

FOR RELEASE ON DELIVERY
THURSDAY, NOVEMBER 1, 1979
12:30 P.M. EST

THE FUTURE OF FUTURES .

Remarks by

**Henry C. Wallich
Member, Board of Governors of the Federal Reserve System**

at the

Commodities and Financial Futures Conference

sponsored by the

Federal Bar Association and Commerce Clearing House

Washington, D.C.

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The financial futures markets, since their inception in the mid-1970's, have had a tremendous vogue. In terms of volume, they have been a huge success. The number of contracts outstanding on the four organized exchanges on which financial instruments futures are dealt in is on the order of 200,000. The average daily volume of contracts traded so far this year is about 20,000, compared to about 7,000 for the same period last year. The peak volume occurred in September when over 600,000 financial futures contracts were traded during the month.

Achievements of the Financial Futures Markets

These impressive results are a monument to the power of financial innovation. Forward markets in financial assets have always existed and continue to exist. But organized futures markets, with their homogeneous contracts, reduced credit risk, and low transactions costs have made attractive and accessible to many what previously was of interest only to a few.

Simultaneously with, and in fact somewhat ahead of, the development of the financial futures markets, there has proceeded the development of options markets for common stocks. These have had a similar growth experience, to the point where the exchange traded options volume in 1978 on all exchanges combined had come to equal approximately three-fourths of the volume of the New York Stock Exchange. Many of the considerations applicable to financial futures are applicable also to the options markets.

It is somewhat surprising, nevertheless, that a phenomenon so large and dramatic as the growth of the futures and options markets should have produced so relatively few obvious and visible consequences. The activity in these markets seems to be mostly turnover, with very few net results of any sort. To someone like myself who is more at home in the foreign exchange market, it is not particularly alarming to observe such phenomena as heavy trading among financial institutions with only a very moderate residual of customer transactions, such as is characteristic of foreign exchange markets. In the New York foreign exchange market, the share of customer transactions, according to a survey by the Federal Reserve Bank of New York some time ago, stood at about 5 percent of total transactions, the other 95 representing interbank trading. On the other hand, in the forward market for foreign exchange, which is an important part of total foreign exchange trading, they deliver what they sell.

To underline how strongly some people feel about delivery, let me mention an instance from the Congress. It seems that two administrative assistants were talking about their respective Congressmen. They were not being particularly complimentary. The first AA said, "Your man would sell his old mother for a nickel." "So would yours," the second AA replied. "Yes," said the first AA, "but mine would deliver."

It is true, of course, that the many useful functions that the financial futures markets can perform do not necessarily depend on taking or making delivery of the underlying assets. A position can be hedged, risk transferred, the benefits of less risky and, therefore, presumably cheaper and more plentiful credit realized through contracts that are closed out prior to the delivery date. The financial futures markets perform a kind of unbundling job, such as has been thought desirable in many areas of the economy. They allow the activity of generating assets such as mortgages to be separated from the taking of the financial risk inherent in interest rate fluctuations. They permit the same to lenders, such as banks, who are expert at analyzing default risk but may not want to be exposed to interest rate risk.

Information on expectations about future developments becomes more widely available as speculators and hedgers express their views of the future through the prices they bid and offer. The fruits of possibly very costly research into the business and financial outlook are thus made available to the public through the prices of financial futures.

Some Questions

These are valuable services. The trouble is that the theories that tell us about their availability in principle cannot tell us very much about how important these services are quantitatively. Inquiries into the views of market practitioners, as contrasted with economic theorists, provide a picture of conflicting opinions about the merits of the futures markets that are firmly held but with probably little basis in factual evidence. The Federal Reserve and Treasury surveyed a number of market participants

as part of the study of these agencies into the futures market and discovered one set of opinions that was favorable to the futures markets and another set that was unfavorable. Those who thought well of the markets -- generally the majority -- claimed that the markets provide important social benefits by enabling hedging and improving the general liquidity of markets. They saw no adverse impact on the price of the underlying securities. Activity in futures was thought to be useful for banks. Potential problems could be monitored and controlled. Moreover, usefulness of the markets was expected to improve over time as more potential hedgers became aware of these possibilities.

The other side seemed to believe more or less the opposite on each of these issues. Most of the activity, it was said, was pure speculation, not hedging. Financial futures markets were mainly the preserve of wealthy investors and speculators creating unnecessary risks. There was a serious danger of adverse effects on the underlying securities, such as increasing their price volatility and affecting the level of their price thereby complicating Treasury debt management and Federal Reserve open market policy. The markets also created risks for participating banks.

