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MANAGING MONEY IN VOLATILE MARKETS

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## MANAGING MONEY IN VOLATILE MARKETS

It is a pleasure to be with you today to talk about managing money in volatile markets. Sometime in our 'teens we all discover that managing our own money is not easy. Professional money managers, like yourselves, learn very early that the job remains difficult especially when one manages other people's money. Since coming to the Federal Reserve Board, I found out that the task does not get any easier even for institutions that presumably can create money.

First, I will comment on the notion of increased volatility in our financial markets, arguing that instead of an increasingly volatile financial environment, we are facing one characterized by rapid change and dynamism. In this context, I will identify the forces contributing to these changes and their consequences. Second, I will speak about what financial managers can do, and what we at the Fed are doing to cope with the changing financial climate. Finally, I want to speak about the dynamics confronting us in the increasingly internationalized and integrated world of international banking.

## VOLATILITY IN PERSPECTIVE

Volatility in financial markets must be viewed in perspective. In recent years, financial markets have been characterized by rapid change and innovation. While we have observed rather wide swings in most markets for financial assets, these changes have generally been smooth and orderly. Disorderly and volatile markets, characterized by large buy-sell spreads and rapid price movements have been rare. But these rare exceptions, such as occurred in October of last year, have been all the more memorable.

For five straight years, the U.S. equity markets rose cumulatively by nearly 200 percent, without any marked increase in the daily gyrations around this trend. The subsequent collapse of stock prices stands out as a lone occurrence.

Similar long-term swings were observable in the markets for foreign exchange and other financial assets with few, if any, nose-dives. In fact, the findings of the Brady Commission indicate that even in equity markets there was no unusual increase in volatility prior to the October 1987 crash.

While abrupt and disorderly breaks have been few, over a longer horizon, the swings have indeed been wide. One can argue that such fluctuations in the financial markets are not necessarily a bad thing. Like markets for commodities, those for assets generally conform to the requirements of competitive markets. There are a large number of buyers and sellers dealing in homogeneous products, there is a wealth of information shared by the market participants, transactions are executed by willing agents, and transaction costs are relatively low. It is well known that the outcome in such markets are in an economic sense efficient, as prices and quantities transacted are based on optimizing behavior of market participants.

Perhaps the resiliency with which our economy has absorbed the wide swings in the foreign exchange and financial markets is evidence in support of this argument. Indeed, with the benefit of hindsight many are suggesting that the events of last October may have had some positive aspects. The large market correction served to cool off speculative fever, inflationary expectations were lowered, and interest rates leveled out; all without interrupting the economic expansion.

## REASONS FOR WIDER FLUCTUATIONS

What were some of the causes of the wide swings in the asset markets in the 1980s? We have seen a tremendous transformation of the financial services industry during the last decade. Numerous factors have contributed to this transformation. First, deregulation of the financial services industry changed the rules of the game by allowing increased competition among the providers of financial services and created new opportunities for financial institutions to offer a wider range of customized products. The effects on markets have not been always entirely predictable and may well have resulted in some market movements.

Second, the increased internationalization of the financial markets causes events in one country to reverberate beyond national borders. This was underscored by the virtually simultaneous collapse of stock prices around the globe on Black Monday. The global integration is made possible by technological advances in communications and computers. Risk-return analysis across international markets can now be automated and arbitrage executed swiftly in alternative markets around the globe. This international fluidity of funds results in increased integration and

interdependence of markets. But it also means that any given shock will be more readily dissipated and therefore result in smaller - but more wide-spread - fluctuations.

Third, there has been a growing tendency toward greater securitization of assets of financial intermediaries. Increasingly, financial institutions are selling and buying parts of their mortgage, consumer, and foreign loan portfolios in order to reduce risk and improve the diversification of their balance sheets. By reducing the cost of substitution among the various investment instruments, the trend toward securitization may well have contributed to increased volatility of financial markets. On the other hand, one may agree that the markets are made more liquid and that here, too, any given change in the environment may have a smaller impact on a specific market segment.

Fourth, the general change in economic environment from one of high inflation to one of relative price stability has had an impact on asset markets. The bout with inflation in the 1970s resulted in various financial innovations aimed at protecting investors against erosion of earnings and principal. These more sophisticated financial instruments may well

be more sensitive to actual or perceived changes in the environment and react more swiftly to such changes, but they also allow the adoption of defensive hedging strategies that ameliorate market fluctuations.

Fifth, the increasing integration of the world economy set in motion significant adjustments in the global industrial structure, which are now playing themselves out in the world financial markets.

#### COPING WITH CHANGE

How can financial managers cope with these changes?

First of all, as hands-on professionals, you are well aware of the vast array of new instruments that has emerged. One may consider them as much a response to the increased uncertainty as a cause of it. These instruments include floating rate agreements, foreign currency and interest rate swaps, and various options, warrants, caps and collars. Clearly, such instruments have a place in a defensive strategy and can serve to protect against a variety of adverse developments. However, if they are employed in an offensive way in search of high returns they may well expose the unwary to unexpected risks. With little history to go on, their properties are not yet well understood

and their liquidity and predictability remain to be tested.

