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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

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Mr. Chairman, I appreciate the opportunity to appear once again before the Banking Committee, today to discuss initiatives to strengthen financial markets in response to the events of last October. I know that there is some developing impatience in the Congress with respect to the speed with which progress has been made in formulating proposals to deal with the questions raised by the October market crash. Let me say initially, though, that while the various reports that have analyzed the crash are extremely helpful, they are limited in addressing some very complex matters. We are caught in the dilemma of concern that latent structural defects will not be quickly addressed and hence, under a repeat of circumstances of last October, similar outcomes would obtain. Yet there is a pervasive and legitimate sense that acting hastily could inadvertently destabilize the markets, creating the very type of episode we are endeavoring to avoid.

Before taking actions, it is essential that we have as clear an understanding as possible of what happened last October, and why. Only when we have identified the structural problems that contributed to the severity and rapidity of the market break can we judge whether or not various proposed actions in fact address those problems. We must carefully distinguish those problems that are self-correcting, or can be addressed within existing regulatory frameworks, from those that will require more fundamental, perhaps legislative, solutions.

As I indicated in my testimony before this committee on February 2, I believe the severity and rapidity of the plunge on October 19th was, in a sense, the outcome of a confrontation between dramatically changing computer and telecommunications technology and unchanging human nature. The new technology has enabled market participants around the world to respond almost instantaneously both to changing external events and to the internal price dynamics of stock and derivative-products markets. In a market of rapid and large price movements, heightened uncertainty and fear leads people to pull back--to disengage, to withdraw from, or avoid, commitments. Where the consolidated positions of all market participants are net long, such as in equities, disengagement means net sales, and hence lower prices.

On October 19th and immediately thereafter, one could observe the interaction between technology and human nature quite clearly: the news of sharply falling stock prices, communicated instantly to a sensitive investment community, triggered an avalanche of sell orders on both futures and stock exchanges. The overloading of the execution systems then induced breakdowns that dramatically further increased uncertainty among investors, which in turn accelerated the bunching of sell orders.

Prior to the availability of sophisticated telecommunications, it took hours, sometimes days, for the news of a price decline to be transmitted to all market participants. This allowed the self-feeding dynamics of falling prices to be stretched out over a longer time period, reducing the shock effect of an unexpected price decline and softening some of its secondary consequences.

To a significant degree, the uncertainties following the crash of last October reflected increasing concerns about the solvency of the participants in the markets, including, in particular, the various clearinghouses. The extraordinary discount of prices of stock-index futures relative to prices of stocks indicates an unwillingness on the part of arbitrageurs to buy futures and sell stocks. Doubts about the ability to execute trades at reported prices may have contributed to this unwillingness. In addition, however, many arbitrageurs evidently feared that potential profits would not be realized because of defaults by one or more participants in the complex clearing and settlement systems for stocks and stock-index futures.

This points clearly to the need to create real-time information systems for monitoring credit exposures that arise from stock trading and, most importantly, to strengthen the financial position of participants in the clearing and settlement process so that arbitrage will not be inhibited. Specifically, there is no substitute for ample capital to allay fears of potential insolvency of the principals on the other side of a contemplated trade.

Financial Developments Since Last October

The immediate uncertainty and fear that surrounded us in mid-October have eased. The passage of time has provided us the opportunity to assess developments in securities markets and the reactions of the private sector to the lessons of Black Monday. As a result, it is becoming possible to distinguish better the self-correcting problems from those that will require more fundamental changes in financial markets.

Our economy has not fallen into recession, as some had predicted; indeed it has shown considerable resilience. This, of course, has had a positive effect on attitudes of investors in private securities. The volatility in securities prices has moderated, and the premia that investors require in yields on private sector debt above yields on Treasury debt have narrowed from the wide levels that developed immediately following the stock market plunge. This improvement has been most noticeable in the short-term markets for bank CDs and commercial paper, but it also has been apparent in longer-term corporate markets.

