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Statement by
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Committee on Telecommunications, Consumer Protection and Finance
of the
Committee on Energy and Commerce
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I appreciate the opportunity to appear before this Committee to discuss the economic and bank regulatory implications of three major developments in financial markets during the 1980s. As requested, I will focus, in turn, on the trend toward greater internationalization of capital markets, the further growth of securitized credit, and the continued development of futures and option markets based on financial instruments.

Capital has been flowing across international borders for centuries. The economic development of the United States from the colonial period through the 19th century, for example, was financed in good part by capital provided by Great Britain and other European nations. And throughout most of the 20th century--indeed, generally until the current decade--the United States has been a major source of net capital for many other countries.

However during the past 20 years, financial markets in major countries have become increasingly more international in character and increasingly more integrated. Initially this process occurred primarily in the more traditional types of banking activities. Until the mid-1960s U.S. and foreign banks conducted the great bulk of their international banking transactions from offices in their home countries. At that time, under the impetus provided by the United States program to control capital outflows, banking transactions in dollars outside the United States expanded rapidly. U.S. banks developed foreign branch networks to accept deposits from and extend credits to foreign customers. Initially, the growth of this business occurred principally in offices in Europe--hence,

the name Eurodollar market. But soon such international banking activity developed in a wide range of other financial centers, such as Singapore and Hong Kong, and also in newly established offshore banking centers in the Caribbean and elsewhere. And the number of participants grew to include major banks from all countries.

The volume of deposits placed in offshore offices increased greatly in those days because they were not subject to the interest rate constraints or the reserve requirements that applied to deposits in national markets. In addition, growth in the 1970s was particularly stimulated by the emergence of oil producing countries as major creditors, who preferred that their assets be intermediated. Over the same time, the rapid development of communications technology helped to enlarge the competitive environment for international financial services to a worldwide basis. In this environment, banks began to shave margins between rates paid on deposits and rates charged on loans, to develop new types of banking instruments, and (later, when banking supervisors began to require banks to improve their capital positions) to seek income from providing services outside the traditional banking role of intermediation.

Banks have expanded their provision of financial services internationally by playing an important role in the establishment and development of the Eurobond market and by helping to link that market with domestic securities markets. The Eurobond market developed in parallel with the Eurobanking market, although, until recently, at a more moderate pace. Prior to the development of this market, international security issues

took the form of bonds issued by nonresidents in national markets and were subject to the regulations that applied in that market. By the mid-1960s, however, the "offshore" Eurobond market had begun a period of concerted growth, as offerings by U.S. and European corporations and sovereign borrowers became more or less continuous, supplementing the funds raised and loaned in the Eurobanking markets.

Although the Eurobond market, whose market makers are located in a number of financial centers, is not subject to national regulations, its investors, issuers and underwriters are frequently subject to regulation by their national authorities. Examples of such U.S. regulations include the restriction that Eurobond offerings that are not registered with the SEC at issuance cannot be sold in the United States until after they have been seasoned for a ninety-day period. Furthermore, U.S. tax regulations discourage the sale of Eurobonds to U.S. investors, particularly through U.S. banking organizations.

Other governments also regulate access to the Eurobond market. Nevertheless, the trend in recent years has clearly been to open up national securities markets and thus to allow greater integration of these markets with other national and international markets. Recent examples include the removal by Germany and Japan of important restrictions on the use of their currencies in certain international financial transactions.

The securities issued in the Eurobond market have continued to be those of European governments, the most creditworthy of U.S. and

foreign corporations, and international organizations such as the World Bank. One reason U.S. corporate borrowers have continued to be attracted to this market is that in recent years they have been able to issue dollar-denominated securities at cheaper rates than in the United States. In part, this is possible because securities are offered in bearer form, giving a guarantee of anonymity to the investor. Most of the investors in this market have been and continue to be foreign financial institutions and foreign residents.

Thus, the Eurobond market in its maturity is an effective alternative to national debt markets. As such, it provides an important means by which capital can flow between countries internationally, helping to promote its efficient allocation on a worldwide basis. During the 1980s, for example, the market has served as an important source of net capital inflow into the United States, a development which is a counterpart of the large trade deficit this country has been running over this period.

