REMARKS OF
RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

INTERNATIONAL SWAP DEALERS ASSOCIATION
ANNUAL MEETING

MARCH 11, 1993

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
REMARKS OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

INTERNATIONAL SWAP DEALERS ASSOCIATION
ANNUAL MEETING

MARCH 11, 1993

For some, the explosive growth in recent years of swaps activities of different types -- interest rate, currency, commodity, equity index -- has created worries that the stability of financial markets was being seriously undercut by an esoteric set of products being traded wholly outside the traditional regulatory framework. Felix Rohatyn's vivid warning that "26-year-olds with computers are creating financial hydrogen bombs" would make most normal people sit up and take notice.

More than a few regulators in different countries began to lie awake nights, wondering if the rapid growth of the so-called "OTC derivatives" market was a precursor to the next regulatory nightmare. Of course that is a perfectly fair, and quite important question. However, it is not enough to pose provocative questions. One must also look for reasoned answers.

While I do not purport to have all the answers at my fingertips, I would like to share a few observations concerning these products, and how in my view regulatory issues arising from this debate ought to be considered. These views are my own, and
should not be considered to represent the views of the SEC or its staff.

At the outset, it might help to note the perspectives that I bring to the table -- biases some might suggest -- as the Chairman of quite possibly the world's oldest and largest derivatives regulator. While everyone knows that the SEC in America oversees the world's largest cash market for traded securities, fewer remember that since 1934 the SEC has regulated the options markets in the U.S. Those markets have served as the intellectual breeding ground for many of the analytical principles that play a central role in virtually all "derivatives." Thus, for quite some time we have been thinking about the role of "derived" instruments like options and warrants as a complement to the direct or "cash market" instruments like the stocks and bonds some of you may have read about in your history classes.

Another factor is that the U.S. securities market is founded on the principle of open and highly competitive markets. Under the federal securities laws, exchange traded products must compete head to head with off-exchange products. New types of securities can be created and traded through a wide variety of systems that include securities exchanges, but also include direct dealings among market participants such as in "upstairs" trading and the private placement and OTC markets. Indeed, had
the framers of the Securities Exchange Act of 1934 given the New York Stock Exchange, the AMEX, and other exchanges a legislated monopoly trading privilege similar to the "exclusivity clause" of the Commodity Exchange Act, the world's third-largest equities market, NASDAQ, would not exist today. Thus, in my view the very principle of "exclusivity" in trading privileges is per se contrary to the public interest in competitive markets.

The SEC doesn't hesitate to create rules designed to protect the interests of investors in a market that operates with honesty and integrity. We require prompt public reporting of prices and volumes on most transactions in equity securities, and we have set extremely high accounting, auditing and disclosure standards to promote the efficiency of the public markets. We also have rules designed to prevent market manipulations and abuses of investors, such as insider trading. The SEC's capital standards for broker-dealers are deliberately quite conservative, and we work hard to minimize risks to the clearance and settlement system and the stability of the overall market.

There are also many areas in which the SEC has traditionally believed that direct regulation is not needed. For example, earlier in my tenure in office the SEC created the "Rule 144A" market in which issuers may sell securities to "Qualified Institutional Buyers" ("QIBs") free of any registration requirements or limits on resale to other QIBs. Here, the SEC's
personnel are not able to evaluate the terms of transactions among large and highly sophisticated market participants as well as they can do for themselves, so we exempted these transactions from normal regulation. In addition, with limited resources to patrol a vast market, expending those resources to regulate arms-length transactions between sophisticated investors with the interest and capacity to protect themselves does not seem to be very wise. There is an obvious and quite direct parallel between that approach to transactions involving traditional securities among sophisticated institutions and the need for regulation of transactions in derivatives among the same types of institutions.

SWAPS AND MARKET EFFICIENCY

Above all other things, we live in a world of extremely rapid change. Evidence of that proposition is all around us in the world of business, finance, manufacturing, science and technology. Indeed, not since the Congress of Vienna or the Treaty of Versailles have so many countries been added or subtracted from the map of the world as has happened in the past four years. The momentous changes occurring in China today are only one very important example of the scope of change transforming our societies.

