



Testimony
of
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concerning

Derivative Securities Activities

before the

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INTRODUCTION

Good morning, Mr. Chairman, members of the Committee. Thank you for inviting me to testify on behalf of the Office of Thrift Supervision (OTS) on the safety and soundness issues associated with the use of derivative instruments. My testimony today primarily deals with nonmortgage-related derivatives since that has been the focus of the most recent discussions and studies.

The explosive growth of financial derivatives markets has drawn attention to the implications of derivatives for the banking system and financial markets. The focus on these markets by public officials, private market participants, and the press has been intensive and very healthy. It should help to "demystify" the world of derivatives, and bring to the forefront the benefits as well as the potential risks of these markets.

Mr. Chairman, as you know, the topic of derivatives has generated much discussion of systemic risk -- the risk that a mishap in the derivatives market could precipitate a major disruption or collapse of the financial system. A frequently mentioned worst-case scenario is that the default of a major derivatives dealer or counterparty could cause other dealers and counterparties to fail, which in turn could set off a chain reaction of failures throughout the global financial community. As you know, central bankers, other regulators, and market participants are continuing their efforts to ensure that such scenarios remain financial fiction.

Since much of the concern about systemic risk seems to focus on the activities of institutions that act as dealers in the derivatives markets, I should point out that none of the savings associations supervised by OTS are derivatives dealers. However, savings associations are end-users of derivatives. Consequently, I will direct my remarks to the use of derivatives by thrift institutions and to OTS' supervision of their derivative activities.

WHAT EXACTLY ARE DERIVATIVES?

A derivative is a financial instrument whose value is based on the value of an underlying asset, an index, or a reference rate. The most common derivatives include futures, options, swaps, and forwards. These instruments can be tied to interest rates, equities, commodities, and foreign currencies.

BENEFITS OF DERIVATIVES

Derivative financial products are used primarily to manage risk. The demand for these products has grown exponentially over the last two decades in response to the increased volatility of financial markets. In particular, the volatility in foreign exchange, commodities, equities, and money markets has created a strong demand for financial products that can be used to control risks in those markets.

The growth of derivative products that are used to manage interest rate risk is a good example of how innovation is driven by the needs of the marketplace. In the late 1970s and early 1980s, interest rates rose dramatically, and the volatility of interest rates also increased. The need for better and more varied tools for managing interest rate risk became apparent. The markets responded to that need with a host of new derivative instruments, including new financial futures contracts, options on futures, forward rate agreements, interest rate swaps, interest rate caps, floors, and collars.

Before derivatives, financial institutions managed their exposure to interest rate risk by altering the composition of their assets and liabilities. For example, an institution that wanted to reduce its exposure to rising interest rates might have adjusted the liability side of its balance sheet by replacing short-term borrowings with long-term borrowings. Or, it might have adjusted the asset side of its balance sheet by replacing long-term fixed rate assets with shorter-term or variable rate assets. Changing the mix of assets and liabilities can be a time-consuming, expensive, and cumbersome way to manage interest rate risk exposures. Today, an institution can adjust its risk exposure -- with more precision, greater efficiency, and often at a lower cost -- by entering into off-balance-sheet transactions with derivatives, such as interest rate swaps, financial futures, or options.

Derivatives also can enhance the ability of financial institutions to serve their customers' needs. For example, derivatives make it easier for lending institutions to offer borrowers the types of loans they want. The 30-year fixed-rate mortgage is a case in point. Many borrowers prefer 30-year fixed-rate mortgages to 15-year or adjustable-rate mortgages. However, the fixed-rate mortgage carries considerably greater interest rate risk to lending institutions -- particularly in an environment of increased interest rate volatility. Derivatives can enable lenders to better cope with the risks of holding fixed-rate mortgages by enabling them to transfer some of the risk to others.

The enormous size of the derivatives market reflects the broad range of applications for these products, as well as their acceptance by financial institutions, institutional investors, and corporate treasurers. It is a healthy, vital market -- a global market created and dominated by American financial institutions. And it is a clear example of how the creativity and flexibility of our financial system can create a new industry that is a vibrant part of the nation's economy.

SAFETY AND SOUNDNESS CONCERNS

While financial derivatives can be very useful products for managing and controlling risk, they can -- like any other financial product -- be misused. Our primary concern with derivatives is speculation. Put simply, while derivatives offer new ways to reduce risk, they also offer new ways to speculate.

"Speculation" is an emotionally charged word that means different things to different people. Here, I am using the term to refer to the practice of taking on additional risk. There is the danger that insured depository institutions, or even unauthorized staff of such institutions, might use derivatives to take speculative positions.

Although speculators play a useful role by bearing risks that others are unwilling to bear, OTS does not believe savings institutions should be engaged in speculative activities, whether with derivatives or any other financial instrument.

Another concern often raised about derivatives is that they are complex instruments. Some derivatives are structurally complex instruments, but many of the most widely-used instruments are actually quite simple.

Indeed, a case can be made that "plain vanilla" futures contracts, interest rate swaps, and interest rate options are less complex than many of the more familiar financial instruments such as loans, deposits, and equity securities. They are certainly far less complex than a 30-year fixed-rate mortgage which contains an option that permits the homeowner to prepay the loan at any time.

Nevertheless, the world of derivatives is new and unfamiliar. The language is arcane, the theoretical foundation that underlies financial derivatives is complex, and the techniques that are used to measure and monitor derivative exposures are very sophisticated. "Complex" is probably the right word when we look at the entire range of derivatives and it is that complexity that increases the opportunity for missteps.

