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Testimony by

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Chairman, Board of Governors of the Federal Reserve System

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I am pleased to be here today with the other members of the President's Working Group on Financial Markets to discuss issues involving municipal, corporate, and individual users of derivative products and highly leveraged investment strategies. Over the past year, losses by some institutions, including corporations and governmental units, have attracted considerable attention. Much of this attention has been on so-called "derivative" instruments, although that term is poorly defined and it is by no means clear that these losses have been attributable solely, or in some cases, even primarily, to financial instruments that would typically be called derivatives.

We need to view these issues in a broad context. The decline in the value of many portfolios has been a consequence of the rise in interest rates over the past year. This rise was a by-product of a strong economic expansion and of the efforts by the Federal Reserve to foster conditions that will sustain the expansion. Many investors and borrowers had established positions that were especially vulnerable to higher rates. These positions were taken during a prolonged period of recession and sub-par economic growth in which interest rates were relatively low and declining and the yield curve was steeply upward sloped. Furthermore, interest rate volatility was relatively low throughout this period. This unusual environment encouraged some investors to adopt riskier positions in order to boost the returns they were getting or to reduce the costs of borrowing. These positions often rested on the presumption that the unusual

configuration of yields and subdued volatility would persist. Even experienced investors forgot the axiom that all investment yields in excess of the short-term riskless rate of interest are, by definition, risky.

That derivatives have been implicated in many recent losses should not be surprising. Losses to holders of bonds amounted to many hundreds of billions of dollars in 1994. Derivatives transfer risk from one market participant to another, and in such a market they inevitably will be involved in large gross losses. Of necessity, they also accounted for large gross gains since contacts tend to cancel each other, net, but the gains are less newsworthy.

Although the convenience and low cost of using derivative instruments to meet portfolio objectives may have facilitated some investors reaching for more unconventional and possibly riskier strategies, it would be a serious mistake to respond to these developments by singling out derivative instruments for special regulatory treatment. Such a response would create artificial incentives to structure transactions on the basis of regulatory rules rather than of the economic characteristics of the transactions themselves. For example, restrictions on investments in derivative instruments could be circumvented by investing in other financial instruments that provide similar returns and entail similar risks, though presumably at somewhat higher transaction costs. A shift to the use of less efficient instruments as a substitute for derivatives

would mean greater cost to hedgers as well as speculators and a net loss in market efficiency.

Mr. Chairman, you have raised a number of issues regarding derivatives, leverage, and related issues. As I have described in detail in previous testimony and correspondence with members of Congress, the Federal Reserve has been addressing many of these issues in its role as supervisor of state member banks and bank holding companies. In the remainder of my testimony today, I would like to focus on one aspect of the market for financial transactions that has drawn considerable attention in the wake of recent losses -- the relationship between dealers in financial markets and their customers.

Markets function most efficiently when both parties to financial transactions are free to enter into transactions at their own discretion, unhampered by any perceived need to serve the interests of their counterparties. To date losses in the financial markets have not led to broader systemic problems. Moreover, both dealers and their customers, somewhat shaken by the volatility of recent markets, are responding to these events by exercising greater caution. If discipline from incurring losses from mistakes were mitigated, vigilance would be relaxed, the market's natural adaptive response would be blunted, and the value of decentralized market decisions as allocators of scarce capital resources would be reduced. I believe that we should start with the principle that parties to financial transactions are responsible for their own decisions and only use regulation

to adjust the balance of responsibilities between the parties cautiously, after the benefit has been clearly established.

This is not to say that financial markets should operate without rules, or that any and all behavior in the sales or marketing of transactions is acceptable. Misrepresentation or fraud in financial transactions cannot be tolerated. Moreover, in some cases, a dealer in financial transactions may assume responsibilities beyond the role of a mere counterparty. For example, a dealer that provides its customers with advisory services may have a duty to ensure that its advice is not tainted by its own profit or loss in any transactions it undertakes with those customers.