Second, one can adhere to the time tested prescription for risk minimization: diversification. In today's financial environment, the dimensions of diversification are many. It can be pursued across domestic or international geographic locations, types of financial instruments, length of maturities, types of industries, and the like.

Third, investors must assimilate the everincreasing wealth of information available. The need for hard analysis and processing of this information is paramount in today's global markets. No longer can one rely exclusively on the hunches of omniscient gurus as a basis for sound investment decisions. By the same token programmed automatons will not do. Best human judgment and intuition must be brought to bear on solid analysis.

#### THE ROLE OF THE FED

For our part, the Federal Reserve stands committed to preventing disorderly market movements from undermining our financial system. We have intervened in foreign exchange markets in concert with our G7

partners to prevent excessive movements and to  
lend stability to those markets.

Our role in restoring confidence and calm to stock  
markets in the aftermath of last October's events is  
now well known.

But we have also moved on other fronts, in particular  
in the banking area. We are now in the process of  
implementing the pathbreaking new risk-based capital  
rules agreed to by the central bank governors of the  
Group of Ten countries. While former international  
supervisory agreements typically relied upon recogni-  
tion of national supervisory standards, the Basle  
Group's risk-based capital framework represents the  
first truly global effort to level the international  
playing field for the banking industry.

The framework provides for the same definition of  
capital, the same risk classes, and the same leverage  
ratio for all internationally active banks. The  
agreement sets a 4 percent equity standard and an  
overall 8 percent capital standard to be achieved by  
the end of 1992.

Adherence to these new capital standards will make  
banks safer and thereby contribute to financial

stability.

As you will gather from this discussion of capital requirements, the Federal Reserve considers adequate capital as central to bank safety. A key aspect of this is that a bank holding company should serve as a source of strength to its subsidiary banks and stand ready to provide additional capital funds in times of financial stress. If a holding company were allowed to cut each bank subsidiary loose as soon as the subsidiary bank encountered financial difficulties, and leave the FDIC to pay off the depositors, true chaos would descend upon our financial markets. Both Congress and the Federal Reserve have consistently enunciated the central tenet, that a bank holding company should serve as a source of strength to its subsidiary banks -- and the Federal Reserve intends to enforce these provisions to the full extent of the law.

The payment of excessive or unearned dividends by organizations whose capital position needs strengthening is another practice that we wish to discourage and stand ready to prohibit in extreme situations.

Capital adequacy is also of central importance in merger and acquisition cases. The Board has long believed that banking organizations undertaking

expansions should maintain capital well above the regulatory minimum. In that context, we have discouraged the use of creative purchase accounting techniques that might be used to justify a payout of capital funds to shareholders.

#### THE COMING INTERNATIONAL CHALLENGE

I mentioned earlier the increasing importance of international financial markets. In 1992, the European Community will pass a milestone with the planned full economic and financial integration of the member countries. The shaping of EC policy for 1992 toward banks from non-EC countries is of critical importance to United States banks.

There have been indications recently that the EC might impose a policy of reciprocity on banks from outside countries. Specifically, banks from those countries would not be granted the powers that are available to EC banks unless those same powers were permitted by the foreign bank's home country for banks from all EC member countries. As an extreme example of how this policy might be applied, a U.S. bank could be denied the right to branch throughout the EC since no banks, domestic or foreign, are allowed to branch throughout the U.S. Also,

the securities activities of the U.S. banks in Europe could be restricted because of the restrictions on banks' securities underwriting activities in the U.S.

Clearly, a policy of reciprocity would be detrimental not only in that it would harm the ability of U.S. banks to compete in the European market for financial services, but it could lead to further protectionist pressures that would be harmful to all. I strongly hope that the EC will apply the international standard of national treatment, rather than establish a new policy of reciprocity. This source of speculation and uncertainty should be removed swiftly through a clear statement by the Europeans.

#### THE NEED FOR DOMESTIC LIBERALIZATION

I also believe that we in the United States need to move rapidly to remove the restrictions that hamper the ability of U.S. banks to compete with foreign financial firms that operate much more freely.

Greater geographic diversification should enhance the safety of the banking system. This point is illustrated forcefully by the problems encountered

by insufficiently diversified banks in the agricultural and energy producing regions of our country. This is in contrast to the situation prevailing in other countries where nationwide banking has increased the safety and soundness of the financial structure through diversification.

While the states have taken the lead in this area, interstate banking is clearly an area where a national policy is called for. Let's apply the interstate commerce clause, which has brought us prosperity and a competitive marketplace, to banking as well. Unfortunately, Congress failed to enact appropriate legislation and the Federal Reserve may therefore well be faced with applications by banks trying to exercise their legitimate powers within the context of the existing legislation.

#### CONCLUSION

As you can see, life will continue to be interesting for you and me. The financial environment we will face in the future is not likely to be much less uncertain than in the past. Further structural change will occur, and I trust that the innovators will be busy as well. That's the way it should be.

Nevertheless, we should continue to enhance our capacity to cope with this uncertainty. The creative forces in the markets can also be put to use here and we at the Fed remain dedicated to do our best to provide a stable monetary environment and a fair regulatory framework so that the private sector can continue to prosper and flourish.