REMARKS OF

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DERIVATIVES: FUNDAMENTALLY CHANGING CORPORATE FINANCE, ASSET MANAGEMENT . . . AND THE RETAIL INDUSTRY?

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

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I would like to talk to you today about one of the most significant issues the SEC will address over the next few years: the rapid growth of the OTC derivatives market. It may be a topic that you don't think you care about. You may think it's someone else's problem. But I'm increasingly convinced that for everyone in this room it's not if, but how and when you will come face-to-face with it.

OTC derivatives are in the regulatory spot light these days because they are slowly but surely revolutionizing the markets. This market began as an institutional market for shifting currency and interest rate risk. It has blossomed into a market that encompasses innumerable exotic products that allow users to limit nearly any kind of risk, or to shift quickly and efficiently into or out of any asset class. Derivatives are changing the way business gets done, from the capital raising process to the way portfolios of student loans, car loans, and even mortgages are managed.

The growth of the market has been nothing short of phenomenal in the last few years and with that growth has come a host of questions from regulators. The SEC itself is examining the market from at least three different angles: last week the Commission issued a concept release on the appropriate capital treatment to apply to OTC derivative positions, which I'll describe later. And in connection with its Market 2000 study, the Commission is taking into account the effect of derivatives on the equity markets.[1] Finally, the Commission staff is discussing developments in the market with an exchange-NASD task force on OTC derivatives.

The reasons for the staggering growth in the OTC market are clear: with OTC derivatives customers can effect hedges that correspond more closely to the risks they are actually assuming than they can with traditional, standardized products. These products allow them to modify their risks and potential returns in nearly any way that suits them.

What would you recommend to a customer who owned a chain of hotels that was expanding in Europe and wanted to hedge its currency risk? What about a pension fund that wanted to get out of the Japanese market and increase its exposure to the French market quickly and efficiently -- not to mention cheaply? In both cases, the answer is likely to be some form of OTC derivative -- a loose term encompassing swaps, OTC options, futures and other, more exotic products.

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[1] Securities Exchange Act Release No. 30920 (July 14, 1992), at 13.

These days everyone seems to be jumping on the OTC derivatives bandwagon. It seems that each day Wall Street's wunderkinds are devising new ways to slice and dice risk, repackage it, and spread it around.

Certainly, OTC derivatives are becoming an important -- maybe even essential -- component of risk management systems. In fact it's possible that in the future courts may find it irresponsible -- or worse, impose legal liability -- on those who do not take advantage of the benefits the derivative markets do provide. Not too long ago, an Indiana state court found that a grain co-operative's board of directors and manager were negligent for not hedging against adverse grain price movements. The court found that the board of directors should have made a point of understanding hedging techniques and should have made sure that the manager was applying them properly.

In addition to providing an effective hedging mechanism, derivatives allow customers to gain exposure to equity, bond, or mortgage markets, without ever moving their funds out of CDs or Treasury securities. OTC derivatives allow their users to swap nearly any cash flow stream for another. And they provide significant economies of scale, compared with the cost of assembling actual portfolios and subsequently liquidating them when investment strategies change.

OTC derivatives are also revolutionizing corporate finance. Take McDonalds as an example. McDonalds has to borrow the capital it needs to open new stores at medium-term rates. But it would rather borrow at short-term rates. So, it enters into a rate swap that allows it to turn its fixed rate borrowing into a variable rate loan, at a lower rate. McDonald's estimates that it saves as much as 300 basis points from its costs in this manner.[2]

Similarly, many state and municipal governments are using swaps as an integral part of their debt management programs. And numerous other products with colorful names such as RIBs, SAVRs, Bulls and Bears, Short/Rites, Cap/Rites, and Float/Rites have been developed to with institutional investors' needs in mind.[3]

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[2] Robert Lenzner and William Heuslein, The Age of Digital Capitalism, Forbes, March 29, 1993, at 72.

[3] Roberts, "Modernize Customer Protection Rules Too," Remarks delivered to The Municipal Forum of New York (April 21, 1993), at 6-8.

But those of you who think that this is solely an institutional market, think again. Retail investors now are direct or indirect participants in this market. Merrill Lynch, for example, recently began marketing to high net worth customers its Tax-Exempt Municipal Security or "TEEMS," which are somewhat similar to inverse floaters. In addition, most money market funds invest in OTC derivatives, and several banks, such as Citibank and Bankers Trust, have recently begun offering CDs whose returns are linked to stock market performance. Even college students whose loans are guaranteed by Sallie Mae should appreciate the lower rate they receive because Sallie Mae reduces its capital costs through OTC derivatives.

Now we all know full well that there is no such thing as a free lunch -- especially in this business. And OTC derivatives are no exception. Although OTC derivatives allow users to reduce market risk, they require that users accept credit risk in return. In this market, you don't have a clearing corporation guaranteeing your counterparty's performance. Instead, you have to rely on the bi-lateral contract you negotiated and on your counterparty's credit-worthiness for assurance that they will pay you when the obligation comes due.

