

Remarks by
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End-Users of Derivatives Association
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Thank you and good afternoon. I am honored to have been invited to address you at your second annual meeting. At the Office of the Comptroller of the Currency we have been very busy over the last two and a half years addressing capital markets issues generally and derivatives issues in particular. Whether addressing issues on the buy side or the sell side, our primary concern has been the safety and soundness of national banks. However, we are well aware that our guidance and policy in this area have been closely watched and widely followed by other types of financial institutions and by other financial regulators. In fact, as I mentioned recently at the Federal Reserve Bank of Atlanta's annual Financial Markets Conference, there has been surprising convergence among the financial regulators, and especially among the bank regulatory agencies--the Fed, the FDIC, and the OCC-- in their approach to derivatives and the rules, regulations, policies, advisories and guidance that we issue in this area.

Though the derivatives markets certainly went through a rough period for a couple of years, the market has grown up, and both the dealers and the end-users have matured. No reasonable person or institution could claim at this point that they are unaware that some derivatives transactions are unusually complex and that, in large part, depending upon that complexity, the market and liquidity risks of a particular transaction may be difficult to measure, monitor and, consequently, control. In addition, no dealer could reasonably believe at this point that they do not face substantial litigation and reputation risks if they mislead their clients as to the value of a derivative instrument or the risks associated with it. And neither regulators nor legislators necessarily believe anymore that derivatives instruments are financial products from hell, an evil that must be exorcized from the financial system.

Rather we are all aware that the emergence and growth of derivatives instruments is a natural by-product of an increasingly technological society and increasingly global marketplace, where market risks and credit risks are many and varied. We now know, and many of us have known this for some time, that these products can be a useful weapon in any organization's risk management arsenal. We also know that these financial products have allowed our banks to remain competitive and to further diversify their revenue base in the face of increasing competition from investment banks, insurance companies and foreign financial institutions in their core business areas.

Nevertheless, as with other financial products, prudent internal controls are critical to the proper use of derivatives; capital requirements are important to ensure that an institution can withstand product crises; sensible, consistent and easily understandable accounting rules are required to insure that responsible individuals within an institution, and concerned outside parties, can understand the true value (and true risk) of such products; and responsible sales practices are necessary to ensure fair and honest dealings, and the protection of less informed counterparties.

The OCC has taken several steps to address the latter issue -- sales practices -- and, as this is my first time speaking before your group, I thought it would be useful to detail our efforts.

Banking Circular 277 and Qs & As

In October , 1993, we issued Banking Circular 277, "Risk Management of Financial Derivatives." Section C1 of that document provided guidance to banks as to how they should manage the credit risks associated with derivatives transactions. It suggested that responsible bank officers should understand the applicability of financial derivatives to the risks the bank's customer is attempting to manage, and that a dealer bank should make an assessment as to whether a particular derivatives transaction is consistent with its customer's policies and procedures for engaging in derivatives transactions. We came to call this our "appropriateness" standard. And we stated that, if a dealer bank makes a determination that a particular transaction is inappropriate for its customer, it should bring that assessment to the customer's attention. If the customer nonetheless insists on proceeding with the transaction, we suggested that the dealer document its assessment and the information provided to the customer.

The direct intent of Section C1 is to protect the dealer bank against customers that might pose greater credit risk (and, therefore, greater litigation and reputation risks) because those customers desire to engage in inappropriate transactions. However, the indirect benefit of this provision is that dealer bank counterparties are afforded some degree of customer protection through the determination of appropriateness.

The OCC further clarified and detailed BC 277 by issuing a comprehensive set of questions and answers about the circular in May, 1994. In those Qs & As, we stated that our "guidance recognized that buyers of OTC financial derivatives instruments need to possess some degree of sophistication, or have access to such sophistication, in order to understand those transactions. Many end-users of financial derivatives instruments are sufficiently sophisticated to understand the appropriateness of a particular transaction to their risk management purposes. Section C1 provides an added measure of assurance in this regard by recognizing the obligation of bank dealers, who have credit and reputational interest at risk, to assess their clients' sophistication and understanding of the derivatives transaction that they propose to enter into."