There seems to be available only a moderate amount of information to resolve these disagreements. We know that the great majority of contracts is closed out prior to their delivery dates. We also know that up until now the number of banks participating is a small fraction of the total banking community. In addition, the market participants interviewed in the Treasury-Federal Reserve study seemed to believe that in the early stages the futures markets were primarily speculative. Nevertheless, all this

does not prove, though it might suggest that the bulk of the activity reflects speculation rather than hedging.

Evidence of impact on the price of the underlying securities is scanty, in large part due to the short lives, thus far, of the financial futures markets. In the commodity markets, the preponderance of the evidence seems to suggest that futures trading has brought about some beneficial smoothing of seasonal fluctuations. Some observers of the financial futures markets have suggested that there may be some very temporary impacts of futures trading on the price of the underlying securities, especially at the time when contracts mature. Some market participants believe that the possibility of a squeeze on the price of particular Treasury securities exists because the deliverable supply may not be fully adequate.

Information from Futures Trading

The value of information supplied about the future as a result of financial futures trading may be questioned on the grounds that the prices in Treasury futures markets tend to differ from forward prices implicit in the yield structure of spot markets. If the futures market says that the Treasury bill rate eight or nine months hence will be 10 percent, and the yield curve says that it will be 11-1/2 percent, who is right? Moreover, given such frequently occurring differences, why is it that arbitrage is insufficient to eliminate them? Transactions costs, minor risk factors, timing difference in the data, or the difficulty of shorting Treasury bills may be responsible. But in any event, the information generated by these competing markets seems to suffer from some fuzziness.

And, granted that there is value in the information provided by the prices resulting from massive trading, one might still ask whether this is an efficient way of supplying information? People who bet on horses are said to believe that their activity encourages racing and thereby improves the breed of horses. People who bet on future prices of securities are presumed to render a valuable service by generating information. One is bound to wonder whether both parties are not trying to do things the hard way. There must be cheaper ways of producing better horses and better information.

The Viewpoint of the Regulator

Whichever way the balance of truth may point, one thing is certain: The futures markets present a challenge to those charged with regulating these markets. They pose fundamentally some of the basic questions that all regulators must confront. Is it appropriate, in a democracy, to interfere with the free play of market forces even if it could be shown that there is no immediate and obvious social benefit to be observed from the play of these forces? All regulation comes at a cost in terms of freedom of markets and self-determination of human beings. In our present environment, given the prevailing mania to regulate everything and anything, the marginal cost of regulation in these terms is particularly high. Do any potential injuries that futures trading might inflict justify this added cost?

Even if it can be shown that regulation would help to prevent some demonstrable abuses, these may well pertain to a small minority of cases. One might ask whether it is justifiable to limit the freedom and

the opportunity for profit of the many in order to protect the few against the consequences of their folly. This question is being answered in the affirmative in much of our contemporary regulation, particularly in the consumer area. I suspect that protection for the few is being bought at an excessive cost to the many.

Looking at the enormous regulatory burden that today falls upon the banks, there certainly is a heavy cost involved in imposing still another regulation on more than 14,000 banks who will have to read and study complicated material until they discover that it pertains to only a small fraction of their number who today are participating in futures markets. The mere presence of this additional regulatory burden may become an obstacle to the entry of more banks into the futures markets.

It is not obvious that it makes sense to try to control, via regulation, a risk in the very limited area of financial futures that is totally pervasive in banking. No bank engages in perfect maturity matching. Every bank, in a sense, is a comprehensive futures contract, with a long position that typically has a longer maturity than the short position. If we do not prevent a bank from buying bonds and mortgages and financing them with demand deposits or 90-day CDs, it is doubtful to me that we should single out the special risks of financial futures for special regulation.

If, however, we accept that some kind of regulation is needed, should it not at least reflect economic reality to the extent possible instead of artificial legal and accounting principles? For instance, does it make sense to allow a bank to engage in futures transactions in order

to "hedge" some particular asset or liability, even if that does not reflect the bank's overall risk exposure to interest rate changes?

A bank may be in a reasonably well-hedged position if both its assets and liabilities are tied to floating interest rates. Would it make sense, under such circumstances, for the bank to hedge separately any particular asset or liability, thereby in effect unhedging its overall position? This is one of the questions that the Federal regulatory agencies today seem to be facing.

Likewise, would it be appropriate to impose position limits on banks, perhaps in relation to their capital, when the degree of their exposure to risk in futures markets may differ widely, for identical dollar amounts, with the maturity of the futures contract? A bank can be safer with a large volume of very short-term futures, particularly if they fit well into its overall balance-sheet exposure, than with a small volume of longer term futures not well adapted to the interest rate risks it faces.

