'Derivatives[1]—where next for supervisors?'

Mr Brian Quinn, an Executive Director at the Bank of England, spoke to the G30 seminar on derivative financial instruments in September. In his speech he discussed the recommendations and implications for supervisors of the Bank of England study on derivatives which was published in April, and the more recent G30 Report.

Introduction

One thing which I think we need not fear is that derivatives as a subject will suffer from benign neglect. The markets, the media, the industry and the regulators have all had their say in recent months, and the volume of paper generated on the subject, like derivatives themselves, has to be subject to a substantial discount to the nominal amount to get to the underlying issues. I do not think this is necessarily a bad thing. First, because the various parties come at the subject from somewhat different angles of attack. Both the G30 Report and the study conducted by the Bank of England and published earlier this year have concentrated on identifying possible problems and looking for remedies primarily at the level of the individual firm. The work done by the BIS—notably the Promisel Report—and by the Federal Reserve have looked more closely at implications for the financial system.

Second if, like me, you believe that the truly dangerous phenomena are those that sneak up on you without either the analysis or the data required to detect them being available, then there is some comfort to be drawn from the attention that derivatives have received. There seems to be a good prospect that we will have the subject surrounded before it can do too much damage. I hope you will not think that I am making this into an infallible rule of the supervisor; there are always exceptions. Nor does it mean that there is not work still to be done on derivatives. It is part of the work of this seminar to get clear in our minds what that might be.

G30 Report—areas of agreement

The Bank of England study on derivatives appeared in April this year, some three months before the publication of the G30 Report. It is therefore useful to look for a moment at the two together since, as I have indicated above, they both approach the subject from the viewpoint of the individual firm: the G30 Report from the viewpoint of the practitioner, and the Bank of England study from the viewpoint of the supervisor of banks.

The first and most striking thing is the broad measure of agreement between the two reports on some of the principal findings. The G30 Report and the Bank of England study find that there are no fundamentally new or different risks in derivative products; instead, they find that familiar kinds of risks are presented and combined in novel ways. Both reports identify the main areas of risk—counterparty risk, valuation methods, etc—and attach broadly the same order of priority to them. The complexities are recognised, but are not thought to represent an insuperable problem. The G30 Report also makes explicit what is implicit but nevertheless clear in the Bank of England study, namely that the primary responsibility for understanding and managing these products lies with the management of the individual firm.

I make this rather obvious point because it was by no means quite so obvious when the first Basle Capital Accord appeared in 1988. The first reaction of many institutions to that exercise was to incorporate the capital weights unquestioningly into their own management decisions, whereas a large part of the intention was to prompt management to think about the relationship between risk and capital in a more consistent and systematic way. It seems to me that the G30 Report has started from the correct premise in that it proposes that management should itself be thinking through the risk characteristics of derivatives and not awaiting the supervisory response. I think this is a healthy approach. It may lead to disagreement between the parties for a period, but there is much common ground between the supervisors and the practitioners and I do not therefore believe we face negotiations of Balkan dimensions.

G30 Report—recommendations

It might be useful if I comment on each of the four recommendations to legislators, regulators and supervisors in the G30 Report offering, where possible, some indication of the outlook. On the question of capital adequacy, regulators and supervisors have, as you will know, published a Consultative Paper which expands the scope of the original Basle Capital Accord to encompass all off-balance-sheet transactions, including derivatives. These proposals, on which comment is invited by end-December, are very similar to those in the Capital Adequacy Directive recently approved in Brussels and coming into effect from January 1996. It is a matter of regret that the securities

(1) 'Derivatives: Report of an internal working group'—April 1993.

supervisors represented in IOSCO were not able to reach agreement among themselves on the subject. But I certainly have not abandoned hope that they will do so, sooner rather than later. The Basle Committee is also fully seized of the importance of recognising the effectiveness of netting agreements.

Perhaps the most important thing to say here is that the supervisors are not dragging their feet and start with a good prior understanding of the issues. The proposals on capital adequacy came only after very detailed discussions with the industry. This should simplify and speed up the dialogue. The report on netting by the Lamfalussy Committee published in 1990 carried out a very thorough analysis of the subject and recognised the contribution that it could make both to the efficiency of the financial sector and to the reduction of systemic risk. It also highlighted the dangers of resting supervisory treatment on insecure assumptions about the robustness of netting agreements and, in particular, about their vulnerability to legal challenge.

