

PROTECTING THE FINANCIAL SYSTEM FROM DERIVATIVE RISK

In May 1994, the U.S. General Accounting Office (GAO) issued a report, *Financial Derivatives—Actions Needed to Protect the Financial System* (The Report). GAO's objectives for studying the complex world of derivatives were to determine—

- what risks derivatives might pose to individual firms and to the financial system and how firms and regulators were attempting to control these risks,
- whether gaps and inconsistencies existed in U.S. regulation of derivatives,
- whether existing accounting rules resulted in financial reports that provided market participants and investors adequate information about firms' use of derivatives, and
- what the implications of the international use of derivatives were for U.S. regulation.

The GAO survey of practices and the need for regulation focused primarily on the over-the-counter (OTC) dealers and traders of derivatives products. According to the GAO, it is in this market that derivatives activity is concentrated among a relatively small number of dealers that are extensively linked to one another, end-users, and the exchange-traded markets.

The Report says the best available data indicate that the total volume of worldwide derivatives outstanding as of year-end 1992 was at least \$12.1 trillion in terms of the notional, or principal, amount of derivatives contracts. The notional amount, however, is not a meaningful measure of risk. According to GAO, the actual amount at risk varies based on the type of product and the type of risk—credit, market, legal, and operational. Based upon GAO's survey of 14 major U.S. financial institutions, their gross credit risk—possibility of loss from a counterparty's failure to meet its financial obligations—at the end of 1992 was \$114 billion on a notional amount of \$6.5 trillion or 1.8%.

Other kinds of risk, says the Report, are more difficult to measure than credit risk. GAO defines these risks as follows: 1) market risk (adverse movements in the price of a financial asset or commodity), 2) legal risk (an action by a court or by a regulatory or legislative body that could invalidate a financial contract), and 3) operations risk (inadequate controls, deficient procedures, human error, system failure, or fraud). Major losses at one firm were blamed on poor operations controls.

The GAO concluded the following:

- There are no comprehensive industry or federal regulatory requirements to ensure that U.S. OTC derivatives dealers followed good risk-management practices. Regulators have issued guidelines for certain bank dealers, and both regulators and market participants said improvements in risk-management systems have already been made as a result of these recommendations and guidelines. But no regulatory mechanism exists to bring all major OTC dealers into compliance with them.
- New participants entering the market may not be as knowledgeable or control conscious as present dealers and may take on unwarranted risk to gain market share.
- Accounting standards for derivatives, particularly those

used for hedging purposes by end-users, are incomplete and inconsistent and have not kept pace with business practices. The GAO acknowledges the work FASB has done so far and the proposal for expanded disclosures. It feels however, progress toward the ultimate objective of measurement of these instruments has been slow. It also believes market value accounting should be FASB's ultimate objective.

As a preface to its recommendations, GAO states that because of the interrelationships among OTC dealers and markets worldwide, any crisis involving derivatives will be global. Derivatives activities in foreign countries (which tend to be concentrated in 11 countries) are subject to varying degrees of regulation.

GAO's Recommendations

To Congress. Require federal regulation of the safety and soundness of all major U.S. OTC derivatives dealers. The primary need is to bring insurance company and securities firm affiliates under the purview of one or more of the existing federal regulators. Congress should also systematically address the need to revamp and modernize the entire U.S. financial regulatory system.

To the Regulators. Strengthen and make more uniform existing regulatory requirements OTC derivatives dealers are presently subject to including such things as requiring independent, knowledgeable audit committees and internal control reporting.

To the FASB. Proceed with the finalization of the proposed statement for additional disclosures and move towards completion of final guidance on accounting rules for derivative products including measurement and additional disclosures. This latter step should include consideration of a market value accounting model.

To the SEC. Ensure that SEC registrants that are major end users of complex derivative products establish and implement corporate requirements for independent, knowledgeable audit committees and public reporting on internal controls.

The Report strongly reflects GAO's point of view that a industry-wide financial crisis can be avoided by a high level of regulatory activity and effective corporate governance and oversight by OTC dealers through the use of independent audit committees and external reporting on the effectiveness of internal controls.

Greenspan Disagrees

Alan Greenspan, chairman of the Federal Reserve Board, in testimony before the House Telecommunications and Finance subcommittee of the Energy and Commerce Committee, said there was "negligible" risk that the rapidly growing market for financial derivatives might someday require a taxpayer bailout and therefore no need for new legislation to supervise derivatives. Greenspan is quoted as saying, "In a more important sense, today's markets and firms, especially those firms that deal in derivatives, are heavily regulated by private counterparties, who, for self-protection, insist that dealers maintain adequate capital and liquidity." □