United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Environment, Credit and Rural Development, House Committee on Agriculture
House of Representatives

Not to Be
Released Before
10:00 a.m., EDT
on Tuesday
June 14, 1994

Response to the International Swaps and Derivatives Association Position Paper

Statement for the Record
James L. Bothwell
Director, Financial Institutions and Markets Issues
General Government Division

GAO/T-GGD-94-163

060605/151869

U.S. General Accounting Office Response to the International Swaps and Derivatives Association Position Paper: The GAO Report on Derivatives: Good Facts and Bad Conclusions

On May 27, 1994, the International Swaps and Derivatives Association (ISDA) issued a position paper in response to our report on financial derivatives.[1] In the paper, ISDA states that our report contains valuable information and useful suggestions. However, ISDA disagrees with several of our conclusions and recommendations, states that many of our recommendations are not supported by the facts reported, and suggests that their adoption would raise costs and reduce the availability of derivative products.

Our recommendations call for

-- the extension of basic regulatory safeguards and prudent corporate governance to the currently unregulated major derivatives dealers,

-- improvements in the regulatory oversight of bank derivatives dealers, and

-- increased accountability for major end-users of complex derivatives and improved disclosure and accounting standards for users of derivative products.

We believe our recommendations will provide federal regulators both early warning information and the regulatory authority necessary to anticipate and respond to a crisis involving derivatives. We do not believe they will either increase costs or reduce the availability of these products.

Derivatives are a very large and rapidly growing business, and the federal government cannot afford to wait for a crisis to act. Much of the derivatives activity in the United States is concentrated among a few major dealers who are extensively linked to one another, and the failure or abrupt withdrawal from the market of one or more of these major dealers would likely result in federal intervention to maintain the integrity of the financial system. Taking action to fill the gaps in federal regulatory authority over the affiliates of securities firms and insurance companies that are major derivatives dealers would give federal regulators the ability to anticipate and respond to such a crisis.

---

[1] Financial Derivatives: Actions Needed to Protect the Financial System (GAO/GGD-94-133, May 18, 1994).

Our responses to ISDA's specific positions follow.

MARKET CONCENTRATION

Our report cited evidence showing that much of the over-the-counter (OTC) derivatives activity in the United States is concentrated among 15 major U.S. dealers.

ISDA Position

ISDA states that available data do not adequately support our conclusion that derivatives activities and credit exposures are concentrated among dealers. Specifically, ISDA notes that

-- a recent survey indicated that no dealer had a global market share of more than 10 percent, and the share of the eighth largest dealer was only 5.1 percent.

-- our survey of 15 major U.S. derivatives dealers indicated that less than 11 percent of their net OTC credit exposures were with other U.S. dealers at year-end 1992, which was down from approximately 13.4 percent at year-end 1990.

-- no liquidity problems associated with derivatives have occurred, and the credit exposures from settlements of other financial instruments, including securities, deposits, and foreign exchange, are larger than those of derivatives. Even if a major dealer were to fail or withdraw from trading, other instruments and markets would be available as alternatives for hedging and other purposes.

GAO Response

While complete data to accurately assess global concentration levels are not available, existing measures show significant concentration among U.S. derivatives dealers. We reported U.S. regulatory data showing that just seven major U.S. bank and five securities firm derivatives dealers accounted for approximately 90 percent of the derivatives volume in their respective industries in 1992. Even ISDA's international data showed considerable concentration. Using the recent survey data ISDA cited, one can conclude that the top eight international dealers account for at least 40 percent of global market activity.

The information that 15 U.S. dealers supplied to us indicated that these firms' credit exposures to other U.S. dealers declined from 1990 to 1992 as a percentage of their total OTC derivatives-related exposures. However, their credit exposures to dealers worldwide continued to increase over that period. Such exposures represented over 38 percent of the U.S. dealers' total OTC derivatives credit exposure at year-end 1992, which was an increase from about 35 percent at year-end 1990.

As ISDA states, credit exposures arising from other activities often exceed those of derivatives, and alternative markets and products can be used if a major dealer fails or withdraws from the markets. However, because of the concentration of both derivatives activity and credit exposures and the interdependence of many of the derivatives and underlying markets, such a failure or withdrawal could have serious effects on the markets of various products and on other firms. The major derivatives dealers are generally active in the alternative markets that ISDA cites. The potential uncertainty and disruptions to liquidity should one or more of these firms fail or withdraw from OTC or exchange-traded derivatives markets could affect the availability and stable functioning of these markets.

