainly not least, the growing use of both listed and OTC derivative instruments. All of these trends have significant implications for the way regulators are approaching the growth of the OTC derivatives markets.

In the last few decades in the U.S., we have seen a proliferation of multi-national financial services firms that can no longer easily be classified as "broker-dealers" or "banks" in the traditional sense. The divisions among these entities and the functions they perform in the markets have changed more in the last decade than any time since Congress arbitrarily drew the dividing line with the passage of the Glass-Steagall Act in the early 1930's. The breakdown of these traditional divisions is very apparent in the OTC derivatives market, where banks increasingly function as dealers, and dealers increasingly function as lenders.

Unfortunately, and perhaps inevitably, the regulatory structures in most countries, including the United States, have not kept pace. These new instruments were certainly unforseen and no country has been able to put them under the domain of a single regulatory body as of yet.[2] The U.S. approach to financial regulation in many cases has yet to recognize market reality and imposes increasingly unnatural and counter-intuitive constraints on financial services firms. We find ourselves trying to fit round pegs into square regulatory holes.

This is true of current U.S. capital standards, which are derived from a regulatory scheme rooted in the 1930's that strains to address the systemic risks these new types of financial firms and new types of financial instruments present.[3]

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2 See Saul Hansell & Kevin Muehring, Why Derivatives Rattle the Regulators, Institutional Investor, September, 1992, at 49.

3 See Hu, Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm, 138 Univ. of Pa. Law Review, 334, 335 (1989).

One such risk is the interdependent risk that the failure of a participant active in the securities, or lending, or insurance, or other financial markets could deal a severe blow to not just one market, but many markets.

Institutional investors have driven much of the change in the markets in the last 20 years. Many of the largest institutions have adopted low-cost passive strategies that involve tracking a market-wide index, or adopted active strategies, such as tactical asset allocation, in which they may shift large portions of a portfolio from stocks, to cash or bonds, or from U.S. equities to European or Asian equities.

Recognizing the demand and potential profit for these services, intermediaries stepped right up to satisfy investor demand. The result has been unprecedented innovation in international finance in the last decade.[4] For example, seventeen years ago, the only standardized derivative products in existence were call options on several stocks. Ten years later, the derivative markets were trading options on hundreds of stocks, as well as index options, index futures, and futures on options on a dozen stock indices.[5] By the mid 1980's, trading volume in stock index options and stock index futures had exceeded the value of stock trading on the New York Stock Exchange.[6] Last Sunday's New York Times called derivatives "a basic cog in the global economy and one of the most incredible growth industries ever."[7]

The growing demand for sophisticated derivative products has led to the development of the OTC derivatives market, as investors realized that they could purchase "designer" derivatives that would correspond more closely to their

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4 See, e.g., Id.; Miller, Financial Innovation: The Last Twenty Years and the Next, 21 J. Fin. & Quantitative Analysis, 459, 460 (1986).

5 Securities Exchange Act Release No. 30920, 57 FR 32587 (July 14, 1992) (Request for comment on the Division of Market Regulation's Market 2000 Study.)

6 See The October 1987 Market Break, Division of Market Regulation, Securities and Exchange Commission, (Feb. 1988), Chapter 3 at 3-1.

7 Barnaby J. Feder, Chicago's Exchanges Look Toward an Electronic Salvation, N.Y. Times, November 29, 1992, at F5. The article quoted industry sources as showing that more than 500 million futures and options contracts traded worldwide last year -- an average of nearly 1,000 per minute.

portfolios than traditional, standardized instruments.

The staggering growth of this market is easily explained. Customized derivative products can offer many advantages. First and foremost, derivatives provide businesses new opportunities for controlling and eliminating the ancillary risks in their commercial transactions. By allowing businesses to hedge against currency and interest rate fluctuations, as well as against fluctuations in the price of raw materials, derivatives allow industrial managers to focus all their attention on their basic business.

As you know quite well, equity derivatives offer unique advantages to market participants. They allow investors to tailor contracts to suit their particular investment strategies, rather than adjust the strategies to meet their portfolio. Investors can thus use OTC equity derivatives to create more perfect hedges against their portfolios than they can with standardized instruments. In addition, OTC equity derivatives can be used as surrogates for underlying equities or other investment commitments. They may offer better returns because they lack the "frictions" that often characterize entry into international markets; frictions such as management expenses, transaction costs, withholding taxes, and custody costs.

Because every term of an OTC derivative contract can be negotiated, managers can take on risk in the things they know best and mitigate, or eliminate, risk in the things they know least.

Sounds like the perfect financial innovation, so far, doesn't it? Well, maybe. But, in my view these products raise a number of issues that neither the market players nor regulators have yet completely come to grips with.