In addition to adapting to constant change, business today must operate on an international basis, for that is the scope of our economy. What business today can afford to think only of
selling in its own country? Increasingly, businesses also have to produce in multiple countries as part of the job of selling in multiple countries. Capital pools around the world that were formerly isolated have now been linked. For the foreseeable future, I believe that both issuers and investors will look to conduct financings in whatever world market they believe is most attractive to them, rather than whatever market happens in geographic terms to be closest at hand.

In this rapidly changing global marketplace, "real" certainty is tough to find. Since the collapse of Bretton Woods, fixed exchange rates have not generally been available from the governments of the world. The problems of the ERM in Europe seem to suggest that exchange rate volatility is not a transitory problem, even among otherwise closely linked economies.

Similarly, businesses have seen interest rates move sharply up and down over relatively short intervals, often in an unpredictable manner. Absent some spontaneous mutation in the genes of politicians around the world, it is difficult to expect that many countries will pursue sensible fiscal and monetary policies without interruption over long periods of time. Thus, I suspect that interest rate volatility is also going to be a factor business must cope with for a rather long time.
These basic facts of economic life explain why swaps of different types are so important. For the manufacturer of a product like an airliner that will be sold in dollars, but whose workers will be paid in pounds, francs or Deutschemarks, currency swaps provide an opportunity to create relative business certainty. Though the world may not know what the exchange rate will be between the dollar and those currencies at the time the airplane is delivered, the manufacturer is able to create a fixed exchange rate by contract, subject of course to the cost of the transaction (which typically is a tiny fraction of what an adverse move in currency value might cost) and the risk of counterparty default. Interest rate caps, floors and collars may similarly provide a business with sufficient certainty concerning its cash flow requirements that it can build a new plant or undertake other expansion projects that might otherwise be too risky.

Of course, cash market products like a 30-year bond with a fixed interest rate or an equity security are capable of meeting many business needs on more attractive terms than a derivative. Similarly, an exchange-traded currency option or interest rate future may serve a client’s need better than a custom-tailored derivative product. Here, the client must know its own best interests, and look carefully at the costs and other attributes of products available from different markets at specific times that might meet its financing needs.
The "traditional" products are not obsolete, and they still provide the greatest volume of primary capital. For example, public and private offerings of securities in the U.S. last year totalled slightly in excess of $950 billion, which was far in excess of the volume of equity swaps. However, these traditional products come with embedded risks of different types -- credit, market, settlement, operational, legal -- in a relatively fixed pattern.

Combining options in various forms with forward commitments of various types has enabled us to "unbundle" and reconstruct risk into different configurations than would be true for the underlying cash market product. The risk configurations of a derivative are not inherently "better" than those of a cash market instrument, but they can be substantially different. This enables an institutional investor, a financial institution and an industrial company to have far greater control over the nature and timing of their financial risks, rather than taking the "standard" variety.

A good analogy of the net impact of this capacity to "custom-design" risk is to think about a world in which you could only buy shoes in sizes 4, 6, 8, or 10 in a medium width. People whose feet just happen to be a size 9 EE could always make do with the nearest available size. However, the manufacturer that
offered a full spectrum of sizes and widths so that the customer could select the most appropriate size to fit his or her foot would have a great deal of business. It is the old story of building a better mousetrap, and here what is better is the ability to customize risk characteristics. Of course the flip side of that ability is the old saying about being careful about what you wish for, because you just might get it. It would not be a happy experience to find your company undone by risks you specifically designed for yourself. Perhaps that is the price of freedom.

Thus, the marriage of intellect and technology that has made possible the panoply of customized financial instruments that we have come to know as swaps or OTC derivatives is a very beneficial force in the markets. Used prudently and intelligently, these products offer issuers the ability to control risks that would make certain investments or economic activity impracticable, thereby reducing costs and simultaneously expanding market opportunities. For institutional investors, these products offer a far greater capacity to hedge risks of different types, hopefully leading to improved returns over time. Used imprudently or ineptly, these products also offer new ways to lose money, and in some cases new ways to get around regulatory requirements like margin limitations that have a continuing value to the stability of markets.
SWAP RISKS AND REGULATION

In looking at regulatory issues relating to these products, one must ask whether these products are inherently more risky than traditional products. Is an interest rate swap entered into by a bank inherently more dangerous than a loan to a real estate developer, or holding a portfolio of long-term fixed-rate government bonds? Is a currency swap inherently more dangerous to a broker-dealer than the underwriting of a major securities offering or a bridge loan to finance a client's proposed acquisition? Is it inherently more difficult for management to operate risk management controls for trading in swaps than in mortgage-backed securities or spot foreign currency? Is the legal risk of a repeat of Hammersmith and Fulham worse than the risk to bondholders in Washington Public Power System? Thus, the answer as to whether these products are hydrogen bombs or merely bows and arrows, in my view, is that it depends on how someone uses them, and to what extent.