From a macro perspective, OTC derivatives also have the potential to raise the level of systemic risk in the markets. By that I mean the possibility that a failure of one counterparty in this market could have a domino effect on other counterparties.

This is a distinct possibility for two reasons: First, the fraternity of dealers in this market is small, only 25 - 30 banks and broker-dealers are significant players. Concentration like that means that there are fewer parties to whom to turn if you have to unwind a swap.

Second, this market has made the historical divisions among financial institutions and the borders between countries increasingly obsolete. Capital and risk flow freely across both. More than anything else has in years, the OTC derivatives market has linked international financial markets in a web of cross-border obligations.

The possibility that a rapidly growing OTC derivatives market <u>might</u> increase systemic risk is the main motivation behind the SEC's ongoing examination of the market. Recently, the SEC issued a concept release to solicit the market's views on the kinds of risks, as well as the level of risk, that dealers in this market are assuming. In addition, the concept release asks for commenters' thoughts on how the SEC should respond to the risks these products introduce to firm balance sheets.

I want to emphasize that issuance of the concept release doesn't signal any kind of conclusions on the Commission's part as to if, let alone how, this market should be regulated. In fact, the main focus of the release is on determining if we can remove the incentive in the current capital rules to effecting these transactions outside registered broker-dealers.

Our current capital rule does not reflect the new market reality: that broker-dealers are entering into OTC derivatives transactions and, as a result, are assuming long-term credit risk for the first time. Right now, credit risk is treated very harshly under the rule, and that's created an incentive to effect these transactions in affiliates. Removing the transactions from the registered broker-dealer, however, is not the same as removing the risk.

Although I have no preconceived notions about where we go from here in this market, I can say that I am convinced of one thing and that is that there is a cost to outdated rules: they can inhibit market innovation or have other detrimental collateral effects, such as sending business offshore.

Although so far I've focused on credit and systemic risk solely from a regulator's point of view, these aren't just regulators' issues. In fact, every OTC derivatives player, whether intermediary or end-user, had better be prepared to ask itself some tough questions about the management of the risks it is assuming.

That responsibility doesn't end with those who run firms' risk management departments. Senior management and boards of directors need to understand and feel comfortable with the way their firms are committing capital and the risks they are assuming.

There's no doubt that derivatives are complex instruments that are difficult to fathom. And when you add to that the fact that they are difficult to oversee because they often involve several legs in different markets, the task becomes even more complex. Unfortunately, that complexity may tempt senior management to rely too heavily on those who create the products to manage their risks. But simply taking on face value that everything is under control can be dangerous.

Senior managers and boards of directors are responsible for seeing that adequate risk management procedures are in place and that the firm's risk control systems are keeping up with the new types of risks their firms are assuming. After all, even Fischer Black, who developed the Black-Scholes options pricing model with Myron Scholes, recognizes that there may be some residual risk from these transactions that isn't accounted for. He's been quoted as describing risk management as "a never-ending task to identify possible glitches."[4]

The biggest question is whether firms are adequately monitoring risk. I've spent a fair amount of time with OTC derivatives dealers over the last six months discussing these issues, and I have to admit: they make a good case that their risk management systems are in good shape. Firms have now recognized that revenues and the risks generated from those revenues must be viewed in concert and they have built risk management systems to account for that inter-relationship.

Nevertheless, traders will be traders. And whenever there is a human element involved, reliance on systems alone is misguided. There is no substitute for active and careful monitoring by senior management and boards of directors of their risk control systems, as well as the methods used to minimize counterparty credit risk.

In addition, board audit committees need to make sure that firm internal and external auditors are asking the right questions, including identifying a group in the firm primarily responsible for risk management; whether they are separate from the traders who are incurring the risk; to whom the group reports; and whether there is centralized risk management at the holding company level.

Finally, management should give serious consideration as to whether steps need to be taken to minimize, rather than simply manage, risk. Management should ask whether counterparty positions should be marked-to-the-market; whether they are adequately collateralized and whether stand-by collateral will be there when it is needed.

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[4] Robert Lenzner and William Heuslein, The Age of Digital Capitalism, Forbes, March 29, 1993, at 72.

Conclusion

Firms that can respond to these questions positively will achieve two goals. First, they can rest assured that they are in the best possible position to weather market storms. Second, they will provide regulators with comfort about the market's ability to withstand a reasonable amount of market stress. The collateral benefit of that, of course, is that comfortable regulators are rarely rabid regulators.

It's too early to predict where the Commission will come out on the issue of appropriate capital standards for dealers who participate in this market. Nevertheless, I can tell you that the quickest way to end up with a heavy handed response from regulators is for market participants to be lax in monitoring their own risks and to let a major accident occur.

Over the next year, the Commission will be working closely with the dealer community to arrive at a solution to these issues that should help maintain stable markets, while still allowing market participants the freedom they need to continue to meet customer needs with new and innovative solutions. Only through working together can we all meet our objectives.

Thank you.