



Stability of Financial Markets: Federal Reserve Responsibility?

Remarks by

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at the

IMF Institute Seminar

on

The Events of October 1987

Washington, DC

May 11, 1988

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- Are government programs being carried out in compliance with applicable laws and regulations, and are data furnished to the Congress on these programs accurate?
- Do opportunities exist to eliminate waste and inefficient use of public funds?
- Are funds being spent legally and is accounting for them accurate?
- Are programs achieving desired results or are changes needed in government policies or management?
- Are there better ways of accomplishing the programs' objectives at lower costs?
- What emerging or key issues should the Congress consider?

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approximate 4,000 professionals GAO has to cover all functions of the government, we spend about 100 staff years on work looking at the financial institutions and market area. On key assignments our staff go wherever necessary, working on-site to gather data, test transactions, and observe firsthand how federal programs and activities are carried out.

Over the years GAO has been in the forefront of developing professional standards for audits and evaluations. Our prescribed standards are widely recognized and followed by federal, state, local and many foreign government auditing organizations. Two of the most important standards are independence and evidence. Before issuance, the final products and evidence are independently reviewed within GAO to ensure that the evidence supports the report, the information is clearly and objectively presented, and any conclusions and recommendations are appropriate. All of our unclassified reports are available to the public.

With this general background regarding the GAO, I would now like to move into our discussion of the main topic of my presentation. The presentation and accompanying paper are based on some of the knowledge we have gained in the course of doing our work about central bank responsibility for financial market stability in a changing economic environment.

Over the past two decades the interrelated forces of economic change, technology and political/economic philosophy have transformed our financial markets into a single world-wide market. Domestically, the product line offerings of once highly segregated financial institutions are becoming blurred and the futures and securities markets have become linked in several very important ways. Our borders no longer constrain investment possibilities. Borrowing and lending opportunities now exist, and are taken advantage of, on a world-wide scale. Regulatory officials must now consider not only the domestic implications of their actions; but those that are international, since many firms under their jurisdiction can relocate their activities to other countries.

As a result of these changes, the Congress may be on the verge of changing the Glass-Steagall law, which would represent an important step toward modernizing the financial regulations that have dictated the shape of the financial services industry for the past 55 years. This law has prohibited banking organizations from participating in many securities activities in domestic markets. These changes and the regulatory and legislative response to them have far reaching implications for this nation's central bank -- the Federal Reserve. VV

Ultimately, the stability of this country's financial markets is the Federal Reserve's responsibility. This

responsibility is fulfilled through the Fed's conduct of monetary policy, through regulation and supervision of individual firms, and, more importantly, for purposes of this discussion, through its role as lender of last resort. But the operative phrase is "last resort." Central bank responsibility for financial stability is a shared one in which the commercial banking system through deposit insurance, and safety and soundness regulation, are the first line of defense.

Today I would like to first discuss the nature of this shared responsibility and then turn to a discussion of the implications of a more deregulated financial services industry for continued fulfillment of that responsibility.

THE NATURE OF RESPONSIBILITY FOR FINANCIAL STABILITY

Because of its role as a short-term "face to face" lender, the commercial banking system has been relied on as the mechanism for providing backstop sources of funds when alternative sources are not readily available to meet the legitimate borrowing needs of financial and nonfinancial firms. In addition, commercial banks, along with most other types of depository institutions have the responsibility for redeeming the insured deposits that they issue on demand at 100 cents on the dollar. These two roles, played currently only by the commercial banking system, are inextricably linked. The steady flow of insured deposits

and the fact that their redemption at full value is guaranteed, plays a major role in assuring the availability of short-term financing through the banking system during periods of liquidity disruption. The Federal Reserve becomes involved in providing liquidity only during periods of significant disruption to financial markets, when the banking system cannot meet legitimate borrowing needs.

