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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

United States Senate

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Mr. Chairman, I welcome the opportunity to outline the preliminary views of the Board of Governors on S. 2704, which would authorize the Board to impose margin requirements on a broad spectrum of "financial" instruments in both the cash or "spot" markets and in the futures or forward delivery markets. The Board shares the concerns -- growing out of recent developments in the silver market -- that have prompted these hearings and, in that regard, I have appended to my statement an "Interim Report" on the financial aspects of that situation. Rather than delve further into the particulars set forth in that Report, I will use the time provided for my statement to comment on underlying issues to which S. 2704 is directed.

The Federal Reserve does not have direct statutory or regulatory authority over any commodity or financial futures market. We do have statutory authority to establish margin requirements for the purchase or carrying of equity and equity-type securities, including stock options. And, in cooperation with the Treasury, we have a more limited and informal oversight role with respect to the government and government-related securities markets.

While our direct authority does not extend to the "futures" markets, the commodity markets generally, or the gold and silver markets specifically, we do have a continuing interest in the performance and functioning of those markets. That interest arises in several contexts. For example, to the extent that price trends in those markets, or in segments of those markets, radically depart -- for whatever reasons -- from general price movements

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(as was the case with gold, silver and other commodities during late 1979 and early 1980) they can directly and indirectly fuel inflation and inflationary expectations. Recurring headlines detailing the substantial and cumulative rise in gold and silver prices, for example, surely worked to reinforce inflationary expectations in 1979 and early 1980. Indeed, it was largely for this reason that the Federal Reserve, in October 1979 and again in March 1980, called specific attention to speculative tendencies in the commodities markets and requested banks to avoid speculative lending.

The Federal Reserve's general interest in these markets also stems from its responsibilities for promoting the efficient and effective functioning of the financial markets. That interest is obviously more pointed in certain interbank and government securities markets, but financial markets in the United States and around the world have become integrated to the point where it is very difficult, as a practical matter, to segregate one market or one institution from others. For example, some of the institutions with the greatest exposure in the silver situation had far flung activities in many other markets. Had one of those institutions become insolvent, the problem would have quickly spread to other markets, many of which are far removed from silver. Because of the interdependence of our financial markets, the Central Bank must be prepared to take appropriate steps to insure the continued viability and integrity of the markets, particularly in times

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of stress. To fulfill this function, the Federal Reserve must have at least a general awareness of trends and developments in all sectors of the financial markets.

Finally, the Federal Reserve has a direct and immediate interest in the extent to which credit is used to finance transactions in financial markets. That interest can take any of several forms, including a concern about credit-financed speculation, a concern about the diversion of credit from other uses, or a concern that an excessive use of credit for these purposes can ultimately threaten the safety and soundness of individual financial institutions. In the recent silver situation, it would seem that, at least to a degree, all of these areas of concern were present.

Any approach to the regulation of these markets must start with a recognition of the character of the markets themselves. Some tend to use the term "futures market" as if it were a clear term of art which conveniently encompasses the full range of instruments and assets that are traded for forward delivery. In fact, all one needs to do is look at the pages of the Wall Street Journal to capture the diversity of these markets. We tend to think of futures markets as essentially related to agricultural products when in fact a wide range of financial instruments -- for which there is no underlying tangible asset -- are now trading on the futures markets. Trading in these instruments began only about 5 years ago and in the relatively short time since then has grown very rapidly.

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Further, in most cases, futures markets are inexorably tied to an underlying asset that trades actively in cash or spot markets, not just here in the United States but around the world. These markets, whether viewed from the perspective of the relationship of the "spot" price to the "futures" price or from the perspective of the London price to the New York price,are highly interdependent. That interdependence is a reality which must weigh heavily in our deliberations as to the appropriate regulatory framework for the future. At the extreme, for example, we must recognize that excessive regulation may simply work to drive activity off the organized exchanges or offshore where the threat of abuse to the detriment of our own investors and institutions might be increased.

All of this serves to underscore the Board's reluctance to endorse a specific regulatory approach, or even a broad regulatory philosophy, until it has had more time to study the issues. To that end, the Federal Reserve, in consultation with other government agencies, has undertaken an intensive study of these markets with a view toward developing specific recommendations to the Congress for legislative action. As a practical matter, I doubt that we can have even preliminary conclusions before midsummer. I do not want to anticipate the results of that considered review. I do, however, have some more general thoughts on the problems which S. 2704 seeks to address.