While the types of risk that swaps present may not be unique, and therefore should not compel unique forms of regulation, one must also look at the aggregate size of risks in this market. Here, the widespread use of "notional amounts" is the worst thing market participants have done, because the specter of trillions of dollars in "notional amount" has scared many people, including a few members of legislative bodies. In reality, however, while the $1 trillion in contracts that U.S.
broker-dealers are booking annually seems large, the amounts actually at risk in these markets do not appear to be unusually large compared with the size of exposures that banks, broker-dealers and insurance companies maintain for their traditional businesses.

In reality, the notional amount is the principal amount of the underlying asset against which contract terms are multiplied to determine required cash flows. As such this reference amount is irrelevant to determining the real risk exposure on a specific contract to one of its parties. Actual risk is represented by the replacement cost or the mark-to-market value of the instrument, which is typically only 2-3 percent of the notional amount.

A recent study by U.S. banking regulators found that the ten largest U.S. bank holding companies had a total replacement cost credit exposure of $170 billion dollars for their combined derivative contracts, excluding futures contracts, or about 17 percent of their total assets. Those are significant numbers, but not materially greater than their exposure on direct holdings of U.S. government securities and far lower than their credit risk in aggregate loans. For all other large U.S. bank holding companies with more than $1 billion in assets, the total replacement cost exposure was $8.5 billion, or one-half of one percent of assets.
Similarly, ISDA has estimated that daily global cash flows are about $650 million per day from interest rate swaps, and approximately $1.9 billion from currency swaps (where both interest and principal are exchanged). Even the combined total represents a miniscule amount compared with estimated daily settlements of spot FX transactions, which are about 250 times greater. Of course that does not include the value of daily settlements in cash markets in government bonds and corporate securities around the world.

In reviewing these issues, I do not wish to suggest that there are not serious risks involved in these markets, or that the magnitude of those risks does not merit the concern of those who have responsibility for prudential regulation of various types of financial institutions. What I do wish to suggest is that I have not seen the case for a view that the sky is falling. However, it might be useful to suggest briefly where further effort is desirable on the part of both market participants and regulators.

Leverage. As always, the degree of leverage of financial institutions is one of the most fundamental regulatory concerns. Here the SEC has traditionally followed an approach that treated the replacement value of swaps as unsecured receivables, and hence applied our traditional, "modest" 100% writeoff to any such
asset. This approach has essentially forced derivative exposures out of the regulated broker-dealers and into affiliated entities. We have already begun requiring reporting of the size of exposures in such affiliates as part of our new holding company risk assessment program. For the future, I hope that the SEC will propose modifications to our traditional capital rule that will make it possible to carry at least many of these instruments on the books of the regulated broker-dealer (though some may desire to continue using separate entities for credit rating or other purposes).

Already we convert forwards into their underlying securities or currency positions, and we treat interest rate swaps as their bond equivalent positions. This approach is generally similar to that proposed for the future by the Basle Committee.

For portfolios of futures and options, market participants will typically "shock" their portfolios with assumed rate of percentage changes in their portfolios. The staff is looking at pricing models that would follow a similar approach, though we just might shock people a little more than they shock themselves. Some of you would say that there is nothing new in that.

Of course market risk is the traditional focus for SEC capital rules. There is a need for developing a better approach to evaluating market risk to banks than occurs under the current
Basle capital accord for credit risks. Here, I hope that there will be improvements in the future in applying capital rules to both cash market portfolios and derivative books.

Credit risk, on the other hand, is an area where banking supervisors have long experience and considerable methodological and practical skills that the SEC has never possessed. For the future I believe that the SEC will have to become more skilled in this area. By measuring credit exposure on contracts and some appropriate percentage of notional amount, and applying an appropriate percentage charge to capital, we would hopefully be able to develop a conservative but more realistic basis for capital against counterparty credit risk than we have used in the past. This effort will not be easy, but it is one that the staff is working on quite seriously.

