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Testimony by

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Chairman

Board of Governors of the Federal Reserve System

before the

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Committee on the Judiciary

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My testimony this morning will review the Federal Reserve's role in the developments surrounding the recent decision of Drexel Burnham Lambert to liquidate its operations. In addition, I will touch on some possible implications of this event.

My remarks will have to be fairly general in nature. The situation is still unfolding and remains in many respects quite sensitive. As you know, Drexel, in cooperation with the authorities, is endeavoring to unwind its business. This process is being undertaken in what we hope will be the least disruptive manner to the markets and to Drexel's creditors. As I will be detailing later, markets appear to have taken the Drexel problems well in stride, but we can not be certain that the full repercussions are as yet entirely apparent. While it is still too early to draw conclusions, the events of the past few weeks do suggest some issues that might merit further consideration, and I shall indicate what some of those are. One further caveat is necessary: these views are my own, and do not necessarily represent those of the Board of Governors, which has not had an opportunity to consider the contents of this testimony owing to the short time between your invitation and the hearing.

Background

The Federal Reserve, especially the Federal Reserve Bank of New York, has been giving the situation at Drexel extra attention for some time. In that time frame, difficulties arising out of criminal indictments involving key Drexel personnel raised concerns about potential risks to the financial health of the firm. The seriousness of those risks deepened as the problems multiplied for issuers in the junk

bond market--a market in which Drexel had played a leading role, and a market that itself loomed so large in the fortunes of the firm.

The interest of the Federal Reserve in Drexel grew in part out of our business relationship with its government securities subsidiary. This subsidiary is a primary dealer--that is, it was sufficiently strong financially and sufficiently active in the government securities market to warrant its use as one of the forty-four firms with whom the Federal Reserve Bank of New York conducts transactions relating to open market operations. The Federal Reserve Bank of New York carefully monitors the condition of all the primary dealers to ensure that they remain sound counterparties and reliable marketmakers.

Our concern about the condition of Drexel also reflected our more general interest in the continued smooth overall functioning of the financial markets. Congress has given us authority to act as lender of last resort through our discount window for depository institutions, recognizing their central position in the payments system and their use as a repository for a key portion of the wealth of households and businesses. Our direct authority to lend outside of depositories is severely circumscribed--and we have not done so since the 1930s.

But we do recognize a broader responsibility to the financial system. After the stock market break of 1987, we carried out this responsibility by providing an extra measure of funds through open market operations. These operations were designed to meet any unusual demands for liquidity, and, more importantly, by so doing in an open manner, to assuage fears and bolster confidence. At that time we also monitored carefully the provision of credit in securities markets.

Then, as now, our concern was not with the fortunes of a particular firm; rather it was and remains the orderly operation of the financial markets, because that is a prerequisite for the orderly functioning of the economy. We were monitoring Drexel in part to ascertain whether its difficulties, should they mount, might have more general implications for the functioning of financial markets.

The developing situation at Drexel and the role of the Federal Reserve

Against this background, late last year and early in 1990 the Federal Reserve Bank of New York began to receive reports that creditors and counterparties to Drexel were becoming more cautious in the amounts, terms and conditions of credit extensions--including intraday credit--to Drexel. In this same period, Drexel's commercial paper was downgraded, effectively reducing its access to this source of funds. It also came to our attention that as funding for the parent corporation ran off, the firm was upstreaming excess capital from its broker-dealer subsidiary. Consultations were stepped up among concerned agencies and parties, including the Federal Reserve Bank of New York, the Board of Governors, the Securities and Exchange Commission (SEC), the U. S. Treasury, and the New York Stock Exchange (NYSE) as well as Drexel.

