



**REMARKS OF  
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U.S. SECURITIES AND EXCHANGE COMMISSION**

**OTC DERIVATIVES:  
TAKING RISK MANAGEMENT TO NEW HEIGHTS**

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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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Andy Warhol was right: everyone gets their 15 minutes of fame. At least they do, if they know what Mr. Warhol knew: that the secret to attracting attention is to be a little outrageous.

That is exactly what regulators have been doing for the last year or so on the subject of OTC derivatives. Some of the most savvy politicians and public policy makers have realized that the quickest way to focus attention on a problem is to raise the level of the rhetoric. If nothing else, the alarmist tone of some of the earlier warnings about risks in this market has gotten the attention of financial intermediaries and customers. The result has been that it has focused them on the risks they are assuming.

It also set off a round of studies by regulators around the world. To date, the Bank for International Settlements and the federal banking agencies in the United States have issued reports. As I'm sure my co-panelist, JoAnne Madero, will discuss, the CFTC is currently studying the market. The General Accounting Office, which is the research and auditing arm of the U.S. Congress, is expected to release a study as early as this summer.

Even S&P recently announced that it was going review the derivatives market to make sure that market participants were correctly interpreting its credit ratings on these instruments. S&P is apparently concerned that end users might misinterpret its ratings to mean that these instruments are not volatile.

And last, but not least, the SEC is taking a close look at the market. We're taking a two-pronged approach: first, we're trying to get a grasp on the extent of the credit risk U.S. dealers are assuming so that we can adapt our capital rules to reflect that risk. Second, we're actively engaged in attempting to quantify the systemic risk that this market presents.

The reason for the seeming urgency on the part of regulators is that the growth of this market has been explosive. According to one estimate, by 1991, the number of OTC derivatives contracts exceeded the open interest on futures exchanges around the world.<sup>1</sup> The International Swap Dealers Association estimates that the market is probably around \$4 trillion, as measured in terms of notional amount of outstanding contracts. That figure is supported by a recent report by the U.S. banking agencies, which concluded that the market has increased over 790% from year-end 1986. Based on some preliminary numbers the SEC has recently collected, however, it seems possible that even those numbers may understate the size of the market.

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<sup>1</sup> Peter Lee, American Exchanges Plan to Fight Back, Euromoney, January, 1993, at 46.

I fully expect this growth rate to continue. OTC derivatives have fundamentally altered corporate finance and asset management all over the world.

Financial intermediaries are attracted to the market because of the very attractive profit margins on these transactions. In fact, this business is so lucrative, that financial intermediaries' matched books may, in some cases, exceed firm capital 100-fold.<sup>2</sup>

Customers are attracted to OTC derivatives because of the very appealing hedges that can be created. These products allow investors to disaggregate risk, and bear those risks they can manage and transfer those they are unwilling to bear. More and more multinational corporations find that they can't do business without the protection derivatives offer from interest rate, raw material and currency fluctuations. Derivatives essentially allow them to hedge their ancillary risks and thus focus more of their attention on their primary business.

In addition, a financial intermediary can create a derivative to match any risk-return profile an investment manager may want. The most sophisticated of these instruments involve exposure to several different markets simultaneously. Derivatives allow investors to keep their portfolios in safe Treasury securities while gaining exposure to almost any market, equity or debt.

Investors can instantly convert cash positions into equity positions or shift exposures among markets. Investors find, for example, that they can easily shift exposure to the French market for exposure to the German market.

In fact, it's much cheaper to invest in a DAX swap than to invest in German equities directly. In part, that's because of disincentives in Germany's tax code that penalize foreign investors. But it's also because swaps can potentially provide investors better returns. They lack the frictions that normally accompany entry into international markets; frictions such as management expenses, transaction costs, withholding taxes, and custody costs.

The important thing to remember about these products is that although they may reduce an investor's portfolio risk, they don't make risk disappear. OTC derivatives simply allow investors to shift those risks that they are not willing to bear to someone who is.

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<sup>2</sup> David Carey, Hedge Hogs, FW, March 16, 1993, at 50.