Even the market for low-rated corporate debt has rebounded. Current risk premia on such bonds average roughly 4-1/2 percentage points above Treasuries, a range that is well below the 6 to 7 points observed in the weeks immediately after the crash. As these interest rate spreads have narrowed, new issues of low-rated companies have reappeared in the public bond market, along with those of higher-rated firms.

Although investor fears have receded, securities markets--especially equity-related markets--still retain the imprints of the October shock. Corporations have not returned to equity markets to raise capital, despite the reduction in stock price volatility. The volume of new stock issued by nonfinancial firms in January and February was the lowest total for these two months in almost a decade.

Activity in stock-index futures and options markets also has been reduced. Trading in the S&P futures contract recently has been 30 percent or more below average daily volumes in pre-crash months. Although the financial integrity of these markets was maintained during the crisis, many participants sustained large losses or experienced close calls. Investors engaged in trading stock-index products appear to have adopted a more cautious attitude since the crash.

One area where greater caution has been especially evident is in sharply reduced reliance on portfolio insurance strategies. The use of portfolio insurance by large institutional investors is thought by many to have contributed both to the high level of share prices reached in late summer and to the heavy selling pressures in mid-October. These strategies presume a high degree of market liquidity and quick execution of purchase or sale orders near prevailing prices. October demonstrated clearly that such liquidity will not be there in extreme situations. As a result, the use of portfolio insurance reportedly has been scaled back dramatically. Unless memories prove exceptionally short, this is one problem, if it is one, that should be self-correcting. I suspect--though I cannot prove--that the October experience has had similar effects on the attitudes of investors about the degree to which they can lock in gains by using stop loss or limit orders, whose execution can have the same effects on the markets.

Meanwhile, the futures and options exchanges have acted to reduce their risk exposure in the event of large price moves. Several exchanges have expanded their use of intra-day margin calls and the major exchanges now have in place procedures to pay out intra-day margins, thereby limiting one source of liquidity pressures evident last fall. Most importantly, virtually all the exchanges have raised the margin levels applicable to stock-index futures and options. Although margin levels for these derivative products remain significantly below margin levels in the cash markets for equities, they may now generally provide clearinghouses and other lenders with roughly comparable protection against credit losses stemming from adverse price movements. Lower margins on futures can provide equal protection because margin payments are required much more frequently than in the cash markets and because stock index prices tend to be less volatile than prices of individual stocks.

The regulation of margins clearly is a controversial issue. Some industry experts, federal regulators, and members of Congress have, of course, made quite different recommendations for reform. This lack of consensus appears primarily to reflect differences in objectives. Most agree that margins should be, at a minimum, sufficient to ensure the integrity of the markets by limiting credit exposures of clearinghouses and of brokers, banks and other lenders to whom the clearinghouses are directly or indirectly exposed. But there is much disagreement about the need for, or effectiveness of, higher margins to control speculation and limit stock price volatility. If margins are deemed important to control leveraged speculation, this implies a much different structure for the levels and consistency of margin requirements across markets than if the objective is simply protection of the market. The appropriate objective of margin regulation is an issue that needs to be considered carefully before any regulatory reforms are implemented.

The steps taken to strengthen margins, as well as other steps under active consideration, are indications of the serious and widespread effort by the private sector to identify and correct weaknesses. As a general principle, it is in the self-interest of the exchanges and associations of market makers to protect and enhance the integrity of their markets. They also have superior knowledge of their own markets. Thus, we should rely where possible on the private organizations to correct the problems that were evident last October.

However, there are some areas where independent actions by private organizations may be counter-productive and where vehicles for desired joint action do not exist. In this regard, I would suggest that the unilateral efforts we have seen to impose circuit breakers, for example, pose potential problems. The recent studies underscore that stocks and stock-index futures and options products are all components of what is effectively one market valuation system. Such linkage implies the need for a regulatory approach on intermarket issues that is coordinated across markets. Prices limits in futures markets, if they become binding, will tend to push traders and investors to the cash market unless similar restraints are in force there. Likewise, trading halts in the cash markets may impair the ability to carry on hedging strategies in derivative markets and derail arbitrage activities.