By early this month it became apparent that Drexel had lost the confidence of many of its lenders and clients. In these circumstances, it is important to note that the precise financial condition of the firm rested on an evaluation of a large portfolio of loans and securities--including bridge loans and "junk" bonds--whose worth was difficult to assess. Moreover, the ongoing profitability of the firm was likely to be impaired by the declining prices and dwindling activity in junk

bonds. As doubts emerged about the ability of Drexel to meet its obligations in a timely and predictable way, it suffered what in banking terms would be called a "run". The run extended across the various units that make up Drexel--including both regulated and unregulated affiliates, and including affiliates that seemed to be solvent, as well as those whose status was in doubt. It is important to recognize the depth and breadth of the problem. To be sure, the firm defaulted on a relatively small proportion of its obligations, but this was seen by many as only the tip of the iceberg, an indication that many more such problems and difficulties would be forthcoming absent drastic action. Continuous and unimpeded access to credit is the lifeblood of any financial concern, which must in effect refinance itself on a daily basis, and creditor confidence is the foundation on which such access is built.

Drexel recognized the need for action to restore confidence in its ability to continue as a going concern over the longer run. The firm apparently explored several options, including raising fresh external capital and selling all or a portion of its operations. In the face of its lack of success, the government authorities, after careful and frequent consultation, determined that consideration should be given to an orderly shrinkage of the firm to minimize the chance of spillovers from Drexel's difficulties, helping to maintain the integrity and smooth functioning of our financial system more generally. There was likely to be some dislocations caused by the dissolution of Drexel, for creditors, employees and customers. Nonetheless, the fundamental structure and soundness of the securities markets and financial system and its ability

to channel funds to those who could make the best use of them was unlikely to be impaired by the failure of this single firm, provided it was carried out in a generally orderly way.

Consequently, the Federal Reserve, working with other federal authorities, the New York Stock Exchange, and numerous private parties, focused on an orderly winding down of Drexel's business, especially that done in the regulated entities--the government securities subsidiary and the broker-dealer. These entities were not included in the bankruptcy filing of the parent corporation. The Federal Reserve gave particular emphasis to efforts aimed at the orderly shrinkage of the government securities affiliate, in light of our primary dealer relationship with this affiliate, and our heavy involvement in this market as a key participant and fiscal agent for the Treasury, and continuing concern for its orderly functioning. The New York Fed issued a statement to let the market and the public know we were monitoring the situation carefully, and its staff was in close and continuing contact with Drexel and other market participants in order to help facilitate the orderly winding down of its position. Moreover we cooperated closely with the SEC, the NYSE, banks and other market participants as they worked to resolve the broker-dealer. Throughout this process there was close and continuous consultation among the Federal authorities, including the Treasury Department and the SEC, to exchange information and discuss issues.

Our activities had several dimensions. For one, we kept our wire facilities open unusually long hours, as did the banks that cleared for Drexel. Through extraordinary efforts of both the private

and public sectors, the complex mechanisms for transferring securities and funds worked, at least in a mechanical sense. Other problems arose, however, that threatened to derail the process of winding down the firm. Many firms doing business with Drexel, quite naturally and understandably, were exercising extreme caution in their transactions with Drexel. One effect of this attitude was a possible "gridlock" in the exchange of securities, foreign exchange positions, and cash, which could have hindered the orderly sale of assets and unwinding of positions. We had numerous discussions with the private parties involved in these transactions to determine what the problems were and solicit suggestions for their resolution. In our discussions we made it clear that these parties needed to make their own strategic and business judgments. We looked for ways we could be helpful to facilitate the resolution of problems, including offering to provide space at the Federal Reserve Bank of New York where parties could meet. In addition, we had in place detailed contingency arrangements to assist directly in the exchange and settlement of mortgage-backed securities and other instruments had such arrangements proved necessary.

Owing to the efforts of all concerned, substantial progress has been made in winding down the firm. The government securities entity has little remaining on its balance sheet and has very small residual financing needs, which should be reduced even further in coming days. The broker-dealer also is considerably smaller than a few weeks ago and important off-balance sheet positions have been transferred to other parties or unwound. Still, the process is far from complete, both in the regulated entities and elsewhere in the firm. With the easiest and

cleanest transactions having naturally been completed first, remaining positions may be slower and more difficult to resolve.