You are all quite familiar, I'm sure, with the mild hysteria in the press that has accompanied descriptions of regulators' concerns over the growth of the OTC derivative market. There is a certain mystique to these products and they do, of course, present risks that are different from more standardized products. The risk involved in these transactions is the first long-term risk brokerage houses have assumed on a systematic basis and it's the first time that broker-dealers have been in the business of credit assessment -- Unless, of course, you count the bridge loans broker-dealers are still carrying on their books from the 1980s!

But let's put it in perspective. To date, there have not been any spectacular failures where derivatives books have led to a firm's collapse. In fact, the record in this area so far has been far more enviable than the record of traditional credit intermediaries. The problems in the derivative market will have to be enormous to ever rival the recent loan loss and bank failure experience.

In fact, the largest losses in the OTC derivatives market have arisen not from bad risk management, but because of legal uncertainties. You're all familiar with the ruling in the Hammersmith and Fulham case, in which a British court struck a blow to this market by holding that U.K. municipal governments had no authority to enter into these transactions.

The market has weathered big failures -- Drexel and Bank of New England -- though at the time they sent shock waves through the markets. The Bank of New England actually made money unwinding its swaps book while the rest of the bank collapsed, and the Drexel wind-down was an orderly one. Nevertheless, real money was lost in the Drexel situation.

Have we simply been lucky so far, or is the concern about the risks in this market justified? To begin to answer that question, we need to identify exactly the risks we are talking about. First, and foremost is the credit risk participants in this market assume. Because there is no clearing house guarantee backing up these trades, counterparties have to rely solely on each other's credit for assurance that their mutual obligations will be met. The long duration of many of these options only serves to exacerbate this risk.

So far, market-imposed discipline has limited participants to those firms with the highest credit ratings. Marginal credits are simply priced out of the market. But, what will happen when the lower credits really push to get into the market? Will market discipline prevent that, or will the marginal, aggressive players prevail? It's with these marginal participants in mind that regulators design capital standards. As a regulator my first concern is not the mainstream firms whose capital ratios tend to be much more conservative that any minimum level we might require; rather my first thought must always be that market player who, by make-up, is inclined to attempt to do business on razor-thin margins.

The second type of risk is so-called "systemic risk." There is no universally accepted definition of the term, but as a general matter, I use it to refer to the risk that a failure of one major market participant could cause a chain reaction affecting other markets -- What you sometimes refer to here as "knock-on risk." Because the participants in this international market include retail and institutional broker-dealers, banks, insurance companies, pension funds, industrial corporations, and even governments, regulators must be concerned that effects of a failure may be very quickly transmitted throughout the international financial system. Information transmission and market risk assessment now occur at the speed of light, or at least at the speed of supercomputers.

Although market participants often dismiss these concerns with the statement that they run matched books that are completely hedged, when pressed, they sometimes admit that this might not be entirely accurate. As further innovation and "spread pressure" in the OTC derivative market has led to increasingly engineered, individualized and esoteric products, the perfect hedge often is not available and "sympathetic hedges" are, in fact, created to offset risk on a particular transaction.

To the extent that this means these transactions are dynamically hedged, I wonder whether the operative word is "dynamically" or "hedged." Assuming that the necessary liquidity will be there when you need it to adjust your hedge could be a fatal mistake. We were all educated in the pitfalls of dynamic hedging back in 1987 and I guarantee neither you nor any regulators want to repeat that lesson.

Many traders dismiss concerns about the level of risk in the markets as misplaced. But what do the CEOs and boards of directors think? Do they fully understand these transactions and their risks? Are they confident about the control and management of the risks? Are risk control systems keeping up with the nature of the risk? Is the system of bi-lateral mark-to-markets always accurate? Is the collateral or "stand-by" collateral going to be there if the need arises? And what about the legal and accounting uncertainties that still surround parts of this market?[8] Indeed, these are the sorts of questions Mr. Howland-Jackson may address tomorrow in his remarks on what every chief executive should know about the derivatives activities of his own institution.[9] I will listen carefully, because it seems to me that the information gap that sometimes exists between the regulators and the market is probably similar to the information gap that also sometimes exists between trading desks and CEOs and boards of directors.

Indeed, it's not just regulators that are uncomfortable. It appears that a number of CEOs are also not as comfortable with the risks as are their trading desks. Felix Rohatyn of Lazard Freres expressed concern about "26-year olds with computers creating financial hydrogen bombs."[10] Michael Carpenter, of

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8 See Coopers & Lybrand, The Financial Jungle, 392-393 (Phil Rivett & Peter Speak, eds., 1991).