MARKET LINKAGES

Our report cited evidence that derivatives clearly have expanded financial linkages among the institutions that use them and the markets in which they trade, and concluded that such linkages could allow financial disruptions to spread among firms and markets.

ISDA Position

ISDA states that our report does not cite sufficient evidence that linkages among derivative product markets and dealers would cause a financial disruption to spread faster and be harder to contain. It indicates that such linkages are a common part of the increasingly global economy and that risks are spread more widely as a result.

GAO Response

Our report recognizes the differences of opinion among regulators and market participants about whether derivatives linkages diffuse risk or spread problems faster and make them harder to contain. Absent a derivatives-related crisis, no empirical evidence exists to resolve these differences. Nevertheless, the potential for derivatives linkages to hasten the spread and expand the scope of problems during any financial system crisis is a sound reason for federal oversight of derivatives activity. As the Chairman of the Federal Reserve Board indicated in his May 25, 1994, testimony, before the Subcommittee on Telecommunications and Finance, derivatives "may help to speed the transmission of a shock from some other source to other markets and institutions" and that "[g]iven these tighter linkages, if a major international financial firm came under severe financial stress, authorities could face significant difficulties in containing the effects on other institutions and markets."

SYSTEMIC RISK

Because of market concentration and linkages, we concluded that the abrupt failure or withdrawal from trading of a major dealer could create liquidity problems and undermine stability in several markets simultaneously thus leading to a systemic crisis.

ISDA Position

ISDA states that past events do not support concerns that derivatives could cause a systemic crisis. ISDA indicates that the financial difficulties and government intervention that occurred during various events cited in our report, including the 1987 stock market crash, the 1992 European Monetary System disruption, and the failures of the Bank of New England and Drexel Burnham Lambert, were not caused by derivatives.

GAO Response

While the above events were not caused by derivatives, the 1987 stock market crash and the 1992 European Monetary System disruption illustrated that during times of stress, derivatives markets and the firms that use them can be affected. Firms that relied on hedging strategies involving derivatives in 1987 found that these hedges were not as effective after disruptions in the stock markets interfered with the functioning and liquidity of the equity derivatives markets. During the disruption in the European markets in 1992, trading in some OTC derivatives ceased as a result of price and rate volatility in the underlying cash markets.

The termination and transfer of derivatives in the portfolios of the Bank of New England and Drexel Burnham Lambert were concluded successfully. However, these firms were not major derivatives dealers and had portfolios that were much smaller than those of the major dealers we identified. Also, closing out their derivatives activities with minimal disruption required various regulators' concerted efforts and took several weeks or months. All of these cases also demonstrated that during times of financial stress, the federal government is likely to intervene.

REGULATORY GAPS

We found that basic regulatory controls did not exist for many U.S. OTC derivatives dealers, and recommended that these gaps be addressed.

ISDA Position

ISDA states that additional regulation to close the regulatory gaps that exist for the major U.S. derivatives dealer affiliates of securities firms and insurance companies is unnecessary. ISDA cites references to our report where we indicated that these firms all described systems for addressing the credit, market, operations, and legal risks arising from derivatives activities. These firms also said that they set aside capital to cushion themselves against derivatives-related losses, as credit rating agencies and their counterparties expect.

ISDA also questions the need for capital standards that apply to all derivatives dealers given the lack of concern over dealers' capital adequacy, the uncertainty as to whether a derivatives dealer failure would have any broader impact on the economy, and the fact that dealers cannot participate in derivatives without strong capital bases and good business reputations.

Finally, ISDA cites the May 25, 1994, testimony of the Federal Reserve Board Chairman, who said that further regulation was unnecessary because "private regulation" by investors, credit rating agencies, and others require the firms with whom they do business to be financially sound.

GAO Response

Our recommendation for closing the federal regulatory gaps that exist for the major U.S. derivatives dealer affiliates of securities firms and insurance companies does not contemplate a separate, obtrusive regulatory structure for these firms. We acknowledge that market discipline, arising from these dealers' rating agencies and counterparties, provides an incentive for firms to manage their derivatives activities prudently. However, the marketplace does not have verifiable information on risk controls and management intentions. Past experience has shown that firms can develop serious problems before the marketplace knows about them.