In the wake of the surge of U.S. corporate issues, a few U.S. commercial banking firms have become important lead arrangers and underwriters in international (and foreign) securities markets. U.S. banks have been able to participate in the development and operations of international capital markets through foreign subsidiaries by reason of the broad statutory authority contained in the Edge Act (section 25(a) of the Federal Reserve Act). A principal purpose of that act, which was enacted in 1919, was to facilitate the international and foreign banking and financial operations of U.S. banks and to promote, thereby, the foreign

trade and commerce of the United States. Through the creation of subsidiary corporations endowed with greater banking and financing powers than those possessed by domestic banks, it was intended by Congress that U.S. banks should be able to compete more effectively with foreign banking institutions in U.S. trade financing and in international and foreign banking.

It was recognized by Congress that if Edge corporations were bound by domestic banking rules in their operations abroad, they could be placed at a severe competitive disadvantage with foreign banks, and the foreign trade and commerce of the United States would not be promoted. Accordingly, the Congress gave to each Edge corporation the right ". . . generally to exercise such powers. . . as may be usual, in the determination of the Board, in connection with the transaction of the business of banking or other financial operations in the countries. . . in which it shall transact business. . ." The Board has determined, through its regulations and orders in individual cases, which activities abroad are appropriate for U.S. banking organizations in the light of the purposes of the Edge Act and related statutes.

In the mid-1960s, as U.S. companies sought ways to raise medium- and long-term funds offshore to finance their direct investments and operations overseas, U.S. banks asked for authority to underwrite and deal in securities abroad through merchant banking subsidiaries. In this context, the Board gave that permission to a number of subsidiaries, at first mainly in London but subsequently in other banking centers. Although the

primary interest at that time was in underwriting and dealing in debt securities, authorizations were extended to equity securities and other securities containing equity elements. Subsequently, in the 1979 revision of its regulations regarding international banking, the Board placed underwriting, distributing, and dealing in debt and equity securities outside the United States on the list of permissible activities.

There are no specific regulatory limitations on the underwriting of debt securities overseas. However, the underwriting commitment by the Edge corporation or its subsidiary to an issuer of debt securities is considered a liability of that entity and, as such, would be considered an extension of credit to the issuer. Accordingly, these commitments would be aggregated with other extensions of the parent bank to that issuer for the purposes of the bank's lending limit.

The underwriting of equity securities abroad by a banking organization is more limited. No equity underwriting commitment by an Edge corporation subsidiary may exceed \$2 million, or represent 20 percent or more of the capital and surplus or voting stock of an issuer, unless the underwriter is covered by binding commitments from subunderwriters or other purchasers.

More generally, the Board's regulation admonishes U.S. banking organizations that their underwriting and other activities abroad are to be carried out at all times with high standards of banking or financial prudence, having due regard for diversification of risks, suitable liquidity, and adequacy of capital. The Board monitors these activities through regular reporting requirements and the examination process.

U.S. commercial banks, as well as U.S. investment banks, have only become important underwriters in the Eurobond market in the 1980s. In significant part this prominence is attributable to the development of various innovative financial arrangements, most importantly currency and interest rate swaps. In its simple form, an interest rate swap, for example, involves two parties, one with a fixed interest payment debt, the other with a floating rate debt. These parties agree to swap their interest payment obligation. One or both parties enter these agreements to obtain a preferred interest payment stream and/or to lower borrowing costs. Because of the rapid growth of financial swaps and other innovative financial arrangements and the major involvement of international banks in their employment, the Federal Reserve is cooperating with other central banks in assembling information on these arrangements and in analyzing their market implications and policy significance.

A second broad area of financial market developments in which banks are increasingly involved is the securitizing of loans. This is a process which packages relatively illiquid two-party borrowing agreements and transforms them into negotiable securities. Experience with such securities comes almost entirely from the mortgage markets. Congress provided the essential impetus to the securitizing of credit when it created the Government National Mortgage Association in 1968 to guarantee privately issued securities backed by pools of mortgages. These instruments were called pass-throughs, because interest and principal payments on the mortgages were passed through to the security holders. The Federal Home Loan

Mortgage Corporation was started two years later and extended the acceptable limits of loan pools to include conventional as well as federally insured mortgages. Since then, Federal National Mortgage Association and a wide range of private firms have also issued pass-through. The outstanding volume of residential mortgage pass-through securities has grown exponentially. At present, securities guaranteed by the three agencies total \$290 billion; counting mortgage-backed securities with a private guarantee, the total is more than \$300 billion. Over a fifth of all existing home mortgages have now been placed in pass-through pools, representing about 5 percent of all credit market debt.

