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Regulatory Considerations In the Evolution of Risk Management

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I am delighted to be with you this morning and it's a particular honor to address this conference, which is deservedly described in your brochure as "North America's premier annual congress examining the latest innovations, trends, and methodologies for effective risk management and optimal derivatives trading." Having said that, I suspect many of you now may be wondering why one of your keynote speakers at such a conference is a bank regulator, and even worse, *a lawyer*. Regrettably, innovation and trend-setting are qualities not typically associated with either regulators or lawyers.

I hope I have a pleasant surprise in store for you. What I'll talk about this morning is the approach my agency -- the Office of the Comptroller of the Currency -- has taken to the role of banks as financial intermediaries; how this approach has evolved; how it has enabled the national banks we regulate to become robust, vital and *successful and safe and sound* participants in the derivatives markets, and how we take supervisory and regulatory concerns into consideration when we evaluate proposals by national banks to engage in new facets of the derivatives business.

Brief Overview of Banks' Role in the Derivatives Business

At the risk of telling you some things you already know, allow me to provide a little background. First, my agency -- the Office of the Comptroller of the Currency -- does not print money; we regulate the national banking system, including most of our nation's largest, most complex and sophisticated banks. The largest of these banks are active participants in the derivatives business, and the growth of their business has been a significant component of the overall growth of derivatives markets.

Indeed, the phenomenal growth of derivatives has been one of the defining features of global capital markets over the past decade or two, and an increasingly important part of the commercial banking business worldwide. In 1990, total notionals held by U.S. banks was well under $10 trillion; in the first quarter of 2003, they stood at some *$61.4 trillion*, overwhelmingly in interest rate contracts. U.S. banks generated $3 billion in trading cash instruments and derivatives activities during that same three-month period – a tidy sum that reflects one of the better quarters in recent reporting time periods.

As bullish as these numbers are, they don't begin to tell the whole story. Indeed, for technical reasons, the actual profitability of derivatives trading is even greater than reflected in the reported numbers.

But for banks actively participating in the derivatives market – admittedly, still a relative handful -- trading income is but one of the benefits they derive -- icing on the cake, as it were. In a recent speech that deserved more attention than it received, Federal Reserve Board Chairman Alan Greenspan endorsed the view that much of the credit for the resilience of the financial system during the economic turbulence of past three years may belong to the improvements in risk measurement and management techniques in use at our leading banks. And of those improvements, he singled out the growing use of derivatives as of particular importance in assisting financial institutions in unbundling and managing financial risks. As a result, U.S. financial institutions were not only able to withstand the largest corporate defaults in history, and the largest sovereign default in history – Argentina – but are now poised to lend again as companies anticipate quickening demand for their products and services in a recovering economy. Derivatives, as a key risk management device, may thus have helped to play a decisive role in keeping the recent recession both shorter and milder than would otherwise have been the case.

Of course, derivatives continue to be controversial in some quarters. They haven't quite overcome the taint of association with Barings and Long Term Capital Management. Their complexity can be daunting. One investment banker famously observed that he had been "trying to explain [the subject] to my parents and my wife for nine years and they still don't understand it. I still have to assure my mother that what I do for a living is legal." Especially in inexperienced or unethical hands, the risks posed by derivatives are very real.

OCC's Approach to National Banks' Derivatives Activities

At the OCC, we have tried to view the derivatives business not in isolation, but rather as part of an overall approach to the business of banking, its safe and sound conduct, and the management of the risks associated with it. Banks are in the business of serving the needs of their customers, and the OCC has consistently taken the position that the national charter is a dynamic instrument for the delivery of bank products and services. When we authorize -- indeed, before we authorize -- national banks to undertake new banking activities, we also consider how those risks will be managed and mitigated. Banks are quintessential financial intermediaries and derivatives can play an important part in the risk-management strategies employed by financial institutions and their customers. Thus it was logical that banks would seek to enter the derivatives business, and as they did, it presented a new range of legal, regulatory and supervisory considerations for the OCC.

We initially found national banks have authority to enter into derivatives, including swaps, options, and forwards, by looking to the nature of the investment on which the derivative was based. In those cases where national banks could own the underlying investment, we concluded banks may enter into derivatives with payments tied to the value of those investments. Based on these precedents, national banks were able to launch derivatives businesses that focused on management of interest rate and foreign exchange risks and price risk of particular precious metals.