Federal regulation is needed over all major U.S. derivatives dealers because (1) the currently unregulated dealers are active in many markets and (2) derivatives are an increasingly large part of their activities. A failure or onset of financial difficulties at one or more of these firms would almost certainly require the involvement of numerous federal regulators, who would be in a better position to anticipate and respond to such problems if they were already familiar with the firms' operations through reporting and examinations. In this regard, quarterly reporting is not sufficient to prepare regulators. Conducting on-site examinations of the major dealers is the only means for regulators to ensure the accuracy of reported information, assess the extent to which firms are exposed to risk, and ensure that risk management procedures dealers describe are being consistently followed.[2] Examining firms' derivatives activities also would provide regulators with a better view of the overall risks taken and managed by these firms. Finally, the basic regulatory oversight controls--reporting, capital requirements, and periodic examinations--that we recommend be in place for all major derivatives dealers would not supplant or diminish market discipline but instead would represent a prudent way for federal regulators to ensure that derivatives risks are adequately addressed.

ACCOUNTING AND DISCLOSURE

In our report we found that accounting standards for derivatives were incomplete, inconsistent, and had not kept pace with business practices.

ISDA Position

ISDA states that, while our report correctly discusses the need to improve accounting and disclosure principles for derivatives, we have not adequately acknowledged that firms' derivatives activities are fully integrated with their other activities so that separate disclosure and reporting could be misleading rather than helpful. In particular, ISDA indicates that requiring bank regulators to obtain additional quantitative, aggregate information is unlikely to be more useful because positions and strategies can change quickly.

In addition, ISDA expresses its opposition to implementing market value accounting for all financial instruments. It notes that this would be a radical change for many end-users, especially for those using derivatives to hedge risks from nonfinancial instruments, such as inventory. Such a change could introduce an artificial volatility into the financial statements of commercial and industrial companies. For these reasons, ISDA notes that market value accounting for all instruments would be inconsistent with the Group of Thirty's recommendation that end-users account for derivatives used to manage risks in a manner that is consistent with the income recognition treatment of the risks being managed.

GAO Response

Our report discussed the existing and proposed disclosure standards issued by the Financial Accounting Standards Board that address all financial instruments, including derivatives.

---

[2]Although major dealers described their risk management systems to us, we were unable to verify the effectiveness of these systems. In the past, when bank examiners reviewed these systems, they found problems.

Neither these standards nor our recommendations advocate separate disclosure of derivatives from other related financial instruments. However, because of the off-balance-sheet nature of the products we discuss in our report, and the differing objectives for their use (such as speculation or risk management), additional disclosures are needed compared to on-balance-sheet financial instruments. We do recognize, however, that any discussion of risk management activities must consider all relevant activities, not just derivatives. Because derivatives activities are integrated with other activities, regulators should work together and with industry representatives to determine the most meaningful information to collect and to minimize reporting burdens.

Regarding market value accounting, we acknowledged in our report that a number of implementation issues would have to be resolved before a comprehensive market value accounting model for financial instruments could be adopted. The issue of accounting for derivative products used to hedge the risks from nonfinancial instruments is among those that must be resolved. In addition, as indicated in our report, the existing issues surrounding accounting for anticipatory transactions would not be resolved by market value accounting. However, the Financial Accounting Standards Board considers implementation issues as part of its rule-making process. Therefore, these issues should not preclude considering a market value accounting model now.

Further, a financial instruments market value accounting model that allows exceptions for deferral accounting for certain types of transactions, including anticipatory transactions, could reduce the difficulties of implementing such a model. Providing these types of exceptions would make a market value accounting model for financial instruments consistent with the Group of Thirty's accounting recommendation regarding consistent income recognition treatment of derivatives used to manage risks and the risks being managed.

As we reported, most large and sophisticated entities are typically managed through constant monitoring of the market values of their financial instruments including derivatives products. Business decisions about how to operate these entities are generally based on a market value accounting model. However, public financial reports of nondealers are generally prepared on the basis of the historical cost model. The historical cost accounting model masks the realities of today's rapidly changing markets and fails to provide investors, depositors, regulators, and others with the full complement of information they need in making business, economic, and regulatory decisions.

END-USER ACCOUNTABILITY

In our report we recommended that major end-users of complex derivatives establish improved accountability through public reporting on internal controls.

ISDA Position

ISDA states that our recommendation to have the Securities and Exchange Commission (SEC) ensure that major end-users of complex derivatives establish internal controls and public reporting on those controls is not justified. It notes that this recommendation would single out derivatives for such controls and reporting, although other activities undertaken by firms also pose risks. ISDA indicates that such a requirement represents an undue intrusion of SEC into corporate affairs and could inhibit firms from using derivatives because of the added risk management and reporting burdens.