The importance of this dual Federal Reserve/banking system liquidity provision role is perhaps best demonstrated by the events that occurred during and immediately following the stock market crash of October 19, 1987. Market participants --such as broker dealers and specialists-- needing short term financing to maintain positions, and meet margin calls and clearing requirements, activated standby lines of credit at their banks. Accounts of events indicate that a point was reached where some banks were either unwilling or unable to continue meeting their traditional commitments to the market. Even though bank lending during this period to meet the liquidity needs of broker dealers and others was much higher than normal, a point was reached where some banks were unwilling to grant further extensions of credit. The unmet need was financed with the provision of general liquidity through open market operations and Fed encouragement to banks to meet market participants' needs. The Fed's actions were demonstrably important in preventing firm failures and arresting the market tailspin that had begun.

The second leg of the federal financial safety net --deposit insurance-- has also proven instrumental in promoting financial stability. On the one hand, because deposits are insured there is unlikely to be a flight from bank deposits to currency or other forms of hard money during financial panics, which, in turn would only serve to further destabilize financial markets. On the other hand, because deposits are insured they serve as a source of funding to meet the needs of borrowers during difficult financial times. In fact during difficult periods, there is generally a flight to insured deposits, providing additional funding for increased liquidity needs.

The third leg --oversight and supervision of the banking system-- is the process through which the bank regulators, including the Federal Reserve, assure to the greatest extent possible, the safe and sound operation of depository institutions. This oversight is designed to detect weaknesses in financial institutions and correct them, with the objectives of limiting the risks being underwritten by the Federal government through deposit insurance and preventing the spillover of individual bank failures to the entire banking system.

Besides the fact that the Federal Reserve's responsibility for market stability is shared with other components of the safety net, there are two other important attributes of this responsibility. First, the role played by the Federal Reserve

has not been designed to prevent the occurrence of financial disruptions or upheavals. Rather it is designed to effectively cope with those events when they occur. Neither the Federal Reserve nor any other federal body should be expected to completely prevent financial calamities, such as the large adjustment of stock prices that occurred on October 19, 1987. This event --perhaps arguably-- represented an expression by the investing public of a change in opinion about the nation's financial health. In my view, it would be undesirable public policy to attempt to suppress the implementation of the decisions or preferences of investors. But there is an expectation that, to the extent that such events strain the ability of market makers to meet the needs of investors and threaten the credit system, the Federal Reserve has an important role to play in helping key market participants cope with the demands placed on them.

Second, with limited exceptions, the Federal Reserve has, as a matter of tradition, rather than law, provided liquidity assistance to the economy during troubled periods through the banking system. In other words, regardless of where a crisis has originated, its effects have been dealt with through provision of assistance to banks. This assistance, in turn, has been channelled by the banks to troubled segments of the financial markets. Even open market operations which are designed to provide economy-wide liquidity, provide reserves to the banking

system because Federal Reserve purchases of Treasury securities create deposits.

IMPLICATIONS OF MODERNIZED REGULATION
FOR THE FEDERAL RESERVE'S RESPONSIBILITIES

This last point is particularly relevant in light of the changes that have occurred in the financial services industry and the current efforts at modernizing regulation to recognize those changes. Because of the changes it is important to question whether the Federal Reserve can continue to effectively channel lender of last resort assistance exclusively to and through the commercial banking system. In our view, with deregulation of financial services, sometime in the future financial services conglomerates offering a full range of services throughout the world will pepper the financial landscape. Whether the commercial banking system can continue to be used to channel lender of last resort assistance is a particularly important question if

- there are doubts about the continued ability of insured deposits to fund liquidity needs during adverse periods because of limitations on their use.

- the speed of transmission of crises becomes so rapid that channeling assistance through the banking system may not be sufficiently rapid.
- a crises can originate in some part of the economy or the financial sector without quickly reaching or passing through the banking system, (farm credit system's financial crises may serve as an example), or
- it is impossible to distinguish between banking and other functions in the financial services conglomerate of the future.