Think of it in terms of insurance, which, after all, is one of the primary functions derivatives serve. I spent a little over a year on the board of directors of the Overseas Private Investment Corporation ("OPIC")<sup>3</sup>, which insures investments in developing countries. Foreign investors in developing countries assume the risk of political upheavals and nationalization, among other things. Such risks substantially reduce the appeal of such investment and many investors are not comfortable assuming this risk. So investors pay OPIC to assume the political risk, such as currency non-conversion, and the investor accepts the risk that he will not recover his premium by making a claim.

There's been no net reduction in risk, but both are presumably happier with their risk profiles. The investor can focus on what he does best: take advantage of business opportunities, and the insurer, what he does best: handle risk.

OTC derivatives better allocate risk, but is it possible that they introduce new risks to the equation? In some respects, yes.

From the perspective of a securities regulator, the biggest concern that I have with these products is the credit risk they present to firms. OTC derivatives are effected outside the traditional clearance and settlement process and thus don't benefit from the clearinghouse guarantee that exchange-traded products enjoy. Instead, participants must assume the risk that their counterparties won't meet their payment obligations at some point down the road. The long-term nature of these contracts only means that counterparties assume this risk for even longer periods of time. It follows that firms receive high premiums up front. In exchange, they accept substantial risk for a long period. In a sense, they are trading tomorrow for today. All that has implications for capital levels.

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<sup>3</sup> OPIC is a self-sustaining U.S. government agency that provides project financing, investment insurance, and a variety of investor services in 140 developing economies throughout the world. OPIC implements its financial programs through direct loan, loan guaranty, and equity techniques that provide medium to long-term funding and permanent capital to overseas ventures, by U.S. businesses.

The OTC derivatives market represents the first time that U.S. broker-dealers have been in the long-term lending business. And the SEC's current capital rules treat these exposures harshly. Right now, the SEC's rules require broker-dealers to take a 100% capital charge for unsecured receivables that arise from OTC derivatives or any other lending activity. That's because the fundamental principle that underlies the capital rule is that broker-dealers must maintain adequate liquid capital to assure that they can meet their financial obligations to their customers and creditors if they are forced to liquidate.

Of course, OTC derivatives' greatest attribute is that they are customized, based on the end-user's needs. Thus, there is usually no liquid market for these products.

Nevertheless, a 100% charge is a prohibitive penalty to pay for the assumption of credit risk. And the predictable effect has been that some of these transactions have shifted off-shore or to affiliates. Recently, broker-dealers have begun setting up unregulated affiliates, referred to as derivative product companies or DPCs, whose sole business is the trading and positioning of OTC derivatives. Not only do these affiliates sidestep the capital issue, they can offer the added advantage of a AAA credit rating to potential customers.

This spring the SEC will take a look at this issue. In fact, just before I left for this speaking engagement, I saw a draft of a concept release the SEC's Division of Market Regulation is preparing that will request comment from the industry on possible approaches to net capital treatment for these transactions. In particular, we will ask commenters to focus on the credit risk issues. We're aiming to issue the release soon.

I am hopeful that we can change the capital rules to remove the disincentive that currently exists to effecting these transactions through broker-dealers. To do that, we will have to amend our capital rule to provide a more practical approach to credit risk; at least a more practical approach to the credit risk presented by OTC derivatives. At the same time, we can't forget the main purpose of the capital rule, which is to assure that broker-dealers will have adequate capital to meet customer obligations in the event of firm failures.

Meeting these two objectives will require some delicate balancing. But if we do our job right, we will develop a rule that achieves our objective of assuring stability without unduly inhibiting the market. Financial intermediaries should be encouraged to innovate, but they must be willing to accept the notion that innovation has to be supported by adequate capital.

The second risk that causes regulators concern is systemic risk. A significant part of the activity in this market is conducted in entities who aren't required to report these transactions. In addition, current accounting rules don't require that total exposures be included on firm balance sheets. The net result is that both counterparties and the market as a whole are in the dark as to the true size of the market. Perhaps more importantly, we don't know exactly how concentrated the risks in this market are.

As a securities market regulator that concerns me, OTC derivatives are making historical divisions among financial institutions and borders between countries increasingly obsolete: Capital and risk flow freely across both. More than anything else has in years, the OTC derivatives market has increased the probability that a meltdown in one financial sector will spread to others.

The SEC took the first step last summer to address this issue by adopting our risk assessment program. The program will allow the Commission to get a better picture of the scope and nature of the broker-dealer affiliates' exposures. This should provide us with very important information on what kind of impact these positions could potentially have on the equity markets in a future market crisis.

