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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Commerce, Consumer, and Monetary Affairs of the

Committee on Government Operations

House of Representatives

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Before turning to the substantive questions in your letter to me, Mr. Chairman, let me say I am aware of a good deal of confusion, misinterpretation, and questions engendered by the initial press reports about my, or the Federal Reserve's involvement in certain loans to Hunt interests. In the circumstances, I particularly welcome this opportunity to outline my role, and that of the Federal Reserve, with respect to assessing the financial repercussions of recent silver market speculation.

As you are no doubt aware, the Federal Reserve has no statutory or other authority over commodity markets in general or the silver market in particular, nor over brokerage or commodity houses buying and selling commodities for their own account or for others. We do have supervisory responsibility for member banks, but, with one exception, our legal authority does not reach to particular loans to particular customers, nor are we ordinarily informed of specific loans or lending decisions except as part of the ex-post examination process. The Federal Reserve does, of course, have a general interest in developments in any market that bears significantly upon economic and inflationary developments, and particularly on developments that may affect the safety of our financial institutions, most especially banks.

Because of that general interest, I did initiate inquiries of other agencies with direct responsibility for, or sharing a general interest in, the performance of the commodities markets when reports and rumors first surfaced last fall of unusual speculative activity in silver. Those discussions led to little or no specific information beyond that publicly available. On October 6, 1979, the Federal Reserve did make a general request to banks to refrain from speculative lending as part of the credit restraint program introduced at that time. That action was not specifically directed to the silver market, but did reflect our growing concern about speculative price developments in a number of sensitive commodity markets. Indeed, as we indicated at the time, the highly speculative atmosphere contributed to our decisions with respect to monetary policy generally.

We continued to follow price developments in the silver and other commodity markets as part of our normal economic intelligence throughout the fall and winter. During this period, we had no knowledge, apart from rumors reported in the press, of the size or value of the Hunt positions in the silver market, or of any bank lending against silver. As you will recall, prices moved sharply higher in December and January, amid intensified inflationary expectations, but began to fall rapidly after an environment of intense credit restraint developed. In January and February, the organized commodity exchanges also acted to increase margin requirements substantially and to limit individual positions.

The first indication I had of any potentially serious financial consequences arising from the sharp fall of the silver price was in an urgent call at midday on Wednesday, March 26 from a leading brokerage house, indicating that Hunt interests were failing to meet substantial margin calls and that certain loans the brokerage house had with banks, secured by Hunt silver, were either undermargined or in imminent danger of becoming undermargined. As a result, the firm was concerned that its capital position could fall below certain requirements imposed by the SEC or the New York Stock Exchange if the silver price continued declining, and if further margin calls went unanswered.

I immediately alerted the Chairmen of the Commodity Futures Trading Commission and the Securities and Exchange Commission, as well as Treasury officials. That afternoon, as well as in ensuing days, the concerned agencies urgently began to develop further information about the extent of the Hunt involvement in the commodity markets and the potential exposure of other brokerage houses, commodity dealers, and commercial banks involved in Hunt business. While precise and comprehensive data were difficult to obtain, it quickly became apparent that hundreds of millions of dollars were involved in silver credits or personal loans of one form or another. There were also large amounts of credit outstanding to various Hunt business enterprises; while those latter credits basically appeared to grow out of ordinary business requirements and to be well secured, the close relationships of those businesses to the Hunt family warranted close scrutiny of the degree of insulation of those credits from the personal fortunes of the family.

During this period, careful consideration was given by me and others to possible action by the Federal Government with respect to the silver market, but in the event no special government action regarding the markets was deemed appropriate and desirable. The Federal Reserve, itself, as I noted earlier, has no authority over commodity markets or brokerage houses. However, among other things, the SEC and CFTC undertook to inspect the position of certain brokers or commodity dealers with Hunt-related accounts, and both the Federal Reserve and the Comptroller's Office, using examination authority where appropriate, began to develop more detailed information on the extent of commercial bank loan exposure, including information on the collateral or other security for loans to the Hunts and Hunt-related companies.

Late on Friday, March 28, I learned of some particularly large forward contracts providing for the purchase of silver by Hunt interests from the Engelhard Minerals & Chemical Corporation at prices far above the current market. Settlement was due after the weekend, with no apparent prospect for payment. Engelhard, while itself in a strong profits and asset position, felt they might be faced with a decision on Monday to sue the Hunts for payment, forcing probable bankruptcy and possibly triggering massive liquidation of silver positions to the peril of all creditor institutions (and indirectly placing in jeopardy the customers and creditors of those institutions in a financial chain reaction). The alternative, as the company saw it, was to negotiate with the help of some banks a credit to the Hunts or intermediaries that could provide time for repayment and avoid forced liquidation of silver in an already nervous, depressed market. The precise nature of the proposed credit was rather vague to me, but the question did arise as to whether such a credit would in any way be considered speculative within the context of our credit restraint program.