If we accept the validity of these possibilities, then barring actions to mitigate them, the relationship between the Fed's responsibilities for financial market stability and those heretofore met by the banking system, deposit insurance and safety and soundness oversight may be weakened. And, this means that in a deregulated banking environment, in which we cannot rule out the possibility of a financial market disruption like that which occurred in October 1987, our central bank will have a larger and considerably more complex role to play.

In recent months, we have undertaken two bodies of work that have relevance to the questions that surround the deregulation of the banking industry and the implications of the October stock market crash for the future regulation of the futures and cash

equity markets. In January of this year, we issued two reports addressing these subjects.¹

Implications of Relaxation or Repeal of
Glass-Steagall Laws for Safety Net Responsibilities

In our recent report on issues surrounding repeal of the Glass-Steagall laws separating the banking and securities businesses we made a number of recommendations for changes that would need to accompany any relaxation of prohibitions on banking powers. All have relevance to the question of central bank responsibility because they all would change various aspects of the federal financial safety net.

An essential element for coping with safety and soundness difficulties and their potential to disrupt financial stability is owner supplied capital. Because of the sad state of affairs in the thrift industry, we recommended that expanded powers such as securities underwriting and trading should only be engaged in by firms that have sufficient capital to absorb the losses that will invariably occur from such activities.

¹Bank Powers: Issues Related to Repeal of the Glass-Steagall Act, GAO/GGD-88-37, January 22, 1988. Financial Markets: Preliminary Observations on the October 1987 Crash, GAO/GGD-88-38, January 26, 1988.

The structure of organization as well as regulation of expanded activities also has an important bearing on safety and soundness and market stability. In our view, the holding company structure provides the greatest degree of legal, economic and psychological insulation of insured deposits from non banking activities. For this reason we recommended that any firm wishing to engage in combined banking and securities should adopt this form of organization. We envision each subsidiary of the holding company being subjected to functional regulation. But we also believe it is absolutely essential that the Federal Reserve oversee the holding company itself. Because of the concerns we expressed earlier about the growing importance and complexity of the Federal Reserve's role in providing financial stability it must have this vantage point in order to stay abreast of events, acquire needed information, and deal with market crises if they arise. Furthermore, because we view responsibility for dealing with crises as a shared one between the banking system and the Federal Reserve, and because we are concerned about extension of the lender of last resort function as well as deposit insurance to non banking activities, we recommended that the holding company maintain sufficient capital to act as a source of strength for its depository and, perhaps securities affiliates.

Some of the proposals to modernize financial regulation would simply move the wall separating the banking and securities business that currently is constructed under Glass-Steagall laws

inside the organization offering both banking and securities products. Those who hold this view would encase the banking organization within a set of so-called firewalls designed to prevent the spread of problems in nonbanking affiliates to the bank itself thereby jeopardizing insured deposits.

In our view, attempts at complete insulation may be impossible to achieve, should not be relied on as the only means to control risk, and may increase the burden of the Federal Reserve in maintaining financial market stability. Insulation strategies or so called firewalls should be viewed as but one of a number of measures such as increased capital, the creation of incentives for management to operate in a safe and sound manner, and regulatory oversight to protect bank safety and soundness. We are most concerned about proposals that would prohibit loan transactions between banking and securities affiliates. The events of October 19th revealed the importance of banks as providers of liquidity to securities firms and we are very concerned that the proposed outright prohibitions could have a destabilizing effect if the events of the 19th repeat themselves. If such a prohibitions inhibited the flow of liquidity during another market crises, this would simply increase the burden on the Federal Reserve to supply liquidity and, it may also portend the direct provision of lender of last resort assistance to securities firms rather than providing such assistance through the banking system. In our view, the current Federal Reserve Act

23A and 23B restrictions that limit interaffiliate transactions provide ample safeguards against abusive or unsafe and unsound practices, although we would support increased penalties for violations.

Finally, we expressed the view that the degree of comfort that one has in repeal of the Glass-Steagall laws will depend on one's faith in the regulators' ability to effectively oversee the newly allowed activities in terms of safety and soundness and protection of consumer interests. And, in our opinion, the regulatory resources to oversee activities of financial institutions and markets are inadequate in today's environment and are woefully inadequate to oversee tomorrow's much more complicated one. We do not believe powers should be expanded until the situation is corrected.