At this point, I am tentatively inclined to the view that all forward and futures instruments should not be treated alike.

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More specifically, I believe that the distinction drawn in S. 2704 between "financial" futures and other forward-type instruments may be appropriate from the viewpoint of public policy. Certainly, futures in Treasury securities, foreign exchange, and perhaps gold and silver, to name a few, do have characteristics -- including low costs of transportation and storage in proportion to value -- that distinguish these instruments from futures in wheat or other agricultural products. There is some evidence that speculative, as opposed to hedging, activity tends to be proportionately greater in those markets. "Financial" futures, moreover, are of more direct and immediate interest to the Treasury and the Federal Reserve than are the traditional agricultural futures, given our general responsibilities.

The bill now before this Committee would seek to regulate these markets through the use of "margin requirements." Such requirements might take the form of limiting the use of credit to finance transactions, establishing minimum cash or other deposit requirements associated with the acquisition of such instruments, or both. Margins can be a useful tool for limiting speculation, but their use in the context of the futures market is quite different in substance than is the case in the equity markets.

Margins on futures contracts, as the markets are now organized, are simply a kind of performance bond to assure that contractual obligations are met. Unlike the case in the stock

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market, no cash payment (apart from the margin requirement) is necessary at the time a futures contract is acquired. Because of this, and because of the need to keep capital costs for legitimate market participants low, initial margins on futures contracts are very small -- normally only large enough to cover one or two days maximum movement in price. Setting higher initial margin requirements would work to dampen speculation by reducing leverage but will also work to drive participants out of the market, thereby reducing liquidity. Thus, it is not apparent to me at this time that the level of the initial margin -- of and by itself -- can be the sole, or principal tool, for reaching the speculative problem in all these markets. In this connection, it seems to me worthwhile to explore the possibility of differentiating between classes of instruments and classes of market participants for purposes of setting initial margins.

There is another aspect of margins on futures contracts -- that of maintenance margins -- that is appropriately recognized in S. 2704 as an area of concern. Under current procedures, futures contracts are marked to market daily. Thus, when the price of a contract rises, those holding short positions must make daily cash payments to satisfy the maintenance margin. These cash payments are transferred through the exchange clearing house and paid out to the long position. In the recent silver episode, it was the maintenance margin and the daily marking to market with corresponding cash payments that triggered the substantial use of bank credit. This same mechanism also permits

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the pyramiding of positions as prices are rising. This raises in my mind the question of whether it might be appropriate -- at least in some circumstances -- to withhold cash payments from those on the "plus" side of the market in connection with the daily marking to market.

Margin requirements are only one possible approach to preventing abuses in these markets. I expect therefore that our study will examine alternative or complementary regulatory approaches, such as position limits and increased monitoring of positions across exchanges and across markets. It may be that these or other approaches will be found to be equally effective in forestalling potential problems. In any case, I would not want to rule out such a possibility before the study is completed.

There is also a question as to how margin requirements (or other regulatory tools) should be administered. I can understand a certain logic of placing any such authority for such financial futures with the Federal Reserve, partly because there is no other natural, logical forum. I must confess to a sense of uneasiness arising from the potential complexities of effective regulation of these markets, with all of its implications for staffing requirements and for demands on the time and energy of the Board. I believe I can tell you the Board does not eagerly seek this authority. At the same time, we are willing to approach the subject with an open mind should legislation of the type proposed be pursued.

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It is conceivable that a regulatory plan could be modeled after the Municipal Securities Rulemaking Board; in other words, a self-regulatory organization made up of industry representatives, but whose decisions would be subject to oversight by one or more government agencies. However, I believe that the judgment as to the most appropriate body to administer any regulations that are deemed appropriate can best be made in the light and the conclusions of our study.

My concerns about the appropriate approach to regulation of these markets should not be misconstrued. In the aftermath of the silver situation, the nagging problems in other areas of these markets, and their continued explosive growth, I am firmly of the view that a clearer focus for some form of government oversight and regulation, taking account of the credit aspects, is needed. We fully expect, upon the completion of our study, to report back to the Congress with specific recommendations, or a more detailed reaction to S. 2704, taking full account of issues surfaced in market developments and in these hearings.

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