9 Mr. Howland-Jackson is the President of Nomura International plc, London.

10 Where Do We Go From Here?, Institutional Investor, July, 1992, at 213.

Kidder, Peabody predicted last December that several major broker-dealers would be forced to take "huge write-offs" on derivatives in the next several years.[11] And Buzzy Krongard of Alex Brown wondered if "there dwells in a basement somewhere a 13-year old genius using a Cray supercomputer to keep track of everything."[12]

Although we have no evidence that the risks of the OTC derivative market aren't being managed adequately, these statements aren't very reassuring.

Today's regulators need to make sure that effective capital rules are in place to ensure that broker-dealers and their affiliates are financially stable and strong enough to withstand the market disruption that might occur if a major firm failed. I am concerned that in attempting to meet that goal, current SEC capital rules have created an incentive to run OTC derivatives books out of unregulated affiliates. Our current capital rules treat OTC derivatives as unsecured receivables, with a 100% capital charge. That's a prohibitive penalty to pay for the assumption of credit risk. And the predictable effect has been that these transactions have shifted to unregulated affiliates or off-shore.

There is a fair argument to be made that segregating these risks in entities that do not hold customer funds and securities is good policy. But I wonder if creating incentives to effect these transactions in unregulated entities where they are out of sight fulfills our obligation to protect investors. If we follow current practice, regulators will end up stubbornly standing guard over a shrinking core of the retail-related markets while ceding rapidly growing portions of institutional and cross-border finance to the unregulated arena.

At the same time, there are the growing cries of the systemic risk that this unregulated market represents to all players and all markets. Thus, the near term challenge regulators face is to find a way to afford these instruments sensible capital treatment, without forcing the transactions into affiliates or forcing the market off-shore. Simply shifting the systemic risk out of one's domain is certainly not the appropriate answer.

I continue to believe that harmonization of international capital standards is a laudable goal and one that must be pursued

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11 Miriam Bensman, Too Damn Smart . . ., Global Custodian, September, 1992, at 132, 135.

12 A.B. Krongard, If the Swaps Come Unglued, Watch Out!, N.Y. Times, July 5, 1992, at 13.

to adequately address systemic risk and to assure a level playing field for all market participants. The goal should not be to codify the lowest common denominator, but rather should incorporate the positive elements and hard-learned lessons of many differing national schemes.

At the SEC, we are moving forward on the issue of capital standards, concentrating, for the time being, on domestic capital standards. Last week we adopted higher capital standards for U.S. broker-dealers. Our action addressed a long-standing need to raise the minimum requirements that were set when the markets looked very different than they do today. The SEC's actions last week also represented the second step in an ambitious program for the next year or so. We announced at the meeting that the SEC's Division of Market Regulation will be studying the OTC derivatives issue over the course of the next year, as well as examining how to address listed options and futures, and mortgage-backed securities.

The SEC took the first step last summer when we adopted risk assessment rules that will allow the Commission to get a better picture of the scope and nature of the risks that are outstanding in these affiliates. Under these new rules, firms will have to file quarterly summaries that include a breakdown of the firms' exposure in off-balance sheet deals. Armed with this information, which we will begin getting next year, we will be in a better position to determine how to treat these instruments for capital purposes.

This effort will be enhanced by the recent actions of the Financial Accounting Standards Board, which adopted guidelines requiring institutions to publish information on derivatives exposures on their balance sheets starting in 1994. The net effect will likely be a huge increase in both assets and liabilities for many institutions, but it will also result in far more accurate disclosure of the financial condition of these institutions.

Ultimately, the Commission will have to decide whether to continue to encourage these risks to be domiciled outside the regulated entity. The obvious benefit of such a scheme in the United States is that the risks these transactions present are partially walled-off from firm retail activity and the government safety net provided by the Securities Investor Protection Corporation.

The other option is to change our capital rules to remove the incentive to book these trades in unregulated affiliates. Although this certainly will raise the risk profile of the regulated firm, it will, at the same time, give the Commission some reach over these activities and the risks that pose to the entire system.[13]

Whatever the Commission adopts in the end, however, will address credit risk for the first time. The net capital rules now focus on market, operational, and settlement risk. Crafting additional rules to account for credit risk presents a challenge for the SEC. Rest assured we will be up to the task in the coming year and we will work closely with the marketplace in trying to set the right balance. Indeed, that is the reason I was delighted to receive the offer to participate in this conference.[14]

The organizers of this symposium should be commended for the format they adopted, which brings regulators and the marketplace together. After all, responsibility for assuring the viability of this market does not rest solely with regulators. We are all in this together and market participants bear a major portion of the responsibility. Although I can speak only for my self, I assure you that the SEC is committed to adopting capital rules designed to address the special dynamics and structure of this market in the future. You, as market participants, must continue to be ever vigilant in policing yourselves. As I have said before, CEOs, boards of directors, trading desks, portfolio managers, risk managers, and corporate treasurers need to make sure that the use of leverage is at prudent levels and risk control and management procedures are in place and are serving their intended purpose. You can rest assured that regulators will take a much harder look at firms without good controls. If the unthinkable happens and there is a major accident, historical precedent tells you that the response will be heavy-handed and unpleasant.

