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Revised OCC Derivatives Handbook Focuses On Strong Risk Management and Emphasizes Importance of Internal Controls

WASHINGTON, D.C. -- The Office of the Comptroller of the Currency (OCC) today issued revised guidance to examiners for supervising national banks' derivatives activities. The OCC has updated Risk Management of Financial Derivatives to reflect the evolution of bank derivatives activity and risk management practices over the last few years. The revised 190-page section of the Comptroller's Handbook for National Bank Examiners replaces the first OCC derivatives handbook section published in October 1994.

"The new handbook emphasizes the importance of national banks' having strong internal risk management controls for their derivatives activities," said Comptroller of the Currency Eugene A. Ludwig. "It also communicates the OCC's support for the prudent use of derivatives by institutions that employ sound risk management systems."

The handbook stresses the responsibility of bank senior management to ensure the implementation of strong risk management systems for derivative activities. This entails developing and implementing a sound risk management framework composed of policies and procedures, risk measurement and reporting systems, and independent oversight and internal control processes. For example, the handbook recommends that banks require employees in positions that can significantly affect the books and records of the bank to take two consecutive weeks of leave each year.

"This action is designed to prevent employees from concealing unauthorized trading activities over an extended period of time as occurred in the Barings and Daiwa cases," said Mr. Ludwig. In discussing personnel and compensation programs for bank employees involved in derivative activities, the handbook also says that compensation programs should not reward employees for actions that may generate high levels of income but also expose the bank to excessive risks.

Examination procedures in the updated handbook section have been expanded to provide a more comprehensive guide for examining both bank dealer and end-user activities, and incorporate the OCC's supervision by risk philosophy.

Among new issues the revised handbook addresses are the credit, reputation and compliance risks associated with banks' entering into transactions with undisclosed counterparties through agents and other intermediaries. Before banks enter into these transactions, the handbook says, banks should have minimum controls in place, including receiving prior approval from senior bank management, limiting transactions to reputable agents and other intermediaries, and limiting the size of transactions.

The discussion of stress testing derivatives portfolios was expanded in the updated handbook to help bankers better understand risk exposures in unusual market environments. A new section discusses the importance of validating, back-testing, and calibrating price risk measurement models on a regular basis. In recognition of the complexity of evaluating these models, the OCC has developed a cadre of specialists who periodically evaluate the complex risk measurement models used by the larger national banks in their derivatives trading activities.

Derivative activities at commercial banks have risen dramatically over the past several years. At the end of the third quarter of 1996, the notional volume of derivatives activities at commercial banks was $19.8 trillion. The top 25 banks accounted for 98 percent of the total activity.

To order copies of Risk Management of Financial Derivatives, please send your request and a check for $15 for each copy to: Comptroller of the Currency, P.O. Box 70004, Chicago, IL 60673-0004.

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