After informing other government officials of this development and considering all the implications of the matter, I interposed no objection to Engelhard pursuing whatever negotiations the company felt essential to protect its own position, but made it quite clear that the net result should not be to free funds for renewed speculative activity by any of the parties. In view of the wider implications, I asked to be kept informed of the progress of any negotiations.

While fulfilling a speaking engagement before the Reserve City Bankers Association meeting in Boca Raton, Florida that weekend, I learned that the Engelhard and Hunt interests would together approach a group of banks with a refinancing proposal late in the evening on March 30 in Boca Raton. While the nature of that proposal was not known to me, I asked to be kept informed because of the potential implications for the silver and financial markets. Subsequent to the negotiation (and well after midnight), I was informed that the banks had, or planned to reject the proposal by the Hunts and Engelhard on business grounds. Neither I, nor any other government official, either instigated or guided these negotiations.

Following the rejection of the proposal to consolidate and restructure the Hunt silver indebtedness, negotiations proceeded through much of the night directly between the Hunts and Engelhard. The results of those negotiations, involving in part the transfer of certain oil properties owned by the Hunts to Engelhard, became known to me in the morning, and were announced the same day. This exchange of assets for the Hunt indebtedness to Engelhard involved no credit extension.

In the following days, the Federal Reserve and other agencies continued efforts to develop more comprehensive information on the extent of Hunt and Hunt-related obligations and to appraise the potential vulnerability of banks and other intermediaries. While very large amounts of credit remained outstanding, those creditors who had appeared to be in the most vulnerable position appeared to have extricated themselves, albeit with some losses (some of which, at least, have since been recouped). Together with representatives of other agencies, I also turned attention to ways of developing means of avoiding further extreme speculative episodes of this kind in the future, with all their implications for the stability of financial institutions and financial markets.

The credit referred to in recent press articles first came to my attention in a general way at the initiative of one of the lead banks involved on Easter weekend. By that time, lending banks had more fully appraised their overall exposure to Hunt interests and had reached at least tentative conclusions regarding the value of available Hunt assets and those of key Hunt-related companies. A small group of banks developed a concept over the next few days about a method of restructuring the Hunt silver indebtedness in a manner that would greatly strengthen the security position of creditors with outstanding silver loans or contracts. In the process, new creditors would in some instances replace existing creditors, while other creditors would essentially exchange old loans with new. The new bank loans would be to and secured by the assets and earning power of, perhaps the strongest of the Hunt-related companies, the Placid Oil Company. Control over the silver and silver contracts, with appropriate safeguards, would pass into the hands of that same company. Silver-related loans to the Hunts would be paid off. The immediate purpose would be to protect more securely the interests of existing Hunt silver creditors, bank and non-bank. That result, in itself, was not, and is not, contrary to the broad public interest in the stability of financial markets and institutions.

I recognize that the outcome, while plainly desirable in the interests of the creditors and financial stability generally, could have as a by-product some stabilization of the financial position of the Hunts themselves. For that reason, my particular concern was that the funds not be used, directly or indirectly, to support new speculation by Hunt interests in the silver or in any other commod market. Moreover, while the creditors and others have a legitimate interest in not <u>forcing</u> liquidation of silver in an unreceptive market at the expense of their own stability, that of other institutions, and the market itself, continued concentration of a massive silver position in the hands of one family or institution is fundamentally unhealthy for the performance of markets.

The bank negotiators indicated they fully understood my concerns on these issues; they have assured me that all parties to the potential loan agreement recognize and share the concern.

On that understanding, and after consulting with other government agencies, the bank negotiators were informed that our main concern was that the loan be structured in such a manner, through appropriate covenants or otherwise, that the funds not directly or indirectly be used for speculative purposes; that indeed the parties to the agreements refrain from silver and other speculative commodity purchases for the life of the loan. Provided that stipulation could be met, the banks could reasonably conclude we had no objection, within the framework of our loan restraint program, to the negotiations proceeding along the lines of the general concept of the financing arrangement as a whole as outlined to me. The business and credit judgments involved are, of course, entirely their own.

I would emphasize, too, that the arrangements, if completed, will be essentially a restructuring of existing obligations rather than fresh credit, although the total of new <u>bank</u> loans could exceed outstanding <u>bank</u> loans. The difference would reflect refinancing of obligations on futures or forward contracts or loans extended by brokerage houses from their own funds.