In a similar manner, markets for equity-related products are linked across countries. Many large financial intermediaries operate across several national markets, and in some instances, their ownership is international. Shares of large American firms often are listed on foreign exchanges, and foreign firms are listed on ours. Indeed many of the world's larger companies trade on a near 24-hour basis on exchanges around the world. Trading hours on domestic markets have been extended to overlap with activity in other time zones, and some exchanges have established formal trading links. At every step, communications systems have facilitated these developments. The forces moving us in the direction of further domestic and international market integration are irresistible. Coping with such change may be challenging, but we should view the process as offering the opportunity for better economic performance here and aboard.

Proposals for Restructuring Securities Industry Regulation

Many people have already concluded that the events of last October reveal a need for fundamental restructuring of federal regulation of the securities industry. I believe that we need to proceed cautiously in this area. There are two criteria that any such restructuring should satisfy. First, restructuring should allow for the continued evolution of financial markets. The regulatory structure should be appropriate not only to the world as we know it today, but, if possible, to that likely to exist in say 1995 and beyond. In particular, the structure must be appropriate in an environment in which cross-border financial activity is even more important than it is today. We also need to frame our regulatory system to deal with the structure of financial organizations--a particularly important issue today, with repeal of Glass-Steagall on the table. And we need to address the issues of the comparative virtues of, and the possible melding of, functional regulation and oversight of consolidated entities. The Congress may decide that partial adjustments may nonetheless be appropriate. But it should do so with the understanding that further restructuring requirements remain on the table.

Second, restructuring should be carefully designed to avoid adversely affecting the efficiency of existing agencies. I am concerned that some existing proposals for restructuring may not satisfy this criterion. For example, the proposed Intermarket Coordination Act of 1988 seeks to address intermarket issues by forming a committee composed of the Chairmen of the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the Federal Reserve Board. This committee is intended to serve as a forum for regulatory cooperation on circuit breakers, margins, contingency planning, information collection, clearance and settlement, and so forth. However, the prospect of such a committee raises several questions that need to be considered carefully. A particularly thorny issue concerns the role of the board members and commissioners, other than the chairmen, of the constitutent agencies. It is not hard to imagine a situation in which these individuals have differing positions from their chairman. Their ability to affect decisions of the Intermarket Committee might be limited, yet they could be asked to implement these decisions and perhaps placed in ambiguous legal positions. Another question to be resolved concerns the scope of authority of the Intermarket Committee. By nature, intermarket issues cut across the interests and policies of existing regulatory bodies. Some mechanism will have to be devised for appropriately delimiting the Intermarket Committee's powers, lest the burden of the committee becomes too great or the existing regulatory bodies become redundant.

Answers to many of the questions I have posed may be suggested by our experience with the Presidential Working Group on Financial Markets. This group should provide a forum for addressing concerns outlined in the proposed Intermarket Coordination Act, and it should indicate the feasibility of such an approach to regulatory issues that cut across markets. I am optimistic that members of the Group will work closely with each other and with the private sector to achieve the goals stated by the President. It would seem appropriate to attempt first to solve our problems in the context of the existing regulatory framework. Nonetheless, it is quite possible that efforts of the Group will reveal a need for some legislative changes. In the Board's view, however, specific legislative proposals mandating a new regulatory structure appear premature.

Once again, let me stress that I sympathize with the concerns of the Congress at the slow pace at which a clear legislative agenda is developing. As I have pointed out, however, market participants have already taken some useful steps. At the same time, the Working Group has begun the task of producing a report, including any necessary recommendations for legislation, within the 60-day deadline imposed by the President.

Thank you again for this opportunity to discuss these very complex and important issues.