CHALLENGE TO REGULATORS

Derivative financial products available for use by depository institutions present difficult challenges to bank and thrift regulators. Four key challenges come to mind:

- o Keeping up with the pace of financial innovations in the derivatives markets;
- o Risk measurement;
- o Obtaining the information needed to measure properly the risks associated with the use of financial derivatives without imposing an undue burden on the industry; and
- o Ensuring that regulatory policies and practices provide an environment in which qualified depository institutions with the specialized expertise are not discouraged from using these instruments to reduce risk and to lower their cost of carrying out many kinds of financial transactions.

MEETING THE CHALLENGES

With regard to the first challenge -- that of keeping pace with financial innovation in the derivatives markets -- we have made a special effort to maintain a group of capital markets and interest rate risk specialists in our Washington D.C. headquarters and in each of our regional offices. These specialists are available to assist examiners and other supervisory staff that have questions on derivatives or need assistance in evaluating the positions of individual savings associations. In addition, OTS offers its staff a number of training courses that cover derivatives and their use by savings associations.

The second challenge posed by derivatives -- that of risk measurement -- has been a major priority of OTS. We have developed and implemented a sophisticated, state-of-the-art interest rate risk model that is capable of measuring the effect of derivatives on an institution's overall interest rate risk exposure.

The OTS model measures risk on a "total portfolio basis." This approach recognizes that risk is properly viewed in the context of an institution's entire portfolio of assets, liabilities, and off-balance-sheet contracts. The effect of a derivative on the overall risk of the institution, not the derivative's "stand-alone" risk, is the proper focus for an institution's management.

For example, the addition of a particular derivative to the portfolio of Thrift A might further increase its overall

risk, while the addition of the same derivative to Thrift B's portfolio could decrease its risk. It is the contribution to portfolio risk, not the risk of the instruments on a stand alone basis, that counts. The failure to evaluate the effect of derivatives on an institution's total portfolio can lead to inappropriate risk assessments.

Each quarter we use our model to generate interest rate risk exposure reports for individual savings associations. The exposure reports include OTS' estimates of the economic value of the institution assets, liabilities, and off-balance sheet contracts, including derivatives, under nine different interest rate scenarios. These reports are sent to the savings associations and to OTS supervisory and examination personnel for their use.

To address the third challenge -- that of collecting sufficient information to supervise the derivatives activities of savings associations -- OTS staff has worked closely with industry experts to re-design the reporting form that we use to collect the necessary data. As a result, we introduced a new reporting form in March of this year that provides extensive information on derivatives.

The new reporting form uses a unique four-digit coding system that allows us to distinguish among nearly 300 different types of off-balance-sheet derivatives. Using these data, OTS estimates the value of each reported derivative position in conjunction with the rest of the institution's assets and liabilities under the current interest rate environment and under eight alternate interest rate scenarios. These estimates are used to determine whether institutions are using these products to reduce or increase their overall interest rate risk.

This information must be reported by all savings associations except those with assets of less than \$300 million that have risk-based capital ratios in excess of 12 percent. Although such small, highly-capitalized institutions are exempt from filing this report, over 70 percent of them submit the schedule voluntarily.

Finally, with respect to the challenge of providing a regulatory environment that does not discourage qualified institutions from using derivatives instruments to reduce risk, we have made progress. But further progress is needed because, simply put, in a business that is exposed to considerable interest rate risk, savings institutions may be hurting themselves by avoiding legitimate risk reduction tools for fear that their use will invite undue regulatory scrutiny.

Today relatively few institutions use derivatives. Only 117 of the 1,822 SAIF-insured savings associations reported positions in derivatives, as of September 30, 1993. Of these, 82 had positions in interest rate swaps, 20 had futures contracts, and 43 had options positions.

These institutions appear to be using the derivatives to reduce their risk exposure. The Risk Management Division of OTS conducted a sensitivity analysis of these institutions to assess the hedge value of their derivatives positions, or more specifically, to determine the protection they would provide against rising interest rates. The analysis suggests that if interest rates were to rise by 200 basis points, the economic value of the derivatives reported by these institutions would increase from their economic value as of September 30, from \$547 million to \$911 million -- providing hedge protection amounting to \$364 million.

There is no question that regulators need to be able to distinguish proper use of derivatives from improper use. We believe that the OTS interest rate risk model has gone a long way toward addressing this concern.

Under the new framework, an institution's capital requirement is directly related to its overall interest rate risk exposure. Thus, the effect of derivatives on an institution's interest rate risk exposure is taken into account in determining its capital requirement.

On this particular challenge of providing a safe harbor for derivatives usage, I have been asked the question: "Is the risk of using derivatives less than the risk of not using them?" Surprisingly, I learned that even the courts have been asked to address this question. Last year, an Indiana court ruled in Brane vs. Roth that a grain elevator operator that did not hedge could be held liable for losses it sustained. Clearly, we have to be prepared for change.

CONCLUSION

The financial engineering that is taking place at our nation's leading financial institutions is evolving. Futures, options, swaps, and other derivatives have been proven to be efficient and effective risk management tools. The growth of the derivatives markets underscores their usefulness. Many depository institutions have used them to reduce risk. In so doing, risk to the Federal deposit insurance funds has also been reduced.

At OTS, we have devoted considerable effort to develop and implement a supervisory approach that allows qualified institutions to use derivatives to reduce risk exposure.

We are particularly mindful that an overly cautious supervisory approach could have the unintended effect of discouraging the use of these products to reduce risk.

Mr. Chairman, that concludes my testimony. I would be pleased to address any questions you may have.