Regulation of Over-the-Counter Financial Derivatives

by Jeremy D. Weinstein

The multi-trillion dollar over-the-counter financial derivatives market will present the most important regulatory issue of the 1990s. Financial derivatives can dramatically reallocate interest rate and currency exchange rate business risks, but misallocation by federally-insured depository institutions could ultimately be at the taxpayer's expense. The issue will take center stage as the House Committee on Banking conducts hearings on proposed legislation, and as various federal agencies issue reports and regulations on derivatives, especially on their use by banks, thrifts, S&L's and insurance companies.

BACKGROUND

Financial assets can be used for capital formation, such as stocks and bonds, or to transfer risk, such as futures, options and over-the-counter financial derivatives. The latter designates the winner and loser upon the occurrence of an unknown. Many financial assets are issued and secondarily traded on regulated markets; stock and bond exchanges are regulated by the Securities and Exchange Commission (SEC) and future and option exchanges are regulated by the Commodity Futures Trading Commission (CFTC).

Futures have been used for over a century in agricultural markets to allow businesses to "hedge," or transfer their price fluctuation risks to speculators. Starting in the 1970s, futures exchanges introduced futures on domestic and foreign currencies, national debt, interest rates and market indices, such as the yen, pound and mark, American, Japanese, British and German government bills, bonds and notes, eurodollars, euroyen and euromarks, and the S&P 500, Nikkei, FTSE and CAC indices. These have become enormously popular risk-transfer and speculative vehicles.

The hedger can rarely match futures to this risk, since standardized futures contracts may be denominated and require delivery differently than the hedger's risk. Certain customized off-exchange risk transfer instruments between commercial parties are specifically exempted from regulation, including over-the-counter financial derivatives such as swaps on interest rates, currencies, and other financial risks of large or international business and banking.

In a simplified example of an interest rate swap, Acme Widget has a $100,000,000 line of credit for capital-intensive widget production on which it pays the floating prime rate of interest, currently 6%, and would like to set its cost of production using a fixed rate of interest. Safeco Radioactive Waste Handling and Storage has regretted issuing $100,000,000 in bonds bearing fixed interest at 6% per annum, because it believes interest rates will decline. Acme and Safeco can by contract "swap" their interest payment obligations: Acme will pay to Safeco the amount by which 6% exceeds prime, while Safeco will pay to Acme the amount by which prime exceeds 6%, on $100,000,000 a year.

Since there is rarely a precise match of risk, end-users Acme and Safeco will typically deal through an intermediary called a "dealer" which will use swaps, hedges, caps, options, futures, and outright positions with Acme, Safeco and others to create or hedge against risks it buys, sells or retains. Dealers can theoretically extract all the various risk elements from any type of financial instrument for precise redistribution and efficient reallocation.

DANGERS

The use of derivatives has expanded exponentially in just a few years. The six biggest players, Chemical Bank, Bankers Trust, Citibank, Morgan Guaranty, Chase Manhattan, and Bank of America, with total assets of $110, $64, $168, $103, $80 and $114 billion respectively, have respective notional exposures of $2.1, $1.8, $1.8, $1.5, $1 and $.9 trillion. However, notional exposure is greater than maximum potential exposure, which is more difficult to quantify. For example, Acme and Safeco each have notional exposures of $100,000,000, but their maximum exposure is the maximum future difference between prime and 6%, which is unknowable.

House banking committee chairman Henry Gonzalez, pointing to defaulted third world, LBO, and real estate loans, wonders whether derivatives may be yet another in a long string of bank missteps that necessitate a taxpayer bailout. Representative Leach has pointed out that the extraordinary profits of some derivatives departments may attract marginal players.

Creating and shopping for products is mathematically very sophisticated; some practitioners are known on Wall Street as "rocket scientists." Their complex models may contain errors or not effectively account for changes and crises. There is a clear potential for an individual bank to misuse derivatives

and weaken itself as well as the infrastructure for derivatives activities. According to the Promisel Report, "at many firms, significant gaps remain between the desired capabilities of risk management systems and the systems actually in operation." Weakness in the derivatives infrastructure could cause systemic weakness. The banking system should be able to withstand heavy shocks, and to the extent a fine spider web of international derivatives positions reduces that ability, the system is at risk.

There are straight credit risks of counterparty default, and foreign or sovereign counterparties add further performance risks. For example, a war could cause a foreign government to require national counterparty default, or a foreign government could instruct its major banks and corporations to take massive short positions on the national currency through intermediaries immediately before a devaluation.

Dealers argue that regulation will simply move the business (and profits) off-shore. The regulated exchanges will seek to move activity into their arena, enhancing their fees, either through deregulation of their products or regulation of competing products.

CFTC REPORT

Congress asked the CFTC to report on whether OTC derivatives required regulation. The CFTC report issued in October concludes that while no fundamental changes in regulatory structure are needed, greater coordination among federal financial regulators would help assure that regulation remains adequate, and so recommends establishing an interagency council to consider common approaches to market information access, market transparency, internal management controls, and development of clearing facilities for OTC derivatives. The CFTC rejects a merger of the primary federal market regulators, the SEC and CFTC, on the grounds that the savings would be modest and competition among regulators is beneficial, but at the same time complains about recent court decisions on transactions in the regulatory vacuum in which the Treasury took a position contrary to that of the CFTC. The report's primary concern is protecting the CFTC's regulatory turf.

