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Statement by

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before the

Subcommittee on Conservation, Credit
and Rural Development

of the

Committee on Agriculture

House of Representatives

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I am pleased to be here this morning to share with you my observations and thoughts concerning the encyclopedic study compiled by the Commodity Futures Trading Commission regarding events in the silver market in 1979 and 1980. However, before turning to that specific subject, let me begin by providing the Subcommittee certain further information concerning this situation which has been assembled by the Federal Reserve. This information supplements the material supplied earlier to the Congress in the Federal Reserve's "Interim Report on Financial Aspects of the Silver Market Situation in Early 1980" and should serve to complete the record with respect to that earlier report.

As the Subcommittee will recall, Federal Reserve interest in the silver situation arose because the combination of events described in the CFTC report produced problems for individual financial institutions which appeared to have some potential for spreading to the financial markets generally in what was already a very difficult and turbulent period. In addition, the Federal Reserve was also concerned about the use of bank credit in connection with the overall episode -- especially in the context of the Federal Reserve's credit restraint program then in effect.

The "Interim Report" detailed the extent, timing and nature of the use of credit by the Hunts and their interests during the period between August 1979 and the spring of 1980. Further analysis and investigation did not yield information which is substantially different from that supplied in the "Interim Report." However, on the basis of this further analysis, there are three considerations which warrant mention: First, it now appears that the peak level of Hunt indebtedness -- including debts to nonfinancial interests -- was $60 million larger than was indicated earlier ($1.825 billion rather than $1.765 billion). This higher level of debt reflects certain broker loans that we were not aware of earlier. Bank credit to the Hunt interests is now estimated to have peaked at about $1 billion.

Second, the timing of the rise in Hunt-related bank credit is somewhat different from that reported earlier. In the earlier report we had estimated that Hunt-related domestic bank credit was approximately $125 million in 1979. It now appears that the amounts of bank credit involved during the latter part of 1979 were somewhat larger than earlier estimated. New information indicates that Hunt-related bank credit was slightly in excess of $300 million by the end of that year. The fact remains, however, that the bulk of silver-related indebtedness developed after the silver price peaked in January and that such credit was apparently used by the Hunts to meet margin calls as the price of silver dropped. During that time frame and until late March, the Federal Reserve had no direct knowledge of the size of the Hunt positions or of the fact that they were financing margin calls by borrowings of any kind.

Finally, we now have information to suggest that in the final 4 or 5 months of 1979, during which the price of silver was rising sharply, the shorts in the market were also using bank credit -- presumably to meet daily margin calls on their short positions. In some, if not many cases, these short positions were hedged against holdings of physical silver. In a sense, therefore, the reversal of the silver price in mid-January had the effect of shifting existing credit of the shorts in the market to the Hunts and others with long positions.

The second major issue discussed in the Fed's "Interim Report" was the $1.1 billion credit line granted to Placid Oil (which is owned by the Hunt family trusts but not by the Hunt brothers themselves) by a syndicate of 11 domestic and 2 foreign banks. In light of the size and nature of the credit, allow me to re-state the circumstances surrounding the granting of the credit -- including the role of the Fed in that regard and then provide the Subcommittee with a current report on the status of the credit.

The credit in question was negotiated between a syndicate of banks, including the then existing creditors, and the Hunt interests. It was entirely a transaction between these private parties operating in their own natural interests. The creditors -- sensitive to overall financial market conditions and to their own exposure -- obviously wished to solidify their positions and remove themselves from any further vulnerability to falling silver prices. The Hunts presumably had a similar concern as well as an interest in consolidating their indebtedness. The credit was a re-structuring of existing debt and did not represent a new extension of credit. In effect, existing credit secured in part or wholly by silver would be replaced by credit secured by the resources and earnings of the Placid Oil Company and supported by the collateralized guarantee of the Hunt brothers.

While we did, of course, have an interest in the outcome of these negotiations, no official of the Federal Reserve initiated or participated in the negotiations. The Federal Reserve's primary concern was that the terms and conditions of the loan agreement were consistent with the Special Voluntary Credit Restraint Program then in effect. In particular, the Federal Reserve had a concern that the proceeds of the loan not be used directly or indirectly to support any renewed speculative activity by the Hunts and that the silver be liquidated in an orderly manner. More generally, the Federal Reserve, in consultation with the other government agencies involved, felt it appropriate that the situation be resolved in an orderly fashion.

The various agreements constituting the credit were executed as of April 28, 1980. Consistent with the position taken by the Federal Reserve, those agreements did provide rigorous covenants prohibiting renewed speculation by the Hunts. In addition, it was understood that the lead banks would provide periodic reports about the credit to bank examination personnel. In the light of these stipulations and arrangements, The Federal Reserve interposed no objections to the loan. Again, it was only because of the coincidence of the Special Credit Restraint Program then in effect that the Fed was able to seek the commitments against further speculation contained in the loan agreements.

