EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

STATEMENT NO. 3

Paris, 1 March 1999

Towards Safer Derivatives Markets

The trading of derivatives contracts has grown tremendously in recent years. Such instruments perform a valuable economic function in facilitating the efficient allocation of financial risks, and thereby improve the performance of the economy. The rapid growth of derivatives markets nonetheless raises legitimate concerns among regulators relating to the adequacy of bank risk control measures and the potential for significant trading losses at one institution to spread illiquidity or insolvency much more widely. The Committee takes the view that public debate on such matters has not focused sufficiently on technical aspects of market operation, which we deem to be of central importance. Our statement addresses two such aspects: procedures for internal risk control, and the clearing and settlement of trades.

Risk Control Procedures

There are three levels at which accountability for financial risk management can logically be lodged: bank management, independent auditors and government regulatory bodies. Were it not for the putative existence of significant systemic risk deriving from bank failure, bank management - acting on behalf of shareholders - could be expected to exercise undivided authority and bear full responsibility. However, legitimate public concerns related to the mechanisms through which the illiquidity, or even insolvency, of large banks or highly leveraged funds might spread default risks throughout the financial system justify regulatory intervention to ensure prudent internal risk management and effective procedures for dealing with insolvent institutions. This issue we addressed in our statement of 22 June 1998 on "Dealing with Problem Banks in Europe".

The traditional approach to the problem of ensuring effective internal risk management in international banks has been the 1988 and 1993 Basle Committee model, and the 1993 EU Capital Adequacy Directive model, of setting specific bank capital to asset ratios on the basis of risk weightings established by regulatory fiat. This approach has revealed several significant limitations in practice: in particular, incentives to bank management simply to swap one form of (regulated) risk for another (unregulated) form of risk, and insufficient credit risk discrimination among broad categories of counterparties.

Such limitations have long been recognized in the private sector, and encouraged the development of internal "Value at Risk" models, based on more sophisticated portfolio approaches to risk management. The 1996 Basle amendment legitimized this approach as a supplement to the capital-asset ratio approach.

Regulators now face the significant task of determining principles for distinguishing between prudentially sufficient and insufficient risk modelling, delineating procedures for effective internal implementation and operation, and delegating responsibility for the external evaluation of internal risk management systems to appropriate private or public bodies.

In the context of derivatives, reliance on internal models raises a number of concerns. First, market risk can be exceptionally difficult to estimate, owing to such factors as a lack of reliable data to determine price parameter inputs on OTC products and insufficient consideration of market liquidity constraints. Second, credit risk is not independent of market risk, but is in fact dynamically linked to the performance of underlying cash instruments. Finally, the existence of estimation risk and dynamic credit risk can exacerbate "implementation risk"; that is, the ever-present risk associated with the unreliability of internal procedures for implementing control systems based on the output of market risk models.

The Committee proposes that regulators address these issues by:

1) establishing good practice guidelines for validating internal risk models;

2) requiring clear line management responsibilities to board level for ensuring compliance with such guidelines; and

3) extending the role of external auditors to include responsibility for assessing compliance with these guidelines and reporting significant breaches to the regulatory authorities.

The above procedures would reduce the present unrealistically heavy burden on regulatory authorities while preserving their responsibility for determining capital requirements.

Clearing and Settlement Procedures

Robust clearing and settlement procedures are a basic precondition for financial stability, since any disruption in this area has the potential to trigger defaults throughout the financial system. The Committee notes that in the derivatives markets the use of clearing houses offers significant advantages in terms of transparency of risk exposures, standardized procedures and prudential safeguards. In contrast, without such systems, OTC derivatives contracts expose market participants to counterparty, operational and greater legal risks. Furthermore, a recent BIS study (September 1998) documented that market participants often fail adequately to address such risks.

In light of the systemic risks which inhere in large-scale international banking operations, the Committee proposes that regulators encourage the use of central clearing systems via the imposition of capital requirements which reflect the higher settlement risks encountered in OTC derivatives trading. Furthermore, regulation pertaining to the role of external auditors should strengthen their role in identifying and addressing problems in the OTC settlement processes.

Recognizing the systemic concerns which would accompany the collapse of a major clearing house, the Committee also proposes that all derivatives clearing and settlement systems should themselves be subject to minimum operational and prudential standards, including in particular adequate margin requirements. Moreover, the facts relating to the recent collapse of Griffin Trading, a clearing member of the London Clearing House, and the resulting freeze of margin assets of non-defaulting customers, should be made public. This is essential to enable market participants and regulators to learn from the specifics of the case, and adapt their expectations and practices in the future.