In addition, there may be cases in which certain customers can, in principle, use complex instruments to reduce risk or enhance yield, but, in practice, cannot reasonably be expected to understand the instruments and the risks sufficiently well to achieve these objectives without assistance. For such customers, a way must be found to ensure that transactions are used effectively for the purposes for which they are intended. The approaches to ensuring safe and efficient use of the financial markets by the unsophisticated vary and include restricting their access to certain markets, providing guidance for their investment and risk management practices, encouraging them to obtain independent advice, encouraging diversification of their portfolios, and shifting some of the risk of loss from the unsophisticated customers to the dealer by establishing special responsibilities for dealers' transactions with their less

sophisticated customers. Each of these approaches has its own costs and benefits; however, the approach that may appear easiest -- placing additional responsibilities on the dealer community -- may entail considerable indirect costs to the economy in terms of interfering with liquid and efficient markets. Rules that create a duty on the part of dealers in derivative instruments to ensure that these transactions are being used by their customers appropriately may serve as a means for customers to shift the risks of the transaction back to the dealer retroactively through legal actions. If such legal risks are exacerbated dealers are likely to charge an additional premium to compensate them for the uncertainties of future legal claims and some dealers may move their activities off-shore or withdraw from the market -- in any case causing their investments to incur higher costs.

With these considerations in mind, the Federal Reserve, in its role as a supervisor of banking institutions, recently has taken a number of actions that bear on relationships between dealers and their customers. The Board has had long-standing risk-management guidance for banks that are users of sophisticated instruments. In the wake of losses on investments in structured notes, the Board recently reiterated the applicability of this guidance to investments in such instruments. While the Board has suggested steps that institutions should take to control their risk from financial market transactions, it has not prohibited the use of any types of transactions and leaves the institution responsible for choosing specific transactions.

The Board has also issued guidance for banks that act as dealers in sophisticated risk-management instruments. The primary purpose of this guidance is to assure that dealing in financial market transactions is conducted safely and soundly. The guidance encourages dealers to ensure that the counterparties understand the nature of, and the risks inherent in, the agreed transactions. Where the counterparties are unsophisticated, either generally or with respect to a particular type of transaction, the guidance encourages additional steps to ensure that counterparties are made aware of the risks attendant in the specific type of transaction. While the guidance notes that counterparties are ultimately responsible for the transactions that they choose to enter into, where a bank recommends specific transactions for an unsophisticated counterparty, the guidance encourages the bank to ensure that the bank has adequate information regarding its counterparty on which to base its recommendation.

Consistent with this guidance, the Federal Reserve recently entered into a written supervisory agreement with Bankers Trust Corporation. The agreement focuses on Bankers Trust's policies and procedures for marketing practices and affiliate transactions in its leveraged derivative transaction business. Basically, the agreement reflects our conclusion that Bankers Trust had not put in place adequate procedures and controls to ensure that its employees' dealings with its customers met applicable standards and would not damage the company's business by detracting from its reputation as a

reliable financial intermediary. This action was specific to Bankers Trust and was based on a particular group of the transactions in which Bankers Trust had engaged and the practices followed in these transactions. Thus, the provisions of the Bankers Trust agreement should not be taken as new general guidelines for the derivatives dealers. Rather, this action should be viewed as implementing existing guidance in the context of this institution's particular circumstances. Each institution needs to have effective procedures and controls tailored to that institution's own products and practices.

Finally, as you are aware, the Government Securities Act Amendments of 1993 gave the Board the authority to adopt sales practice rules for state member banks that are government securities brokers or dealers. Many of the recent losses in the financial markets, particularly losses by governmental entities, have involved investments in securities issued by government sponsored enterprises, which are defined as government securities for the purposes of this Act. Although we have no evidence of sales practice abuses involving these securities by state member banks, we are currently exploring with the other bank regulators the possible adoption of sales practice rules for these dealers. In this process, we will be assessing carefully the benefits of adopting rules that parallel the rules currently under development for nonbank brokers and dealers.