NOT RELEASED

Remarks by

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at the

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I appreciate your invitation to discuss with you today the currently burning issue of so-called derivatives and their use by mutual funds. It goes without saying that interest in the subject has intensified as legislators and media gurus, neither of whom would recognize a derivative if they bumped into one, have tried to characterize derivatives as an imminent threat to western civilization.

To my knowledge, no public institution has failed because of its derivative activities, and there are no widows and orphans now destitute because they were put at imprudent risk in the derivatives market. But the press thrives on crisis, whether real or imagined, and legislators often measure their own achievements by how close they can come to legislating regulation for every aspect of economic activity.

To be sure, markets for mutual funds and derivative products have grown exponentially over the last decade or so. And the variety of new products, created by rocket scientist traders has expanded similarly. Monetary policy introduced into that mixture

a strong catalyst in the form of a dramatic change in the structure of interest rates. It is not surprising that some violent reactions ensued. What may be surprising is that the resulting accidents have not been more serious and the casualties have not been more numerous.

In the early 1990s, low short-term interest rates and slack loan demand put heavy downward pressure on the rates banks were willing to pay for deposits. At the same time, longer term bond yields remained relatively high and the stock market was a bellowing bull. Mutual funds, which could capture the higher income yields and market appreciation opportunities in bonds and stocks, became an attractive enough alternative to bank deposits to create a huge migration of funds from banks to mutual funds, in spite of traditional consumer concerns about deposit insurance.

In order to defend customer relationships, banks became active participants in the mutual fund marketplace. Some banks entered the proprietary mutual fund business as advisers. Some sold funds managed by others. Relative stability in financial markets during this period probably obscured some of the risks inherent in the increasingly widespread use of derivatives, both as hedge instruments and vehicles to enhance returns. It is apparent that, for many users of derivatives who employed stress testing as part of their risk management systems, the degree of stress used did not contemplate the magnitude of change which markets have undergone in 1994. Also, lack of experience with many of the new products being created daily by traders in a

highly competitive market made it difficult to predict their performance under a variety of market conditions.

The losses in 1994 which have been attributed to derivatives have been widely publicized. In some cases, the investment positions sustaining losses appeared to have been well hedged using derivatives as hedging instruments. This has led to speculation that derivatives are somehow defective instruments or too complex to be responsive to existing risk management techniques. What has not received any publicity is the large number of investors who have reduced or eliminated losses through the prudent use of a variety of derivative products.

A great deal of confusion today stems from what the term derivative means. The most commonly used definition is the one adopted in the Group of Thirty report. Under this definition, a derivative is a contract whose value depends on or derives from an underlying asset, reference rate, or index. However, this is an extremely broad definition and could apply to a very broad array of standard financial instruments such as certain bank deposits, CMOs, and perhaps even to stocks. It might be more useful to restrict the term to include futures, options, forward contracts, swaps, and structured notes. The latter might be regarded as a derivative security while the others are derivative contracts. Certain mortgage-backed securities, such as IOs, POs, and so-called kitchen-sink bonds are regarded by some as derivatives, but their inclusion seems to stretch the definition. Indeed, their price volatility may have more in common with derivatives than the procedure for setting their yield.

Although the market for derivatives has come under a cloud of public skepticism, it is worth noting that derivatives are not necessarily new and they do perform an important economic function. For example, the callable corporate bond, a long-time fixture of U.S. securities markets, can be viewed as containing an embedded call option -- a feature that has always contained an implicit cost to the investor. Moreover, by their very nature, derivatives permit participants to reallocate risk in a cost-efficient manner. Derivatives markets encourage the redistribution of risk from those less willing and able to bear it to those better positioned to absorb and manage it. They permit end users to identify, isolate, and manage separately, fundamental financial risks.

The market for derivative contracts has evolved toward OTC contracts as opposed to those traded on exchanges. To an important degree, this reflects the natural evolution of the financial marketplace as OTC products can be better customized to meet the specific needs of individual users. Nonetheless, in these circumstances, dealers in OTC derivatives commonly use exchange-traded contracts to adjust their own exposures, and in that way such contracts complement the OTC market.

While the market for derivatives by all accounts is large and growing rapidly, documenting the size and growth of this market is problematic. No comprehensive data on the size of this market exist. Moreover, a great deal of confusion has been caused by the use of notional as opposed to replacement values of derivatives. One estimate of the size of the over-the-counter market for swaps and options, prepared by the International Swap

Dealers Association (ISDA), places its notional value at $9 trillion in 1993, double its size in 1991. Replacement values of the contracts, however, might be $75 billion, a much smaller, though still significant, figure. We expect that a survey of major dealers in OTC derivatives will be conducted by the Federal Reserve next spring, and that should help in gauging the dimensions of this market more accurately.

In general, users of derivatives tend to be corporations, institutional investors, and financial institutions, as well as government entities.