Upon execution of the loan, the loan proceeds were used to pay off existing debts and to obtain the release of silver and other assets securing the existing debt. Thus as a result of the loan (1) existing silver related debts were paid off; (2) the collateral for the then outstanding credits, largely the Hunt's remaining silver, was freed and, together with certain other Hunt assets was paid into a partnership formed between Hunt and Placid as part of an agreement; these Hunt assets therefore became the assets of the partnership; (3) the liabilities of the partnership are the indebtedness of the partnership to Placid arising from the cash proceeds of the loan to Placid which were paid into the partnership. Thus, while the old and new creditors are no longer exposed to a drop in the silver price -- they were either paid out in full or are secured by the assets and earnings of Placid -- the Hunts and the partnership remain vulnerable to the silver price.

In the months since the loan was consummated, periodic reports supplied by the banks indicate that the Hunts have refrained from renewed speculative activity. Thus, we are satisfied that the broad purposes and protections that form the basis for the Federal Reserve's decision to interpose no objection to the loan are being satisfied. From time to time, the Federal Reserve has reminded the banks of the importance we give to these protections.

Turning now to the CFTC report, it is obviously impossible to comment in detail on its specifics, so let me focus my attention on a single aspect of the report which in my judgment goes right to the heart of the matter -- namely, could this kind of thing happen again? If so, what are the risks and what, if anything, should public policy do to prevent it from occurring again?

The CFTC report answers the threshold question in the affirmative, and I would answer it the same way. That is, one cannot rule out a similar occurrence, althought I too would consider it unlikely -- particularly in the light of the things that have been done since last spring to strengthen the market and to tighten regulations.

Nevertheless, since one cannot rule out the possibility of a similar event, the question then shifts to the implications of such an occurrence. Obviously, one risk is that market participants might face losses, defaults, and even bankruptcies. In and of itself, that need not be an overriding concern for public policy so long as we are comfortable that market participants recognize the nature of the risks involved in taking positions in these markets. Indeed, markets, by definition, assume there will be winners and losers. And, futures markets, by their very nature, require the participation of speculators because it is only the speculators in the market that allow the hedgers -- whether a farmer or a silver producer -- to protect themselves against future price or interest rate changes. In short, it should not be the job of public policy to protect individual market participants from the risk of loss or failure.

Having said that, let me hasten to add that it is most certainly a responsibility of public policy to insure that unsafe or unsound practices of an individual, a firm, or even an exchange, do not spill over and precipitate major problems in other institutions or other markets. Elements of this spill-over phenomenon were seen in the silver situation, although in the end they were contained.

In considering possible sources of a major spillover from one institution to others or from one market to others, it seems to me that the greatest danger may lie in the admittedly remote possibility of a major default in one of the clearinghouses that are characteristic of all of the futures exchanges. These institutions are carefully structured and have several layers of protection and insulation designed to prevent just such a problem. Indeed, one sign of the strength of these institutions is that even in an event as traumatic as the silver situation no such problem developed. However, there are those who would suggest that we may have come too close for comfort.

Because of this I applaud the initiatives taken or under contemplation by the CFTC over the past year which work in the direction of providing a higher level of assurance against such a problem occurring. Indeed, the use of position limits, the shortening of the time frame given to customers to satisfy margin calls and strengthening capital rules all work in the direction of providing further safeguards. Despite all that has been done I, for one, would not object to considering even further steps to cushion the liquidity strains that can be associated with meeting margin calls in an environment of very sharp short-run changes in futures prices. That result could be achieved with higher levels of margins or, perhaps through some other mechanism that might retain some greater margin of liquidity in the clearinghouse.

In saying this, I don't want to leave the Subcommittee with the impression that I believe there is a fundamental flaw in the design and workings of the markets and the clearinghouses. I don't. However, I do believe that the potential problems associated with a major default are large enough that every conceivable measure of insurance -- consistent with the smooth functioning of the markets -- should be examined.

In closing, allow me to make one further point which is implicit in what I have said earlier and is explicit in the CFTC report. We in the United States are blessed with the most advanced, the most sophisticated, and the most efficient markets in the world. Those traits also imply that most of these markets -- futures and spot, grain and precious metals, government securities and bank CD's -- are highly interconnected and interdependent domestically and worldwide. In turn, most if not all of these markets are directly or indirectly dependent on the banking system as their ultimate source of credit and liquidity, if and when strains arise. Obviously, if we have learned one thing from this experience it is that the tendency for such problems to occur are much greater in periods of financial market uncertainty and turbulence, which in themselves are an outgrowth of an inflationary environment.

While I am confident that the basic institutional and regulatory framework is there to meet and manage problems when they arise, I also believe that the task of insuring the sound and efficient functioning of markets in this period of unprecedented financial change and innovation is more challenging than ever. This hearing and the efforts of the CFTC in completing the study requested by the Congress are both constructive steps in the direction of permitting us to meet that challenge.

Thank you.

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