Advisory Letter 94-2

The OCC addressed an issue specifically related to banks acting in an end-user capacity with the July, 1994 issuance of Advisory Letter 94-2, "Purchases of Structured Notes." This advisory specifically cautioned banks about the potentially high market and liquidity risks associated with certain of these investment securities. We issued this guidance because we had become aware, through the examination process, that many of our smaller community banks had purchased structured securities without a complete understanding of the sometimes substantial market and liquidity risks. Rather they had focused on the high credit quality of these assets as a result of their issuance by government-sponsored enterprises and other highly-rated institutions.

Advisory Letter 94-2 was the only instance, to date, where the OCC provided guidance with respect to a specific type of derivative product, rather than guidance addressing the types of risk that could arise from any financial product. Derivatives, after all, pose essentially the same risks that are present in an institution's other financial activities. What is unusual is that derivatives may combine those risks in different and perhaps less intuitive ways, and the basic message of BC 277 is that an institution should already have the ability to identify, measure, monitor and control the risks posed by its activities, no matter how they arise.

Sales Practices Review

In order to better understand how banks were complying with Section C1 of BC 277, the OCC conducted a review of sales practices of the largest national bank derivatives dealers. We specifically chose banks for the review that we had already determined were in compliance with Section C1. In June, 1995, we released our report together with a list of best practices. In short, we found that

- national bank derivatives dealers had in many ways gone beyond the requirements of Section C1;
- for the most part, compliance with section C1 could be attributed to the banks' adherence to sound credit principles and the desire to deal in transactions that make sense for their clients;
- banks' desire to deal in such "common sense" transactions comes from their relationship-oriented approach to customers that seeks to generate repeat business;
- the vast majority of the derivative transactions engaged in with end-users are "plain vanilla" deals linked to the financial hedging need of the customers; and
- none of these banks had experienced significant problems related to customer defaults, complaints or lawsuits

regarding inappropriate transactions.

One of the things that we were most pleased to find was that these banks were formalizing their internal policies regarding disclosure to customers. These policies generally established varying levels of disclosure based on the sophistication of the counterparty and the complexity of the transaction. Sophisticated counterparties may receive only a confirmation. Less sophisticated counterparties may receive a detailed analysis of price sensitivity over a broad range of price movements reflecting both upside potential and downside risk.

Based upon what we learned in this review, we are planning to update our examiner guidance and examination procedures in this area.

Generic Risk Disclosure Statements

The OCC recognizes that the industry is also taking steps to improve the extent to which derivatives end-users fully understand the impact derivatives transactions might have on their financial condition. Late last year we had the opportunity to review a generic risk disclosure statement prepared by a major derivatives dealer. That statement served to identify broad categories of risk that a market participant should consider in evaluating an over-the-counter derivative, structured note, or warrant transaction. The statement also warned that a market participant should not enter into any transaction unless it fully understands the specific risks of the transaction, and has financial and operational resources, or the transaction is appropriate in light of other relevant circumstances.

While the disclosure statement did identify the major categories of risk to be considered in these types of transactions, it remains simply a generic disclosure. The OCC has thus stated that it believes that additional disclosures, including further discussion of the risks associated with particular transactions, may be necessary depending upon the nature of the counterparty and the type and complexity of the particular transaction.

The particular risk disclosure statement we reviewed was a hybrid, in that it also contained a statement as to the legal nature of the relationship between the dealer and its customer. It stated that the customer should be aware that the dealer is acting solely in the capacity of an arm's length contractual counterparty and not in the capacity of a financial adviser or fiduciary unless the dealer has so agreed in writing and then only to the extent so provided. In commenting on this particular statement, I stated in a letter to the dealer in question that this provision apparently represents the dealer's view of its liability in any potential dispute with a customer by placing the burden on its customer to prove that the transaction is not at arm's length. I further stated that while this statement is useful in educating customers as to the dealer's view of the relationship, courts, if necessary, would likely look beyond this statement in evaluating the nature of the relationship between the parties. Mine were cautionary statements about the use of

generic disclosures.