Implications of the Market Crash for the Federal Reserve's Responsibilities

I have dealt at some length with the merging of the banking and securities business and the implications of this for central bank responsibilities. Let me now discuss the implications of the October, 1987 market crash for central bank responsibilities.

The events of October 1987 laid bare (for those who were not already aware of it) the fact that in many important respects the financial futures and cash equity markets in this country are

linked. Events in one market rapidly affect price formation in the other and, given the uses that are made of these markets by major investors, disruptions that break the links between the two markets have proven highly destabilizing. However, these two markets are overseen by different regulators and operate under very different rules.

Because of this situation, we recommended that several steps be taken to better integrate the workings and regulation of the futures and equity markets with a view toward better enabling market participants as well as regulators to cope with the new market demands.

We recommended that the self- and federal regulators work together to develop an integrated contingency plan to deal with any market breaks that might occur in the future. In our view, at a minimum this plan should contain the following elements:

- A contingency committee or control center to be activated in the event of a market crisis; with established lines of authority for decision making.
- A clarification of the regulators' and markets' duties and responsibilities in a crisis and a consideration of the circumstances in which these organizations should undertake identified tasks.

-- A clear delineation and emphasis on communication channels and procedures to be used during a market crisis including identification of liaison personnel and the conditions under which the communications channels should be opened.

In our view, these plans should contribute to confidence by assuring the market that a repetition of the October events has been considered by those responsible for regulating these markets and an approach to dealing with the problems created by those events has been developed.

While the development of contingency plans may enable markets and the regulators to better cope with another market emergency, a more appropriate intermarket regulatory structure needs to be developed. Regulation of these markets must be coordinated and decisions must be made on such issues as intermarket products and strategies, margin regulation, clearing systems, the provision of liquidity during normal and abnormal times, and the growth of linkages across international boundaries.

The President's Task Force on Market Mechanisms expressed the view that the Federal Reserve is in the best position to accomplish the coordination and decision making result. We are

not convinced at this time that the Fed should play this role nor are we convinced that a single market regulator is needed to oversee and coordinate regulation of the linked aspects of these markets.

However, as of mid-April no contingency plan had surfaced. And, the SEC and CFTC have not been able to resolve fundamental disagreements over margins, limits on trading and other matters which are crucial to more harmonized regulation of these markets. In addition, the New York and Chicago markets appear to be taking unilateral actions which threaten to decouple rather than fuse important aspects of their operations. It remains to be seen whether the separate regulators can work out their differences. If they cannot in the relatively near future, then a focal point for the development of a contingency plan and for coordination of the regulation of the linkages may have to be identified.

Regardless of the outcome, the Federal Reserve has an important stake in the smooth functioning of futures and equity market mechanisms. The central bank was ultimately responsible for picking up the pieces last October and, it will not doubt have to involve itself to protect the credit markets should the events of last October repeat themselves.

Of particular concern to us is the possibility of a catastrophe resulting from a breakdown of the payments and securities/futures clearing systems in a future period of

financial stress. Problems that occurred in these systems on October 19th and 20th, 1987 though not catastrophic, caused some market participants to leave the market. In the future, depending on events, and as these systems become increasingly linked to their foreign counterparts, the potential for a serious breakdown in meeting financial commitments grows. We intend to begin studying this issue this summer.

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Let me sum up by reemphasizing my view that central bank responsibility for financial market stability, while shared in many important ways with the banking system and other aspects of the financial safety net, is still one of last resort. Given the momentum toward further integration of financial services and the linkages between the futures and equity markets we need to preserve the liquidity provision functions of the banking system, strengthen oversight and regulation, harmonize regulation of the futures and equity markets and, assure to the greatest extent possible that the Fed's role as lender of last resort does not become one of lender of first resort to any and all participants that experience difficulty or threaten to destabilize the financial system.