GAO Response

While we think our recommendation makes prudent business sense for any going concern, it is most specifically directed to a limited number of end-users those actively using more complex derivatives. Our recommendation seeks to increase the accountability of management and boards of directors of firms actively using complex derivatives to their shareholders, creditors, and other counterparties. This accountability would be achieved by requiring formal, documented assessments of risk-management policies and controls, with public reporting of the results. As stated in our report, this type of formal assessment and reporting helps fulfill (1) the need of investors to know how well their investments are being managed, (2) the necessity for regulators to have an early warning of problems that could lead to future financial deterioration of regulated entities, (3) the obligation of counterparties and other creditors to understand the credit risk associated with these entities, and (4) the desire of the general public to have accountability in our financial system. As far as the additional management and reporting burden, firms should have such internal controls in place as a matter of sound corporate governance, and any additional effort in reporting on such controls should be minimal.

GROUP OF THIRTY RECOMMENDATIONS

In our report we stated the Group of Thirty study indicated that not all industry participants were following recommended benchmark risk management practices. We also noted that no regulatory mechanism existed to bring all major dealers into compliance with these practices.

ISDA Position

ISDA states that implementing regulations requiring financial institutions to follow the risk management practices recommended by the Group of Thirty-sponsored report on derivatives would be detrimental to firms' efforts in this area. They note that the Group of Thirty's recommendations were designed to be flexible.

ISDA also notes that our report's use of the data obtained from a survey of 80 dealers conducted as part of the Group of Thirty's report understates the current level of compliance with its recommendations. According to ISDA, this dealer survey was conducted in late 1992 and many of the weaknesses in firms' risk management systems that it found were at small non-U.S. dealers.

GAO Response

We recommended that regulations be implemented that stipulate the core elements of prudent derivatives risk management practices. Such regulations would provide regulators criteria and leverage for better ensuring that financial institutions comply with such practices. We recognize that risk management practices are evolving, and we do not want to discourage continuing innovation. As a result, we envision that regulators would supplement regulation with interpretive guidance that keeps firms advised of state-of-the-art risk management practices.

The information in our report represents a snapshot in time. We are aware that some firms have continued to improve their risk management systems, and we encourage such actions. Given the responsibility of federal regulators for the continuing stability of the U.S. financial system, we believe that the implementation of our recommendations is still needed to ensure that such improvements are made by all existing major U.S. dealers as well as by new industry entrants. Further, the risk management system weaknesses of non-U.S. dealers that ISDA identified further support our recommendation for U.S. regulators to work with their foreign counterparts to ensure that the risks of global derivatives activities are subject to coordinated and harmonized regulation.

CAPITAL REQUIREMENTS

We stated that capital requirements do not exist for the unregulated affiliates of securities firms and insurance companies, and that the capital requirements for banks do not address all types of risks associated with derivatives.

ISDA Position

ISDA states that, because legal and operations risks cannot be quantified, our recommendation that a standard be in place for these risks is inappropriate. They also imply that the current credit risk standards for banks already address legal risk.

GAO Response

Our report describes the difficulties in both attempting to quantify legal and operations risks and in developing a capital standard to address them. Consideration of this issue is also complicated by the recent inclusion of the value of derivatives contracts (those with positive market value after netting agreements are considered) in the calculation of banks' leverage ratio capital requirements.

Credit risk standards for banks may not completely protect them from losses arising from a legal or regulatory problem. For example, current capital standards allow banks to hold reduced amounts of capital on transactions with other banks, including major foreign banks, because their risk of becoming insolvent is less than other private companies. The legal risks on these transactions may not be the same, however, because of differences in U.S. and foreign laws.

Given these circumstances, bank and other regulators should evaluate their existing capital standards to ensure that all the risks of derivatives--credit, market, legal, and operations--are adequately addressed. As a result of their evaluation, regulators may find that the existing requirements are appropriate. If not, they may need to adopt a standard for legal and operations risks that would require additional amounts of capital to be held depending on the quality of derivatives dealers' risk management systems and internal controls. Regardless of the type of standards implemented, all major U.S. derivatives dealers should be required to follow them.

RECOMMENDATIONS TO FINANCIAL REGULATORS

In our report, we made the following recommendations to the appropriate regulatory authorities:

-- Develop and maintain accurate, current, and centralized information, that is accessible to all regulators, including information on the extent of major OTC dealers' counterparty concentrations and the sources and amounts of their derivatives earnings and

-- Perform comprehensive, annual examinations of the adequacy of major OTC derivatives dealers' risk management systems.

ISDA Position

ISDA questions the need for these recommendations for the following reasons:

-- centrally collecting information on derivatives-related concentrations of counterparty credit exposures would be expensive and would not produce much benefit, given that other activities can create larger credit exposures;

-- collecting additional information on earnings from derivatives, especially by product line, would not be meaningful, given that a firm's activities are integrated; and

-- conducting annual examinations of dealers' derivatives risk management systems would be inefficient because other activities may have greater risk.

