Greenspan Suggests Derivatives Require Wholly Different Kind of Regulation

WSJ AS 5/26/94

By CHRISTI HARLAN
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON — Federal Reserve Board Chairman Alan Greenspan suggested "a whole new kind of regulation" to deal with derivatives and their kin.

Mr. Greenspan was one of five federal financial regulators who urged Congress to eschew writing new rules for the use of derivatives by banks and securities firms, saying that legislation could be more hurtful than helpful.

Current derivative regulations, Mr. Greenspan said, are "increasingly less relevant to the type of risk-management endeavors" undertaken by banks and securities firms. Regulators should concentrate on a firm's processes for dealing with risk and ensure that a firm's "risk-management systems work for that firm," he said.

Derivatives are financial agreements whose returns are linked to, or derived from, the performance of some underlying asset, such as interest rates, currencies or commodities.

The Fed chairman described regulation that would focus on banks' and securities firms' internal systems for dealing with risk in lieu of the current emphasis on making sure banks and firms have enough capital on hand to cover losses. He and his fellow regulators appeared before the Telecommunications and Finance Subcommittee of the House Energy and Commerce Committee.

Mr. Greenspan wasn't able to elaborate on his suggestion, because of subcommittee Chairman Edward Markey's insistence that regulators really need more tools for dealing with derivatives.

Rep. Markey clearly took to heart a General Accounting Office report last week that raised alarms about the havoc that could result from a sharp change in one of the underlying variables or from defaults on derivatives contracts by a large user.

The Massachusetts Democrat said he is also troubled that derivatives activities by some of the largest players aren't closely watched. Insurance companies aren't subject to any federal oversight, and securities firms' derivatives activities are conducted through unregistered affiliates that are immune from direct inspection by the Securities and Exchange Commission. For now, banks' derivatives activities are the most closely watched of the bunch.

Mr. Greenspan and his fellow regulators praised the GAO report for its scholarliness but politely disagreed with its doomsday theme. Less than polite were some of the exchanges between the subcommittee members who want to write more rules and Mr. Greenspan and SEC Chairman Arthur Levitt, both of whom urged restraint in legislating derivatives oversight.

Mr. Greenspan was particularly adamant that regulators need as much flexibility as possible to deal with derivatives and the institutions that use them. Even well-intended rules could hamstring regulators, he said. "We don't know at this particular point whether legislation would have unintended consequences," he said.

Rep. Markey ended the hearing — his third on derivatives — with a warning that unless legislation is introduced now, none would be passed before October 1996, given the traditional legislative cycle. "When we come back here in October 1996, I just hope we haven't had a circumstance" when new regulation was needed, he said.