Later, banks explored with the OCC the possibility of expanding their derivative business to include cash-settled derivatives based on the value of investments that banks generally cannot own, such as commodities (including oil, gas and electricity) and certain securities (generally equities and some types of debt). Banks sought to provide customers with derivative products useful for managing risks of price fluctuations in those commodities or securities.

In reviewing these proposals, the OCC considered carefully the nature of the transactions and activities involved and determined that cash settled derivatives with payments tied to the value of securities or commodities essentially involve exchanges of payments, similar to traditional banking activities. We also concluded that this line of business was fundamentally financial intermediation -- a new form of banks' long-recognized role as financial intermediaries. I will have more to say about these precedents in a moment.

Today, as in the past, the OCC takes a favorable view of banks' efforts to conduct banking activities in new ways to respond to changing financial needs of customers. In this regard, we also support and *encourage* national banks in their well-established history of serving as leaders in the development of risk management and controls.

Legal Foundation for National Banks' Ability to Conduct Derivatives Activities

Now I get to the part where I explain how our legal positions actually have been constructive.

OCC legal precedents interpret banks' statutory authorities broadly, consistent with both the language and goals of the National Bank Act. We approach banking powers -- guided by decisions of the U.S. Supreme Court -- as not just the activities listed in the National Banking Act, but as including a more general authority to engage in the business of banking and incidental activities. Our precedents have permitted ever expanding and more sophisticated banking activities. At the same time, and of equal importance, we have developed supervisory guidance to ensure these activities are conducted safely and soundly and we have assembled a talented staff with outstanding expertise, who understand this business and take a risk-focused approach to applying that guidance to the banks they supervise.

Using the procedures, interpretations and safeguards I have described, the OCC has permitted new and more efficient forms of hedging risk. Banks do not need to hedge each transaction, but can hedge on a portfolio basis to within appropriate risk limits.

The OCC also has permitted hedging with holdings that generally are not permissible for banks. Equity hedges are an example of this. Our decision to permit this new form of hedging was based on evidence from a national bank that conducting the hedges within the bank resulted in substantial savings and reduced operational and other risks arising from the bank's derivatives business. Our legal opinion was that the equity hedges are incidental to that business because they enable the bank to conduct the business more profitably and effectively.

Also permitted are new forms of settlement to allow banks to participate in a broader range of markets. Over the last year, the OCC issued two newsworthy rulings authorizing a national bank to engage in what appeared to be novel types of financial intermediation transactions. In the first case, a bank proposed to add transactions based on the price of electricity to its existing energy-related financial intermediation derivatives. In the second case, a bank proposed to expand its financial intermediation business to include customer-driven, electricity derivative transactions that involve transfers of title to electricity.

In both cases, however, there actually may have been less news than met the eye. The rulings were premised on a common set of assumptions – assumptions that have long been the foundation of our approach to bank powers generally.

First, we held that financial intermediation transactions involving commodities are authorized as part of the business of banking. We have previously recognized, in a variety of contexts, that commodity and commodity index derivatives are a modern form of traditional financial intermediation functions performed by banks. Based in part on that lineage, we have concluded that national banks may make payments to – or receive payments from – customers under commodity derivative contracts in the event of a gain or loss in a metal or energy product or index thereon. These derivative transactions thus have been recognized as permissible for national banks as a financial intermediation activity.

In these arrangements, national banks act as financial intermediaries between customers that want to manage risks resulting from the variations in the price of a particular commodity or commodity index. Customers do not deal directly with one another, but instead make payments to the intermediary bank. Under these authorities, the OCC has determined that national banks may engage in matched and unmatched commodity price index swaps, and manage and warehouse them on a portfolio basis.

Based on similar reasoning, we have permitted national banks to engage in various commodity-linked transactions involving oil, gas, other hydrocarbons, and metals. "Commodity-linked transactions" include making loans, taking deposits, and issuing debt instruments having terms related to commodity prices, sales, or indices, or measured in relation to the future; and entering into swaps, forwards, and other transactions relating to commodity prices and indices, or combinations thereof, in order to assist bank customers in managing their financial exposures.