For some derivatives, market liquidity and pricing can at time be a problem. In the case of more exotic and complex instruments, such as structured notes, market participants in times of well-functioning and smooth market conditions may be lulled into assuming that they can readily dispose of these instruments at favorable prices. However, once markets become more turbulent, liquidity can disappear quickly and bid-asked spreads widen substantially, inflicting sizable losses.

The use of derivatives by mutual funds varies by the type of fund. Stock and bond funds are relatively unrestricted in the use of derivatives or other financial instruments so long as their use is consistent with the stated investment purpose of the fund and is fully disclosed in the prospectus.

Money market funds, however, have restrictions imposed by the SEC. A fund which calls itself a money market fund must comply with limitations on interest-rate risk and credit risk. Interest-rate risk is controlled by limitations on maturities at 13 months or restrictions on repricing options. Credit risk is

limited by prohibiting certain asset holdings. If a money market fund purports to preserve net asset value of $1 per share, additional restrictions apply such as an average maturity limit of 90 days. Some derivatives are prohibited, but not all. For example, money funds have been permitted to hold some structured notes having longer than prescribed maturities provided they were issued by government entities and had repricing intervals within maximum maturity limits.

Interestingly, available survey data indicate that usage of mutual funds is primarily for hedging purposes by bond funds. But at the cost of additional risk, there has also been some limited use to attempt to enhance yields.

Many of the publicized losses by money funds have been concentrated in structured notes. When interest rates rose, the market value of some structured notes failed to return to par during the adjustment period, thus threatening and in some cases breaking the buck -- or pulling net share value below $1.

In light of this experience, the SEC has further restricted holdings of structured notes. The new restrictions on money funds prohibit range notes, cost of funds index notes, and inverse floaters under role 2(a)7.

For the longer term funds, the SEC has imposed additional disclosure requirements including investment practices and risks. Also, during inspections, more focus will be placed on review of compliance by the funds with their stated investment policies vis-a-vis derivatives.

Banks, of course, as mentioned earlier, are deeply involved with mutual funds and with derivatives. Under existing law,

banks may act as investment advisers to funds as well as transfer agents and custodians. Banks also act as sales agents for nonproprietary funds in return for origination fees.

The two principal issues in bank mutual fund activities relate to safety and soundness of the bank and risk disclosure to the investor. Banking concerns must operate their involvement with funds prudently so as not to impair the viability of the bank. But it is also essential that investors, whether or not they are already customers of the bank, be fully informed that the investment in a fund is not an insured deposit and they must be advised that their principal may be at risk. Furthermore, those selling mutual funds in a bank should be qualified to determine the suitability of an investment for a particular potential investor and advise that person accordingly.

We remain concerned about possible public misperceptions regarding the riskiness of mutual fund investments and the possible confusion with insured bank deposits. In response, banking regulators have taken a number of actions to better ensure that investors know that mutual fund investments are not deposits and are not FDIC insured but are subject to investment risk. This involves the selection of fund names that differ from that of the bank, the sales of funds apart from the areas where bank deposits are taken, training of sales personnel, and suitability of sales practices.

We also have been concerned about bank advisers being fully aware of the risks involved in the investment products they recommend to client funds. As a consequence, we are examining

carefully the policies and procedures of bank investment advisers as they relate to the management of risk.

Most bank involvement in mutual funds to date has been with money funds even though there has been some increased effort over the last two or three years to expand into long-term funds. Proprietary bank mutual funds represented about 10 percent of the industry in 1993. Their share of money market funds was 20 percent in that year and only 4 percent of longer term funds.

[Side comment about money fund injections by BNCs--also Mellon.]

It is our view that the problems which have surfaced with regard to bank involvement with mutual funds and with derivatives are manageable under existing authority in the hands of regulators and supervisors. At this point we do not feel additional legislation is needed or desirable.

In respect to mutual funds in general and their use of derivatives, the same conclusion may be drawn. The problems have been manageable and have not generated broader systemic risk. And the markets are already making corrections in adjusting to new economic factors. Investors are pulling away from the riskier funds, and fund managers are shying away from the riskier instruments. Regulators have responded to the reality of more volatile markets in timely fashion. It is apparent that existing authority is sufficient to address the emerging situation. Further legislation is probably unnecessary and might even be counterproductive.

It is always important to remember that a fine line exists between the need for regulation that ensures that investors are fully aware of the choices they are making -- including the degree of riskiness of investments -- and the need to avoid protecting investors from losses resulting from their well-informed mistakes. When the discipline of incurring losses from your mistakes is removed, vigilance is relaxed and the value of decentralized market decisions as allocators of scarce capital resources is weakened. That discipline and the resulting market allocation of capital have served this country well. It would be bad public policy to scrap it with a burst of self-righteous legislation.

Thank you for your attention to my thoughts on this complex issue.