Bank Regulator Signals Move On Derivatives

Comptroller Voices Concern Over For-Profit Trades And Internal Oversight

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WASHINGTON – The Comptroller of the Currency is moving toward tighter regulation of nationally chartered banks' derivatives trading, perhaps including limits on the risks banks can take in using such instruments.

Comptroller Eugene Ludwig signaled the effort in a speech here to the Exchequer Club, a group of financial trade-association executives. "Because of our increasing concern about the risks posed by exotic and complex derivative instruments, we are looking at whether they are appropriate for national banks and, if so, to what extent they are appropriate, and whether we need to take further regulatory action," Mr. Ludwig said.

In expressing that concern and his agency's consideration of tougher enforcement, the comptroller reflected growing criticism of derivatives trading by members of the House Banking Committee and banking securities regulators. Some sizable investors have been hit by recent big losses in mortgage-related and other derivatives, with rising interest rates compounding other financial difficulties with the instruments.

Mr. Ludwig said he is considering whether to place limits on investments in derivatives "or whether some other type of regulatory response is appropriate." Banks often use derivatives – which are financial instruments tied to, say, commodities prices or interest-rate levels – as a hedging device to manage interest-rate and other risks that they take in the course of their normal business. But Mr. Ludwig is concerned mainly about the growth of so-called proprietary trading, where banks take positions in derivatives and other securities in search of a profit. These trades use insured bank deposits, though it's a small part of the banks' total trading activities, Mr. Ludwig said.

The comptroller also raised questions about whether all banks adequately monitor their derivatives trading. "We are still not comfortable with the extent of senior management and board knowledge and oversight," he said.

In addition, Mr. Ludwig expressed concern about the use of exotic or especially complex instruments – certain kinds of "collateralized mortgage obligations," structured notes and highly leveraged over-the-counter transactions. Mr. Ludwig said that some prominent and sophisticated investors have lost considerable money trading such instruments as "principal-only strips," which pay investors only the principal on underlying mortgages, and "inverse floaters," with yields designed to fall when interest rates rise or vice versa.

Mr. Ludwig said his staff has come up with a list of more than 1,200 financial derivatives that are currently offered, with such names as "harmful warrants," "worthless warrants," "death-backed bonds," "limbos," and "heaven and hell bonds" – descriptions, he said sarcastically, that are "obviously designed to

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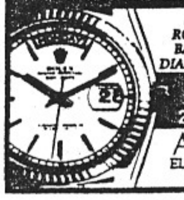

Comptroller Signals Tighter Bank Rules On Derivative Trades

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inspire confidence."

Hundreds of national banks are involved in derivatives trading, and the comptroller's office has identified six that have set up proprietary-trading desks.

Next week, the office will issue 20 pages of further guidance to bankers, covering such topics as the duties of senior management and directors for overseeing derivatives, monitoring the relationship of risks and meeting dealers' responsibilities to users, Mr. Ludwig said. Last October, the comptroller issued its first guidelines for banks in managing the risks of financial derivatives.

Now, the office is developing "comprehensive procedures" for examining the derivatives activities of nationally chartered banks, Mr. Ludwig said. "Since October, a lot of water has gone under the bridge . . . and some over the bridge – and there are several bridges missing," he said. Like any complex tool, he said, derivatives "can be misused and abused."