OCC GUIDELINES

The Office of the Comptroller of the Currency (OCC) supervises 3700 nationally chartered banks, of which 328 use derivatives. The OCC recently issued guidelines on bank derivative activities requiring senior management and board oversight, written policies and procedures, "appropriate and effective" independent credit, liquidity and market risk management systems, counterparty due diligence, and capital adequacy. This positive initial step does not extend to all federally-insured depository institutions, but will likely provide a meaningful reference point for legislators and regulators.

LEACH PROPOSALS

Representative Leach has made detailed regulatory proposals focussing on capital adequacy and reporting, pursuit of international standards, and an interagency commission to establish uniform rules for dealers and end-users. Leach suggests that dealers and end-users should have to demonstrate sufficient capitalization and technical capabilities, with failure a sanctionable "unsafe and unsound" banking practice. He suggests regulatory exams for dealers and training programs for examiners, reserve requirements, dealer ethical standards, and collateral guidelines for foreign and domestic counterparties, among other things. Leach calls for compensating the legal risk related to foreign counterparties with higher capital requirements, for the Treasury to hedge risks with derivatives, and for regulations to protect against systemic risk. Leach suggests that to the extent this cannot be implemented administratively, framework legislation outlining regulatory responsibilities without delineating specific standards may be necessary.

Although Leach's proposals are thoughtful and apparently desirable, most of the "action" is specifically put to the regulators, rather than to Congress itself. Leach's proposals, like too much of what comes out of Congress, wants to abdicate responsibility, in this case, to the executive. Interestingly, the CFTC (executive) also wants to abdicate responsibility.

DEMOCRAT INITIATIVE

Gonzalez would like to see regulation brought together under one authority, and has held hearings. Gonzalez seems prepared to paint with a much broader brush than is Leach, such as requiring banks to establish adequately capitalized subsidiaries for derivatives trading, regulating foreign bank activities, taxing speculators, and prohibiting bank speculation. Proposed legislation along these lines will attract significant debate. An expected report from the General Accounting Office, a Congressional investigatory arm that probably does not wish once again to be caught asleep at the wheel, is expected to add fuel.

SUGGESTIONS

Real estate lending and the purchase of bonds involve a core bank business-assessment of credit risk. Many banks, thrifts and S&L's could not do that right and, according to Congressman Rostenkowski, the "peace dividend" from the end of the cold war will be used to pay the price of the bailout. Dealing in derivatives is not necessarily a core bank business, is exponentially more difficult, and may involve more risk. Bank derivatives activity should be conducted through an independently capitalized subsidiary with tightly regulated parent credit (and perhaps equity) exposure. Banks should be required to use this subsidiary to lay off those risks best removed for the bank's success, such as the risk of borrowing short to lend long. Just as a farmer uses the hedge of wheat futures to focus on his core business of efficient production, rather than wheat price speculation, a bank should focus on its core business of lending capital at a price higher than that paid and use derivatives accordingly.

The complexity of the products is an argument made by some against

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The specific requirements of both statutes are well beyond the scope of this article.

PENDING CALIFORNIA SUPREME COURT CASES

Hill v. NCAA. On November 1, 1993, the California Supreme Court heard argument concerning the constitutionality of mandatory drug tests for college athletes. The case raises the issue of a constitutional right to privacy with respect to non-governmental entities. This could affect the future legality of employers' efforts to collect data and personal information on employees.

Jennings v. Marralle. On October 28, 1993, the California Supreme Court granted defendant's petition for review of a 4th District Court of Appeal decision that held that the FEHA's public policy against age discrimination can support a *Tameny* tort claim against small employers who are exempt from the Fair Employment and Housing Act's remedies. This case has significant ramifications with respect to potential tort damages for public policy violations against employers who would otherwise not be affected by the FEHA.

Runkle v. Superior Court. This case asks whether the preemption clause of the Fair Employment and Housing Act preempts local laws outlawing other forms of employment discrimination.

Chyten v. Lawrence & Howell Investments. On December 16, 1993, the court granted review in the *Chyten* case, 18 Cal.App.4th 618. The issue is whether an in-house counsel can be discharged "at-will" despite a long-term employment contract. The employer's position is that a client has an absolute right to discharge an attorney. The employee's position is that his contract falls within an employer-employee relationship where contract principles apply. Chyten had a contract of employment for five years. ★

Richard A. Frankel practices business and employment law and is a partner in Frankel & Goldware in Danville.

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regulation. However, without a statute from the legislature, or regulation from the executive, litigation resolution by the judiciary will fill the void. Certainly it is wiser for a deliberative body with the benefit of months of hearings and debate to formulate a rule than it is to take chances with trillions of dollars on three 26 year old appeals court law clerks working for the same branch of government that brought us bussing and 12-year death penalty appeals.

Anything that's too complicated for Congress to regulate is too complicated for Federally insured depository institutions to be using. ★

Jeremy D. Weinstein practices corporate and commercial law at his Walnut Creek firm.

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