The second assumption behind our recent approvals was that the electricity derivatives business is the functional equivalent of other commodity derivatives transactions that the OCC has previously determined are permissible for national banks. They are privately negotiated contracts between the parties to the transaction, individually tailored to the specific risk sensitivities of the customers. The parties agree to make payments based on the performance of a particular commodity or commodity index, whether the commodity is a hydrocarbon or a foodstuff.

Third, again, the OCC has long recognized that using derivatives to hedge against the risks associated with bank permissible activities is an integral part of those permissible banking activities. We have determined that national banks may hedge bank permissible commodity derivative transactions with other commodity derivatives, such as futures, and swaps and options and other over-the-counter instruments, when conducted in a safe and sound manner as provided in OCC guidance. Hence, as with other commodity derivatives, national banks may hedge bank permissible electricity derivative transactions with electricity futures, and swaps and options and over-the-counter derivative instruments. Further, we have specifically endorsed the hedging of commodity transactions on a transaction-by-transaction or portfolio basis.

How Supervisory Considerations Intersect with Legal Standards

Perhaps most important, the approval I have described was predicated on the requirement that electricity derivatives – like all financial intermediation transactions that we approve – will be conducted in a safe and sound manner. That is, just because the proposed activity may closely resemble a previously approved activity does not mean that it will automatically qualify for approval itself. Such activities require sophisticated risk measurement and management capacities on the part of a bank, as well as qualified personnel, in order for the activity to operate in a safe and sound manner.

Thus, in order for us to reach the conclusion that the proposed activity was permissible for the bank, the bank was required to demonstrate to the OCC's satisfaction that it had established appropriate risk measurement and management processes – including board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective risk control function. In other words, we did *not* reach a general conclusion that the activity was permissible for every national bank. We explicitly linked our conclusion about legal permissibility with our supervisory conclusion about the capacity and expertise of the particular bank to conduct the business in question.

But the Enron debacle and other events that led to the passage of the Sarbanes-Oxley Act reminded us that risk management is not just about financial exposure; it is also about reputation risk. There was time when some questioned why the OCC included "reputation risk" as one of the types of risks that we evaluate in our supervision of national banks. We don't hear that much any more. Certainly many shareholders would agree that events of the last two years have shown that an institution's corporate reputation has a significant economic value.

We recognize that when national banks engage in complex structured transactions involving derivatives, issues concerning the appropriateness of a transaction may arise. Thus, in our review of a bank's risk management approval process, we look to see how the bank evaluates that consideration, in other words, what it does to protect its good name in choosing the transactions it is willing to conduct and the parties with which it is willing to do business. We expect that banks involved in complex structured transactions involving derivatives will subject those transactions to review and oversight through their risk management oversight process to ensure that transactions conform to the bank's standards of appropriateness and integrity.

We look to see if committees independent of the sponsoring business review the complex structured transactions. In addition, we look to see whether the bank has a process by which it will evaluate the purpose of a transaction to assess whether a client has attempted to achieve a financial statement objective that could be construed as materially misrepresenting its financial condition, even if in conformance with generally accepted accounting principles. And, where such could be the case, we look for an undertaking from the bank to take appropriate steps, including declining to participate in the transaction, or requiring its counterparty to make appropriate disclosures concerning the nature and impact of the transaction on the financial position, so that there will be no misperception of the transaction's purpose and effect..

Conclusion

As I have recounted, the derivatives markets play a vital role in the management and intermediation of risk in our financial system, and the participation of banks, in their natural role as financial intermediaries, has, and should continue to, grow. Whether and how much it does, will be influenced by whether regulators -- or legislators or government officials -- feel the need to intervene to affect the way the business is conducted. And that, in turn, will depend to an important extent on how well *you*, and other industry participants, help to ensure that, in your derivatives business, appropriate attention is paid to both financial and reputation risk.

What does all this presage for the future of banks as participants in this business? The OCC expects that national banks' role as financial intermediaries will continue to grow and evolve in response to customer financial risk management needs and market developments. We view these developments favorably. We support national banks' efforts to better serve customers with new and innovative products. We will continue to strive to take a risk-focused approach to our supervisory responsibilities. But one thing *we will insist on* is that this evolution of activities continues to be coupled with appropriate financial risk controls, and internal checks and balances to ensure that these activities are conducted with integrity and due regard for the bank's good name.

Thank you very much.

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