Although I've focused on credit and systemic risk 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. CEOs 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 the creators of the products. They may be exactly the ones to turn to for innovative, new products. They're probably not the ones to turn to for protection from the risks of the new products. Simply taking on face value that everything is under control can be dangerous.

CEOs and boards of directors need to assure themselves that the firm's risk control systems are keeping up with the new types of risks their firms are assuming. The audit committee of the Board should play a visible role in this process.

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. After the scare on Black Monday in 1987, firms have recognized how foolhardy ignoring risk management is, and they have since built risk management systems that are unrivalled.

Nevertheless, traders will be traders. And whenever there is a human element involved, reliance on systems alone is misguided. For those of you who are skeptical, let me tell you a little story that I think illustrates the point.

A few weeks ago the U.S. financial press carried a little noticed story about how a Nigerian national, living in the United States, passed himself off as a trader for First African Trust Corp. by copying the financials of Security Pacific. According to the report, he was allegedly able to continue the scheme for some time, causing several government securities dealers significant losses.

So much for systems and controls. Stories like that remind me that there is no substitute for active and careful monitoring by CEOs and boards of directors of the risk control systems, as well as the methods used to minimize counterparty credit risk.

CEOs and boards of directors should assure themselves that firm risk control systems are keeping up with the new types of risks they are creating and assuming. After all, even Fischer Black, who developed the Black-Scholes options pricing model along 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."<sup>4</sup>

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<sup>4</sup> Robert Lenzner and William Heuslein, The Age of Digital Capitalism, Forbes, March 29, 1993, at 72.

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.

One out of five corporate investment portfolios and one in three pension fund portfolios contain OTC derivatives, and for investors like these, there are many issues to consider, in addition to credit risk. For example, I often wonder how many of us retained the lessons we learned about liquidity risk on Black Monday.

Liquidity risk is a particular issue for investment companies. Money market funds, for example, are limited in the types of securities they can hold, including illiquid securities such as unrated derivative securities. Our federal securities laws specify how funds value their portfolio holdings, including illiquid securities. If a fund were to fail to comply with the valuation requirements, it would end up pricing its shares improperly, and it would be in violation of the law.

Recently, the SEC considered just such a case. The Commission instituted an administrative proceeding against USAA Investment Management Company, as well as the investment adviser and portfolio manager of a tax-free money market fund. Our action was based on the fund's purchase of over \$175 million of unrated securities, which included a fair amount of OTC derivatives. These securities failed to meet the quality standards for investments in money market funds, which caused the pricing violations.

The message for U.S. fund managers is that they must be diligent in making sure funds only purchase eligible securities. In particular, they must carefully review proposed purchases of unrated securities to be sure that they present minimal credit risks and are of comparable quality to the rated securities that the fund may purchase.

Directors of money market funds also should be on notice that the Commission will closely examine the manner in which they perform their duties under the pricing provisions. Fund directors must adopt and periodically review procedures and guidelines to ensure compliance with these requirements. They must also exercise vigilant oversight to assure that the guidelines and procedures are being followed. Although the SEC did not sue the directors in the USAA proceeding, the Commission will not hesitate to bring actions against directors of money market funds who fail to fulfill their duties and cause violations of the federal securities laws.

Although the case was decided under U.S. laws, the general principles are universal. Global money market funds found out the hard way last fall about the downsides of OTC derivatives. Boards of directors have to be alert for such risks, because they are the crucial line of defense with respect to shareholder interests. In the final analysis, they are responsible for assuring that a fund's investments are suitable, given the nature of the fund's investment objectives and the investors' expectations.

### Conclusion

In case anyone has decided that this market is too complex or simply too risky, let me leave you with this warning: It's possible that in the future you could be found to be irresponsible -- or worse, legally liable -- for not taking advantage of the benefits the derivative markets do provide. Not too long ago, an Indiana state court found that a grain cooperative'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.

It's too soon to know what kind of precedent this case will set. But, we've been forewarned. Soon -- like it or not -- we may find that participation in this market is not optional. Now is the time to understand the products, their benefits, and risks. Only then can CEOs and boards of directors make intelligent choices about how best to take advantage of these products and avoid their pitfalls.

Thank you.