This takes us quite naturally to Recommendation 22 of the G30 Report relating to the resolution of various legal and regulatory uncertainties. Here again I can say that the supervisors, both nationally and internationally, are working hard to address the uncertainties identified in that recommendation.

One difficulty here is that, for the most part, the response has to be country by country; and the system of law, and the procedures for changing laws, may vary quite considerably. The G30 Report notes that England has a well-developed system of commercial law; that English law is used very widely by derivatives dealers; and that our jurisdiction gives rise to very little concern in the market. Nevertheless, the UK system is not free from legal risk. We have decided, therefore, to determine whether greater certainty can be achieved for our legal and regulatory arrangements without going through the time-consuming and sometimes inflexible route of legislation. The establishment of the Financial Law Panel (FLP), chaired by Lord Donaldson, former Master of the Rolls, aims to provide an authoritative opinion, drawing on the expertise of distinguished legal and market practitioners where doubt may exist about the state of the law on particular commercial classes of transactions. Two of its early subjects are vires, and the enforceability of bilateral close-out netting in the United Kingdom, two of the issues identified in Recommendation 22. Netting is taking highest priority and we hope that the FLP will be able to make a statement on this subject before too long. Such a statement will not have the force of law but, given the process of consultation that is involved and the very high reputation and standing of its members, there is every reason to think that the Courts would weigh very heavily the views of the Panel in any case coming before them. Indeed, it might be argued that statements from such a body might, in the case of certain subjects, be preferable to legislation—the wording of which may defeat or delay the parliamentary draftsman.

I do not have a great deal to say on Recommendation 23 which deals with the tax treatment of derivatives. I do not suppose I would be believed if I used the word 'sympathetic' in describing the attitude of the tax authorities anywhere to requests for accommodation on such things, but I do not believe that they are mindless of the risk that derivative products are highly mobile and potentially migratory and that the existing fiscal yield could actually be reduced if the climate were to become relatively unhelpful.

So far as the United Kingdom is concerned, I can report that there is a regular and constructive dialogue between the regulators, supervisors and those responsible for setting accounting techniques and standards. The Accounting Standards Board is already working hard to bring greater consistency to the treatment of all financial instruments and activities. The institutional arrangements for improving accounting practices and accounting standards in the United Kingdom have undergone considerable change recently and it is evident that, among the issues occupying the attention of the Board, the evaluation of financial transactions figures high on their agenda. Getting cohesion internationally is a more difficult problem. Nevertheless, as the Report notes, the IASC is already well advanced in finalising accounting standards on financial instruments. But the accounting bodies have a great deal on their plate and it would be unrealistic to look for definitive results too soon on the treatment of derivative products.

Derivatives and system risk

The G30 Report suggests that because derivatives do not introduce risks of a fundamentally different kind and greater scale than those already present, systemic risks are therefore not appreciably aggravated, and that supervisory concerns can be addressed within the present supervisory framework. I have to say that this strikes me as somewhat complacent. On a general point, there seems to me to be a sense in Part V of the Overview that experience so far, and the related research, do not appear to throw up any serious problems. I would myself lay heavy emphasis on the words 'so far'. These are early days for derivatives and it is not yet clear whether they will follow what I will call the LDC debt path or the leveraged buyout (LBO) path. In the former case, the favourable risk/reward ratio in the early phase attracted many new entrants, on both the borrowing and lending sides, in a great rush. That rapid expansion did two things. First, it moved both the numerator and the denominator in the ratio sharply against the banks. Second, it took place over a period when the availability of data to track this development and its means of transmission were not available. In particular, data on the role of the interbank market in the expansion of LDC lending ran well behind the expansion on the ground.

By the time the full dimensions of the problem became apparent it was almost too late. It was a close-run thing and only the efforts of your Chairman today, together with a few of his closest associates, avoided a real catastrophe. In the case of LBOs, by contrast, the rapid growth in the use of the instruments was matched by an early awareness of their risks, by accurate and timely reporting of the exposures and by clear regulatory guidelines for the main participants. Perhaps most important, the risks were diffused and the involvement of individual institutions did not outrun the supply of skills required to conduct the business with prudence. This latter point is, I think, important. Expertise in derivatives trading is limited. If the demand for this new source of profit should expand more quickly than the supply of people capable of doing the business, there can only be trouble ahead. Derivatives trading is for grown-ups.

Let me now turn to some of the particular potential causes of systemic risk taken up in the G30 Report about which I would like to make some observations.