GAO Response

Each regulator should collect current information from the derivatives dealers it oversees to identify large credit exposures to individual counterparties and to particular countries or industries. Centralized collection of such information would be useful in anticipating and addressing a financial crisis because it would allow regulators to monitor patterns of exposures to particular counterparties or industries across firms and over time. This type of perspective is not always available during examinations of individual institutions.

We agree that information on overall credit exposures would be more useful than information on derivatives credit exposures alone. Firms have made progress in identifying the risks derivatives pose and in developing systems to manage their exposures. Some firms are also adapting the systems and practices used in managing derivatives to address the risks of their other activities. Similarly, regulators could expand the reporting and other requirements we have recommended for derivatives to ensure that all of a firm's financial activities are being adequately managed.

Collecting additional information on derivatives-related earnings is warranted by the increasing percentage of financial institution profits attributable to derivatives. However, historical information on outstanding contracts is not necessarily a meaningful indicator of risk. Volatility of earnings could be a better indicator. At a minimum, regulators should be receiving information that allows them to generally determine how much of a dealer's profits were earned by

-- meeting customer demand or by proprietary position taking;

-- participating in different underlying markets, such as interest rates, foreign exchange, equities, and commodities; and

-- conducting transactions in different types of products, such as written options, swaps, or more complex transactions.

Because the degree of risk can vary across these activities, collecting additional information of this type would allow regulators to better monitor the overall level of risk being taken by these institutions and assist in determining how successful these firms are at undertaking and managing it. Many firms already generate similarly detailed reports of their earnings for internal management purposes. We recognize that the ways these products are used within a firm can vary by transaction and across departments. Regulators will have to work with industry representatives to determine the most meaningful information to collect and to minimize reporting burdens.

Regarding our recommendation for annual examinations of the major dealers' risk management systems, the only way to ensure that a firm is adequately managing its derivatives risk is to conduct an on-site examination of its risk management system and identify, test, and evaluate its internal controls. Currently, only bank derivatives dealers are subject to such examinations. We do not expect regulators to conduct duplicative reviews of a firm's entire risk management system annually if they can determine that adequate policies and procedures are in place and being followed with more limited efforts. Regulatory examinations should appropriately emphasize the areas posing the greatest risk to a firm's soundness, and these areas may vary over time. However, the increasing importance of derivatives activities to financial institutions' profits and the complexity of these activities justify frequent comprehensive reviews. Further, for large banks, examiners can review the management assessments of internal controls that are required by the Federal Deposit Insurance Corporation Improvement Act of 1991 to determine what additional work should be conducted regarding derivatives risk management systems during regulatory examinations.

COMPETITIVE IMPACTS

In our report we stated that U.S. derivatives regulation must be coordinated and harmonized with the actions of foreign regulators because regulation that participants view as too severe could cause firms to move their derivatives activities outside the United States.

ISDA Position

ISDA says that our report does not contain an analysis of the competitive impact of our recommendations. It states that these recommendations would generally have a negative impact on the international competitive position of U.S. firms without generating sufficient benefits.

GAO Response

We do not believe our recommendations will seriously affect the cost of doing business or the competitiveness of U.S. derivatives dealers. First, our recommendations for improved regulatory safeguards apply only to major U.S. OTC derivatives dealers--currently only about 15 firms. Our recommendation for regulatory capital requirements for all major U.S. OTC dealers would ensure that such standards would continue to be applied in the future. It would also ensure that such requirements are consistent across industries and provide regulators with an early warning signal if a firm's capital begins to decline. Second, our recommendations generally address elements of risk management that the major dealers should already have in place, and would require independent verification of the existence of proper systems of internal controls over derivatives activities. Third, except in the United States, all major derivatives dealers in the seven countries we reviewed are regulated. Fourth, we recognize that U.S. dealers are competing in a global market, and we have called for U.S. regulators to harmonize regulatory changes with foreign regulators to minimize any competitive inequalities and to ensure consistent approaches to derivative risks. In addition, as ISDA indicates, counterparties expect the firms they conduct derivatives transactions with to be well managed and financially sound, and any U.S. regulatory actions taken with these goals in mind should increase the attractiveness of U.S. firms as counterparties.

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1000
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066.

United States
General Accounting Office
Washington, D.C. 20548-0001

Bulk Mail
Postage & Fees Paid
GAO
Permit No. G100