The orderly nature of the unwinding process probably has contributed to the relatively calm reaction in financial markets. In addition, Drexel's difficulties had been building for some time, and in certain respects were well known. As a result, the firm's demise was not entirely a surprise, though the particular timing and speed of the downfall may have been. There was a small flight to government securities when the situation seemed particularly uncertain, but that was quickly reversed. In the market where Drexel had been most prominent, that for junk bonds, price reaction also was fairly mild. Drexel had begun to reduce its participation in this market some time before, and the market was focused on the effects of the difficulties of some prominent issuers, rather than of investment banks.

This market reaction tends to validate the judgment that the failure of Drexel, while a tragedy for the many involved, did not present undue risks to the orderly functioning of the financial system or the economy. It is highly likely that other firms will step in to fill the gaps left by Drexel, including picking up that part of the issuance of high yield bonds that represents a legitimate source of funds for smaller and riskier businesses. Yet, complacency would be a mistake. Lenders to investment banks and other intermediaries may become more cautious. In moderation, this should promote greater efforts to enhance the soundness of these borrowers, by capital infusions and other means, but a more general and indiscriminate loss of confidence would impair the ability of institutions and markets to

perform needed functions. I stress that we see no evidence of this, but clearly it is a situation that will have to be carefully monitored. Moreover, the task of winding down a firm of this size is always one that entails at least some risk of more generalized problems and dislocations.

Issues for further consideration

As I noted in my introduction, it is far too early to draw hard conclusions for public policy from the experience with Drexel. Nonetheless, certain issues have emerged that might merit further consideration.

First is the need for our financial institutions to have ample capital and to have arrangements in place to obtain more capital in an emergency. Capital, and in particular tangible net worth, is the bedrock of lender confidence that funds can be repaid. To the extent a financial intermediary is holding assets that may be hard to liquidate on short notice, or whose price may fluctuate or is difficult to determine, greater levels of capital will be required to maintain the needed degree of confidence. Capital adequacy is an issue we have stressed in our oversight of the banking system, and it has been a key element in the SEC's regulation of broker-dealers, but it is a more general problem in our economy--for both financial and nonfinancial firms.

A second set of issues arises out of the structure of Drexel. Drexel was a holding company with both regulated and nonregulated subsidiaries, separately incorporated and capitalized, though engaged in complex transactions among themselves. Problems in one area of the firm

could not be isolated, and quickly spilled over into other areas, some of which may have been fundamentally sound. The government securities affiliate, for example, seems to have been adequately capitalized, and engaged in no unusually risky activities. Yet it, too, found its access to credit curtailed when questions were raised about the health of the parent company and other affiliates.

This experience raises a number of questions about the separation of activities in financial holding companies, and about the possible need for an overview of the entire holding company, both regulated and nonregulated entities. In this regard, collecting information from the nonregulated entities to get a fix on their risk profile, though not without its pitfalls, might be a sensible first step to consider.

A third category of issues arises from our experience with the various clearing and settlement systems as the firm was unwound. The combination of huge positions on the balance sheet and substantial off-balance sheet activity for any diversified financial intermediary implies massive flows of funds and securities on a daily basis. The clearing and settlement systems for these flows work reasonably well in the ordinary course of business. As in October 1987, it takes extraordinary circumstances to bring to the fore potential problems with these systems. As Drexel attempted to sell its securities positions, to unwind its foreign exchange book and to manage various positions in commodities markets, it became clear that the time lag between exchanges of financial instruments and the delivery of payment for those instruments in most settlement systems was a problem when parties to the

transaction were concerned that an event, like bankruptcy, might intervene. One system that did not experience such problems was the book-entry system for government securities. This system works on the basis of payment against delivery, eliminating the time lag, and facilitating deliveries in the unusual circumstances prevailing. Although it would embody a major change to current practices, thought might be given to the feasibility of extending this type of settlement and bookkeeping procedure to other markets.