By and large, the experience with these securities has been quite good. The original intent of federal government participation was to augment the flow of capital to the housing industry to make mortgage credit cheaper and more consistently available over the course of the cycle. The secondary mortgage market, which pass-throughs have been largely responsible for widening and deepening, has helped insulate the housing industry, to some extent, when deposit flows to thrift institutions have been weak. By making it easier to invest in mortgages without having the resources or expertise needed to originate and service such loans, the pool of lenders and investors has been greatly increased. Mortgage interest rates have been more uniform geographically and have moved more in line with market rates.

The ability to sell loans has clear benefits for banks. It makes the asset side of their balance sheets more liquid; it allows banks

to manage their assets. They can spread individual-borrower risks better and control the proportions of different borrower and maturity categories. The securitizing of loans broadens the range of investment opportunities for many investors, offering yet another alternative for increasing the liquidity of a portfolio and diversifying risk. This helps some borrowers compete on more even terms for funds. The extent to which additional funds acquired by households to purchase houses or autos crowd out business borrowing is still a matter for continued research.

There are, however, some increased risks accompanying the packaging and sale of loans. In some private loan packages, the origination is separated from the actual lending for funds, with third parties insuring the loans, still others doing the loan packaging, and even different firms holding the loans in escrow or as trustee. This, as the recent experience of California banks suggests, may tend to encourage sloppy procedures and inadequate loan evaluation as each party relies on others to investigate the loans thoroughly. Furthermore, ultimate purchasers of the securities, who sometimes bear the most risk, may lack the expertise and information to make proper investigations.

As regulators, we also have some concern about how banks account for loan sale transactions. Although outright sales to nonaffiliated parties without residual guarantees cause no problem, loan pools are often sold with some recourse to the originating bank in case of defaults. For example, the bank may commit to replace all loan losses up to 10 percent of the loans sold. With the exception of certain mortgage pool

transactions, the Federal Reserve's position and that of other bank regulators has been that loans sold with recourse to the originator or its affiliate should be classified as collateralized borrowings not as asset sales. Otherwise, such loan sales could be too easily used to keep risk off balance sheets and thus distort capital ratios. Federal Reserve examiners have detailed instructions to take all off-balance sheet risks into account when evaluating the capital adequacy of an institution.

Rapid growth and dynamic innovation have been characteristics of financial futures and options markets since their inception in the early 1970s. The first such contracts that began trading on organized exchanges--futures based on foreign currencies and options based on individual stocks--met with immediate success, and they have grown substantially in trading volume. With this initial experience, the futures and options exchanges were encouraged to introduce other such instruments. Over the latter half of the 1970s and early 1980s, a number of interest rate futures and options contracts, based on U.S. Treasury and federal agency securities and on private debt instruments, were introduced. Trading in many, although not all, of these markets rose sharply from the outset, and it has continued to flourish. Finally, in the early 1980s, the exchanges introduced futures and options contracts based on various stock indexes. Again, these markets attracted wide interest, as reflected by spectacular growth in several of them and broad participation by a wide range of financial service organizations and individuals.

Like their counterparts in traditional commodities futures markets and in the over-the-counter markets for foreign currencies and individual stock options, those participating in the new exchange traded futures and options markets do so to achieve one of two basic purposes. Some seek gains by guessing right on the way that stock prices, interest rates or exchange rates are likely to move. In addition to these speculators who add liquidity to the market and efficiency to the pricing process, there is a wide range of other participants who are in the market to hedge risks that they are exposed to in the course of their ordinary business affairs--that is, to shift their risk exposure to speculators in the market. It is this risk transfer process that provides the fundamental economic justification for these markets.

Congress, in the Futures Trading Act of 1982, directed the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the Federal Reserve Board, with the assistance of the U.S. Treasury to conduct a study of futures and options markets. Since that study was submitted to the Congress in December of last year, I will confine my remarks to a brief summary of its conclusions. Thereafter, I will address in greater detail the regulatory framework the Federal Reserve and other banking agencies have in place to assure that banks participate in these markets in a safe and sound manner.