Concentration, illiquidity and regulated entities

In support of the argument that concentration is not a problem, the Report quotes a survey indicating that the top eight dealers accounted for only 58% of the interest rate and currency swap markets at the end of 1991; and that no firm had over a 10% share of the market. It goes on to state that there are three times as many ISDA dealers as there are primary dealers in US government bonds. I am not altogether sure how much comfort these statements give. First, I have some questions about the scope of the survey. Second, the market in government bonds is, of course, carefully regulated by the Federal Reserve and is a centralised market. A better comparison might have been between the markets in derivatives and those in foreign exchange which are both over-the-counter (OTC). The 1992 London Forex market survey concluded that the ten most active principals have a combined overall share of 43%, while the top 20 account for 63%. These figures suggest a materially higher level of concentration in the derivatives markets, which are much newer. In the Bank of England study we found a diversity of opinion over whether counterparty concentration was a concern. We were also told that the limited number of counterparties was bringing firms fairly quickly against their individual credit limits, suggesting that an expansion in the number of market participants would be both welcome and healthy. But of course I recognise a tension here with my earlier remark about the necessary skill base.

I also find myself unpersuaded by the statement in the Report that the liquidity of derivatives transactions has been successfully tested by several situations of failure by large participants. I believe that this statement rests on a piece of research which looked at the cases of DFC New Zealand, Bank of New England, British and Commonwealth Bank and Drexel Burnham Lambert. I hope I will not offend anyone by suggesting that the derivatives portfolios of DFC and BCMB fall some way short of what I would expect of a large participant. The portfolios of swaps and similar transactions at each of the other two institutions amounted to around $30 billion notional principal. I accept that this would qualify them as largeish, but would also point out that the regulators were heavily involved either as managers or facilitators in ensuring that the demise of both institutions caused as little disruption as possible to the market. In a word, I am not at all sure the market has been faced with a surprise in the form of an unexpected failure of a large participant in derivatives trading.

It would be nice to think that that test may never arise; and it is reasonable to ask whether the system should be designed, and regulations framed, to cope with events which occur once every couple of decades. I would contend that it would be reasonable to answer 'yes'.

I suppose the sentence which struck me most forcibly in this section of the Report was the one which states that participants can evaluate for themselves the risks and benefits of trading with unregulated entities. As a robust statement of the efficient markets hypothesis this is unobjectionable; but to those charged with the responsibility of ensuring the safety of the system and providing some protection to investors and depositors, it certainly makes one stop and blink. A good deal of the work of the banking and securities regulators in the last decade has been devoted to what we have called mapping exercises: identifying institutions which carry or communicate such risks, and trying to ensure that they are subject either to adequate supervision on a consolidated basis or, at least, to close surveillance. The damage limitation which marked the Drexel affair was, as I have already indicated, partly explicable by the fact that the market itself could see what was coming, but also because of the vital efforts of the Federal Reserve to ensure that the fall-out was contained. I myself can see no justification for the failure to include in consolidated supervision the activities of wholly-owned unregulated subsidiaries of banks, securities or other financial companies conducting derivatives trading.

There is, then, the question of market linkages. It is not difficult, given the characteristics of derivatives, to see that failures and shocks could in principle be transmitted faster and further than hitherto. The Report draws comfort from academic research indicating that derivatives trading does not increase volatility in underlying markets. I do not disagree with this statement as it stands, but I would be more comfortable if the evidence on which it was based was more widely drawn.

Let me therefore repeat two of the recommendations from the Bank of England study:

(a) that research into the relative price volatility and liquidity of cash and derivatives markets should be conducted with a view to improving our understanding of the increasing links between financial markets, and their potential systemic implications;

(b) that the Bank, in consultation with the BIS and the market participants, considers which data on exchange-traded and OTC derivative markets it is desirable to collect for the purposes of examining market size and the degree of concentration, and subsequently considers establishing a survey of the derivative markets comparable to that already conducted for forex activity.

Finally, if one were to put these three or four observations together a rather frightening picture could emerge: the unexpected failure of a large, unregulated derivatives specialist operating on a significant scale in a number of markets. But to do this would be to exaggerate my concerns. This is partly because problems seldom come at you in the way in which you expect, and partly because of my earlier observation that both participants and regulators are fully awake to the possible sources of disturbance. So I do not offer this vision either as forecast or as an attempt to foreshadow a heavy-handed treatment of derivatives activities by the regulators. I say only that there is further work to be done on several aspects of the new section of the G30 Report, and I am quite sure that Sir Dennis Weatherstone and his colleagues would find themselves in agreement with that.