Concentration. This is perhaps one of the most important regulatory issues. The swaps market is much more concentrated than traditional lending or securities markets, with fewer players and larger relative sizes of specific positions. That means that concentration limits are, if anything, just as important as capital requirements. The normal practice of looking for the strongest counterparties may at some stage be offset by the risks of concentration, given that the truly unexpected problem could occur to any bank or broker-dealer. Market practices should be free to evolve, but regulators have to
keep a close eye on concentrations of risk as well as the absolute size of exposures.

Legal Risks. The recent CFTC reauthorization legislation and its provisions providing exemptive relief for swaps, and the recent rules of the CFTC under the legislation are steps in the right direction. For the future, however, the "exclusivity clause" remains a problem for market safety that has no apparent justification. Why should these instruments be threatened with potentially becoming "illegal" off-market futures simply from the stroke of a pen in the drafting of a no-action letter? On-exchange and off-exchange instruments should compete in the market, not the halls of the CFTC or the courthouse.

Internal Controls. Swaps can be highly complex, and there is a need for managements to maintain careful controls over their risk management systems. Because these instruments are new, rapidly changing and somewhat more complex than traditional products, risk management controls are, relatively speaking, even more important than normal. This is a prime area of inquiry for the SEC in evaluating broker-dealers under our risk assessment program. We expect firms to know who is responsible for decisionmaking, and to have in place systems to manage risktaking activities.
Liquidity. As demonstrated by numerous cases of bank "runs" and the failure of Drexel Burnham, liquidity problems can create just as serious problems as underlying solvency problems. Liquidity is an important constraint in markets too, as practitioners of portfolio insurance discovered in October of 1987. Liquidity is an issue for swaps in several ways, including the computation of replacement costs in assessing counterparty risk. The replacement cost under normal conditions could be dramatically different than the replacement cost under market stress, assuming that replacement is even possible. That is not, it seems to me, a good assumption.

Liquidity is also an issue for market participants to consider. It is an issue where the terms of Master Agreements could in some cases have a negative effect. If, for example, agreements provide that swaps become callable if a counterparty is downgraded below a certain level in its credit rating, it is possible that substantial volumes of contracts could be opened, and payment requirements created, at unexpected times when an event or events of stress may have prompted rating changes at one, or perhaps many, institutions. Ideally, contracts would not come "unglued" because of reversible changes in financial condition of counterparties. Anything that could cause a sudden and unplanned liquidity demand on the system needs to be very carefully considered.
Accounting and Disclosure. The best regulation of this entire area is probably that provided by market disciplines. We can lower the fear factor and substantially improve the safety factor by enhancing current accounting and disclosure practices, which are not as good as they ought to be. These instruments ultimately need to be "on budget" together with traditional forms of financial instruments, not off budget.

In my view, accounting literature needs to address, with clarity, issues of recognition, measurement, derecognition and display of these assets and liabilities. It also needs to address the relationships among instruments, such as hedging practices, rights of setoff and netting, recourse provisions and many other questions. Today the literature does not address questions like when, how and where an institution must set forth the impact on it of changes in interest rates, for example. Similarly, in actual practice there may be no way to distinguish between speculative trading activity and hedging strategies.

While FAS 105 and FAS 107 represent important improvements in disclosure practices, for the long run they are not adequate and improvements will need to be made to provide greater transparency and greater consistency in the accounting for exposure in all of these financial instruments. In that manner changes to a firm's financial condition can be evaluated by all in the marketplace. That is a long term process, but the result
of higher quality accounting will be even stronger market
disciplines, and those are our most effective protection.

Agency Structure. I do not believe that we need any agency
to serve as a "monopoly regulator" for these products. Rather,
the types of risk arising from these products should be
considered by the traditional "institutional" regulator --
whether the firm is a bank, a broker-dealer or an insurance
company. The risks to a broker-dealer of its swaps positions
should be considered together with the risks on its dealer
inventory, underwriting positions, proprietary trading and so on.
Thus, traditional systems of regulation should be followed and
enhanced in this area, not abandoned in favor of a single agency
"czar."

To date, ISDA and market participants have worked actively
to identify risks and problems in these markets, and to design
solutions to them. That is an important strength of this market,
and one which we will continue to need in the future. I am sure
that there will be many new challenges to face in the future, but
I hope that we will approach them together, in a fully
cooperative and carefully considered manner.

Thank you.