If, as a reluctant regulator, I contemplate questions like these that today confront the Federal regulatory agencies, I arrive at the conclusion that less may be more. Rather than try to write tight rules that will keep many of the banks out of the futures markets and may disorient some of those who enter, it may be preferable to first limit regulation to a requirement that banks establish sensible rules and sound internal controls, and then to monitor the existence of and adherence to these rules and controls through bank examination. Such rules will already be adhered to in well run operations and impose discipline rather than restrictions where needed.

As a regulator, the Federal Reserve today, together with the Treasury, also is required to consider and advise the Commodities Futures Trading Commission (CFTC) on the type of futures contracts that are to be authorized. It has been the particular virtue of our exchanges trading financial futures to provide a framework in which futures trading can take place with minimum credit risk and minimum cost while also limiting the exposure of the trading parties through margin requirements and marking to market. There remain certain risks affecting the issuer of the underlying securities, in particular the U.S. Treasury. However remote, in theory, the danger of a corner or squeeze may appear, under the particular circumstances of ownership of Treasury securities that prevail today, it cannot be discounted altogether. A good share of many Treasury issues today is owned by the Federal Reserve and by foreign monetary authorities, neither of which would be likely to be available to arbitrage special situations. Under these conditions, it is not impossible for a well-financed operator to establish a dominant position in a particular issue. Whether or not such an operator could establish a corner or at least exert a squeeze depends largely on the interest elasticity of the market, namely, the alertness and institutional freedom of action of owners of that issue and adjacent issues. I believe that it is wise to establish precautions against such a contingency, along the lines taken by the Treasury and the Federal Reserve in their advice to the CFTC. Spreading of similar contracts over different months on different exchanges, delivery of securities from a basket rather than restricting delivery to a single security, uniform reporting of positions in new contracts to the CFTC and making sure that exchanges have equally effective rules for dealing with emergencies seem reasonable precautions.

The ingenuity of the writers of futures contracts is not, of course, exhausted in the devising of Treasury and GNMA securities contracts. I find an intellectually fascinating innovation the concept of a futures contract denominated in terms of some common stock index. Such a contract, to be sure, gets away altogether from the concept of a deliverable security. But it fits in with the principles of capital asset valuation and would permit a type of hedging against systemic or industry risk that would offer very interesting opportunities to equity investors. The feasibility of such a contract must remain in doubt until the details have been worked out, but I hope that efforts along those lines will continue.

Misdirection of Risk Taking?

I began my remarks by commenting on the large volume of transactions in futures and options markets by all market participants today. Where such large values are at stake, usually a number of clear facts emerge. This has not been the case in futures markets. We know little about their effects, good, bad or indifferent. The simple conclusion from this might seem to be that if we cannot make up our minds about the nature and consequences of what we see, that there must be less here than meets the eye.

I believe that this usually plausible conclusion does not follow in the present case. There is, I suspect, a consequence flowing from high activity in futures markets and in stock market options that we have not sufficiently evaluated. It has to do with the effect of such trading on the demand for securities, the underlying as well as others. I am not speaking here of volatility or minor price variations when contracts mature. Rather,

it is the absorption of speculative and risk-taking activity into what is essentially a betting operation that concerns me.

Demand for futures and options is not demand for the underlying securities. The willingness to take risks that is absorbed in futures and options markets is withdrawn from the equities markets, among other areas. The supply of such willingness to take risks is not unlimited. Even though the volume of money absorbed by the futures and options markets is small, that is not a proper measure of their effect on the demand for equities. Someone who buys futures or options obviously is a potential investor in equities. In the futures and options markets, one can get a much bigger bang for a buck than by buying into the dull old stock market. I do not know what the bettor then does with the rest of his savings. From the SEC study we do know that only 5 percent of investors questioned in one particular survey said that they were following a strategy of combined options and fixed income securities. Thus, the option buyer apparently does not put his surplus funds into bonds. But given the high risk he runs in his futures and options, he is unlikely to put the rest into stocks. Perhaps he buys real estate, or life insurance. Perhaps he leaves protection of his old age to his pension fund and social security and foregoes significant saving activity in the hope of making a killing on futures and options. It is in this substitution of betting on securities instead of investing in them that the main economic effect of this trading must be sought, to the possibly great damage of our economy which badly needs equity investment.

I do not see a remedy for this absorption of risk-taking capacity into what is essentially a betting activity coming from any regulation or restriction placed on that activity. That, I believe, would be a futile

attempt. Rather, what is needed is to make equity investment itself more attractive. If we could find a good way of eliminating the double taxation of dividends, and if we could limit the taxation of "capital gains" to the taxation of real gains rather than of the capital itself, as inevitably happens after a period of severe inflation, equity investment would again become attractive. It might even then be able to compete with futures and options. Our economy, more than individual investors, would be the beneficiary.