As the negotiations proceeded, I suggested to the banks that they describe the nature of the financing in writing so that I could respond in writing to pin down explicitly the safeguards against speculative activity. As a step toward that end, I and my associates met with bank representatives, as well as with outside counsel involved in writing the loan agreement, so that a clear understanding could be conveyed as to the nature of those safeguards.

These negotiations were then, and are today to the best of my knowledge, incomplete. I believe a fair conclusion from my discussions with the banks would be that the Federal Reserve would not object to the conclusion of the negotiation -- indeed would have no reasonable basis for such an objection in the framework of the loan restraint program -- provided the restructuring of the indebtedness in the manner indicated did not contribute to fresh speculative activity. That remains my judgment today.

I hope this recital makes it evident that neither I, nor any Federal Reserve or government official, instigated or guided the negotiation of the credit. I did repeatedly insist that any possibility of fresh speculation by Hunt interests be avoided, while not barring orderly resolution of the potential credit and market problem. Indeed, we can count ourselves fortunate that while the Hunt family bears the losses and the residual risk, the fabric of our financial institutions has been unimpaired and, assuming the negotiations are completed, we will have in place protection from renewed Hunt speculation.

The larger issues remain. There is evidence indicating that there was an attempt to control the supply of a significant commodity; to some degree, this stimulated uncertainty and inflationary expectations more generally. As the market price declined, funding of the speculative positions required substantial amounts of credit, and certain market intermediaries had, wittingly or not, committed an excessive amount of their own capital in support of speculative activity in one commodity by a single group of people. As the market values collapsed, some of those institutions were placed in jeopardy, and their failure could in turn have triggered financial losses for others and severe financial disturbances. Even today, a substantial fraction of the privately held stocks of silver remains concentrated in the hands of one group -- an unfortunate heritage of the past.

Organized commodity markets perform important economic functions. They provide a means for producers, middlemen, and consumers alike to hedge positions acquired in the ordinary course of business, facilitating production and commerce. They encourage broader participation in markets, including the kind of "benign" speculation that assures market liquidity and bridges temporary imbalances in ultimate supply and consumption. The markets provide for both buyer and seller a clear set of price quotations established in highly competitive markets.

If the markets are to perform these functions, the costs to those participating in the market cannot be too high, but the legitimate "hedgers" and "speculators" that together make the market cannot effectively function. Yet, those same low costs can attract an unhealthy kind of speculation, exemplified by the Hunt activities. At the extreme, while it is very rare, situations can arise in some of the more limited markets where relatively few operators (or even one group) may be tempted for a time to operate in such a manner as to virtually control the available supply and push the price to extremes in the hope of reaping extraordinary profits.

In the end, the best defense against that type of behavior must be the discipline of the market itself. History is replete with efforts at "cornering" that failed. I hope the recent silver experience has had a chastening influence. But memories are short; human greed leads to temptation; and an attempt to corner, successful or not, can be extremely damaging, not just to the speculator, but to all those who count on the stability of markets and financial institutions.

The question is how to minimize the dangers -- arising rarely -- without smothering the markets in their useful -- even indispensable -- everyday work. I have no specific recommendations to make this morning about the structure and regulation of these markets. Indeed, I would caution against striking out with hastily conceived restrictive legislation with respect to organized futures markets. Those markets already have some considerable financial safeguards embedded in their structure. One danger from excessive regulation or the imposition of heavy costs is that activity will shift to unregulated channels here or abroad, potentially leaving the markets more vulnerable than before to manipulation or credit weakness.

I do not suggest at all that the status quo should be left unquestioned. In discussions with colleagues in government, I have urged that the interested agencies sponsor, and complete within the shortest feasible time period, a dispassionate study drawing upon thinking and experience outside the government as well as within -- and the simple fact is the requisite knowledge and experience within government is limited. Specific questions of the amount and form of margin requirements, of position limits for traders, prudent capital requirements for market middlemen, and other issues are sure to be relevant, and no single reform is likely to provide a complete answer.

I am simply not able today, in so highly specialized an area, to indicate with any confidence detailed judgments on these questions; indeed, I believe it would be unwise to do so before I can benefit more fully from the thinking of others familiar with market needs and problems. But I assure you I intend to pursue this matter, and to share my conclusions with the relevant Committees of the Congress.

Finally, I cannot refrain from emphasizing that the environment of inflation, and the uncertainty and doubts about the future that accompany inflation, provided the fertile breeding ground for the recent speculative activity in commodity markets generally --

speculation that reached an extreme form in the case of silver. Stable, well functioning markets ultimately depend upon a sense of stability and confidence in our currency -- and certainly that sense of stability is at the center of our policy considerations in the Federal Reserve.

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