DOL and the Upcoming Bulletin on Fiduciary Activities

An aspect of BC 277 that has not generally received much attention in the on-going public discussions about derivatives, is that BC 277 also applies to a national bank when acting as agent or fiduciary for its customers. As an example of his interest in this area, the Comptroller met over a year ago with Department of Labor officials to discuss derivatives. One of the fruits of this dialogue between our agencies is a letter that the Comptroller recently received from Olena Berg, Assistant Secretary for Pension and Welfare Benefits, which outlines the Department of Labor's views with respect to the utilization of derivatives in the management of a portfolio of assets of a pension plan which is subject to the Employee Retirement Income Security Act of 1974. This letter was a joint project of our agencies and is fully consistent with the guidance which we have set forth in BC 277. We consider it a helpful tool for OCC examiners who examine national bank fiduciary activities. We plan to reinforce these issues in a forthcoming Bulletin to our banks which will review our expectations as to how these banks should manage the risks associated with derivatives and mortgage-backed securities transactions for all of their fiduciary accounts.

As the DOL letter has just been finalized, we determined that this was an opportune time to review our expectations concerning risk management of derivatives and mortgage-backed securities transactions in a Bulletin specifically targeted at national bank trust departments.

Though the Bulletin is still being finalized, it will for the most part cover ground previously covered in BC 277 and our other guidances: we will warn national bank management that all risks -- including credit, interest rate, liquidity, price, foreign exchange, transaction, compliance, strategic and reputation risks -- should be addressed as they relate to all fiduciary investments. In particular, we will remind banks that careful attention must be paid to fiduciary compliance and legal considerations and that a first step is a determination that derivative instruments and mortgage-backed securities are permissible investments for a specific fiduciary account according to governing law and the instruments creating and defining the fiduciary relationship. We will also suggest that a review of account investment objectives, portfolio size, investment horizon, principal and income distribution, liquidity needs, tax consequences, and overall risk profile are necessary to determine the appropriateness of a particular investment for a fiduciary account.

It is also likely that we will address a practice that we have become aware of as a result of our examinations of bank trust activities -- the practice of dividing or participating a derivative instrument or mortgage-backed security between fiduciary accounts and subsequently buying and selling such divided units between these accounts. We will warn banks that

they should first establish that such a practice is permissible under governing law. In addition, we will caution banks about the potentially increased market and liquidity risk resulting from such a practice.

GSA Sales Practices

Finally, you may be interested to know that the banking agencies are close to publishing a proposed rule for the sales practices of government securities pursuant to amendments made to the Government Securities Act in December, 1993. The SEC has currently published the NASD's proposal in this area.

In closing, I would like to state that, unlike the SEC and the CFTC, the OCC does not, and has no claim to, regulate any part of the derivatives market. However, we do supervise banks who are major participants in the derivatives markets, both as dealers, intermediaries and end-users. Our primary supervisory concern is that banks conduct their activities in a safe and sound manner. And this has dictated our approach to supervising banks' derivatives activities. We have focused on risk, and in particular on the accurate identification and measurement, and the prudent monitoring and control of the various risks associated with derivatives products -- credit risk, price risk, foreign exchange risk, interest rate risk, liquidity risk, transaction risk, compliance risk, reputation risk and strategic risk. For banks that act as end-users, this has meant ensuring that they understand these risks and have the ability to measure and control them before engaging in derivatives transactions. For those banks that act as dealers, this has meant, among other things, insuring that they properly manage the credit, litigation and reputation risks by dealing with their customers fairly and honestly and assuming special obligations for those who are less sophisticated and less informed.

Thank you very much.