There are two ways in which you can virtually assure the introduction of a crude, heavy-handed -- indeed draconian -- regulatory system: either be lax in self-regulation and allow a major accident that attracts the attention of your legislative body, or fail to keep regulators educated about the way the

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13 See Michael P. Jamroz, The Net Capital Rule, 47 Bus. Lawyer 863, 897 (1992).

14 I am also pleased to join here today and tomorrow my colleagues from the Bank of England, the Securities and Futures Authority, the Bank for International Settlements, the Bundesbank, the European Commission, the Commodity Futures Trading Commission, The Subcommittee on Telecommunications and Finance of the U.S. House of Representatives; as well as many of the leading swaps and derivatives houses and the leading users of derivatives.

market operates. Educating regulators must include making certain that they understand the safeguards and protections that are naturally imposed on the market. It is imperative that you keep up the educational effort, both within your own firms, and with your regulators.

Finally, I hope you will give serious thought to the benefits a multi-lateral netting system may provide. The proliferation of OTC derivatives has resulted in a retreat to bi-lateral netting arrangements, which do little to reduce the credit risk that parties to these transactions assume. Admittedly, some of this takes place because many OTC derivatives are highly customized instruments that cannot be "netted" in the traditional sense, but I think that there is room for some improvement to the current system.[15] I do believe that the recent steps toward requiring collateral when a counterparty's credit rating slips is a positive step.[16]

The development of the OTC derivatives market has been a credit to innovative and creative market participants who saw needs that were not being met, harnessed technology, and stepped up to the challenge. Although the derivatives market can offer enormous benefits, it also presents risks that are more complex and multi-faceted than we have seen before. My concern is to make certain the great potential for profit that these instruments present does not lull us into complacency about their risks.

There is a fair amount of concern about the effect OTC derivatives can have on the markets overall, as well as their potential to exacerbate crises. Largely, this is because of the lack of information available to the regulators who are held responsible for preventing market meltdowns and who are on the front lines of the post-crisis cleanups. Under the circumstances, it seems that some caution on the part of regulators is indeed justified.

I look forward to next year, when more studies of this market and the challenges its presents should be completed. As you know, the Bank for International Settlements last month issued a report on this subject. A partial list of the current

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15 See also Breeden, Remarks before the Securities and Futures Industry Institute Conference, September 17, 1992.

16 Even this mechanism has limits, however. If all the counterparty's contracts include such a collateral requirement, it may well be that when the downrating occurs, the counterparty will have inadequate collateral to meet all of its contractual obligations.

studies include the SEC, in conjunction with the self-regulatory organizations in the United States, as well as the Commodity Futures Trading Commission, the General Accounting Office, the Bank of England, the Securities and Investments Board, Japan's Ministry of Finance, the EC, and IOSCO. These studies should provide useful insights into the outstanding capital issues, the potential for systemic risk these products provide, and what information regulators need to know about this market and how they should obtain it.

In addition, I am anxious to see the results of the Group of Thirty's inquiry. As you know, the Group of Thirty is a committee of market participants and should bring an informed perspective to this debate.

In the interim, you should be taking a hard look at this market, as well. Further work needs to be done on standardizing the way risk is measured in the OTC derivatives market and you need to continue to inform regulators about the checks and balances that are in place to monitor and control that risk.

The window of opportunity to do so may be shutting quickly. In less than two months, we will have a Democratic administration in the United States, which <u>will</u> have a more pronounced regulatory bent than you have seen in years. It seems clear that more regulation of this market is in the offing and legislative initiatives are an inevitable result of some of the studies now underway. Our joint goal now should be to see that any new regulation be responsible and that undue burdens are not placed on the market.

<u>Conclusion</u>

Before I joined the SEC, I was directly involved in the markets for 14 years. From that point of view, I have come to understand that the competitive spirit that characterizes our markets is perhaps their most important attribute.

Regulation should facilitate commerce -- but also should set a floor as to which types of activities are not acceptable. And it should not be an excuse for protectionism; nor should regulatory laxity be used as an economic development tool. What we must strive for -- together -- is an appropriate regulatory framework that provides a level playing field and that continues to foster competition, creativity and innovation. Working together, I am confident that we have the potential to find the right approach to this market.