The main conclusions of the joint agency study are: (1) The new financial futures and options markets serve a useful economic purpose, primarily by providing a means by which risks inherent in economic activity can be shifted from firms and individuals less willing to bear them to

those more willing to do so; (2) these new markets appear to have no significant negative implications for the formation of capital; (3) financial futures and options contracts differ in important characteristics, but have many common elements, and hence, there is a need for close harmonization of federal regulation of these markets; (4) trading in functionally similar instruments under the jurisdiction of the SEC or CFTC does not appear to have resulted in significant harm to public customers of these derivative or related cash markets; and (5) with respect to the various issues examined in the study, no additional legislation appears to be needed at this time to establish an appropriate regulatory framework.

At year-end 1984, only 268 of the nation's 14,500 insured commercial banks reported any futures or forward positions outstanding; 93 banks reported options positions outstanding. Banks with assets in excess of \$5 billion accounted for roughly 90 percent of domestic bank volume in futures and options contracts. Depository institutions have been able to use derivative instruments in hedging and arbitrage activities related to holding securities in bond trading accounts with both activities contributing to the liquidity of the U.S. Government securities markets. In addition, banks have utilized these derivative instruments in managing various segments of their asset-liability positions.

The involvement of banks in these derivative markets is subject to guidelines first adopted by all the regulatory agencies in 1979. The basic objective sought in these actions was to ensure that, the institutions choosing to use these instruments only do so in a way that will

reduce their exposure to interest rate or foreign exchange risk. Prior to engaging in such activities, management is directed to obtain specific authorization from the institution's board of directors. In addition, management is required to develop appropriate internal controls, including position limits and management reports and to establish procedures for market value accounting with respect to open contract positions. State-chartered institutions also first must verify that applicable state law permits them to take positions in these instruments.

The essential trading strategy directed by the guidelines is that institutions should establish positions that hedge their overall exposure to interest rate risk. This concept, while straight forward in intent, is difficult to follow in practice. Hedging as engaged in traditionally in (say) commodity futures markets has been a rather clear cut process. For example, a hedger simply took a "short" position in the futures market to offset a "long" inventory position he had in the cash market. Since future and cash prices tend to be highly correlated, any loss suffered in the long cash position from a decline in market price would be offset by the profit obtained from the short futures position. This simple concept of pairing a short (or long) position in futures against a long (or short) cash position does not necessarily assure that a hedge is established when it comes to financial institutions, however. Due to the complexity of bank balance sheets, the agencies have held that to determine whether a futures or options position increases or reduces risk exposure, it is necessary to consider the interest rate exposure of the entire balance sheet position.

It is important to note that the theory and means for measuring bank interest rate risk continue to be debated and refined. The Board has adopted an extensive examination manual to aid examiners in assessing and evaluating bank and bank holding company use of these instruments. It is our intent to balance prudential concerns against the industry's need for flexibility and innovation. However, in the final analysis, the policy guidelines require that bank management be able to describe and document in detail how the bank's derivative contract activities contribute to the bank's attaining its objectives of interest rate risk reduction.

An additional complication associated with derivative products is the fact that trading strategies linking cash positions and derivative instruments can be quite complex--especially in the fast moving dealer bank bond trading environment where inventory can turn over in a matter of hours or minutes. Rather than analyze the use of derivative products in detail, e.g., attempting to distinguish bona fide arbitrage from riskier forms of arbitrage, System examiners have been instructed to consider derivative products as part of the overall evaluation of trading activities in the relatively few dealer banks we supervise. This pragmatic approach relies on the fact that all cash and derivative positions in a bond trading area are subject to market value accounting, and hence, vital discipline is imposed to prevent excessive risk taking.

The Board also adopted, in 1980, a general policy regarding the appropriate use of financial futures, forward and options contracts by bank holding companies and their nonbank subsidiaries. This policy,

basically the same as that applicable to banks, limits the position that can be taken in these derivative products to those that reduce exposure to risk and requires the establishment, by written policy, of appropriate internal controls and audit programs to ensure adherence to this limitation. The Federal Reserve has also permitted 13 bank holding companies to establish subsidiaries to conduct business as a futures commission merchant (FCM)--that is, as a broker of futures and/or options on future contracts. In addition, permission has been given to one state member bank to establish a subsidiary to function as an FCM (the Comptroller of the Currency has also given similar permission to a number of national banks). Consistent with the Federal Reserve's general policy, these units of the holding company are prohibited from taking a position in the market for their own account except for hedging a cash position.