



WHAT GOVERNMENT CAN DO TO PROTECT THE
PUBLIC INTEREST IN A CHANGING
FINANCIAL MARKET PLACE

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TO PROTECT THE PUBLIC INTEREST THERE ARE ESSENTIALLY TWO THINGS THE GOVERNMENT CAN DO THAT I WANT TO DISCUSS. THE FIRST IS TO TRY TO ADJUST MARKET SYSTEMS TO ACHIEVE PUBLIC POLICY GOALS IN A WORLD OF INTEGRATED MARKETS. THE SECOND IS TO SEEK TO CREATE A ENVIRONMENT THAT HAS LESS VOLATILITY. MOST OF MY REMARKS WILL BE DIRECTED TO THE FIRST OF THESE -- THE ADJUSTMENTS TO THE MARKET SYSTEMS -- BUT I WILL RETURN TO DISCUSS THE SECOND AT THE CONCLUSION OF MY REMARKS.

EVENTS LIKE THE MARKET CRASH SHOW THE PRIORITY OF THREE PUBLIC POLICY GOALS IN TRYING TO USE THE POWERS OF GOVERNMENT TO COPE WITH MARKET DEVELOPMENTS. THE FIRST OF THESE IS TO TRY TO ASSURE THE FINANCIAL SOUNDNESS OF INSTITUTIONS, ESPECIALLY THOSE AT THE CORE OF OUR MAJOR MARKETS SYSTEMS. THESE SYSTEMS INCLUDE OUR BANKING SYSTEMS, SECURITIES FIRMS, STOCK EXCHANGES, AND CLEARING CORPORATIONS.

THE SECOND GOAL IS TO MAINTAIN MARKET LIQUIDITY THROUGHOUT THE TRADING SYSTEM. THIS INVOLVES NOT ONLY WITHIN INDIVIDUAL MARKETS, SUCH AS A STOCK EXCHANGE, BUT ALSO ACROSS MARKETS. LIQUIDITY ALSO HAS TO DO NOT ONLY WITH THE ABILITY TO MAKE TRANSACTIONS NOW, BUT ALSO WITH THE BELIEF THAT TRANSACTIONS CAN BE DONE ANYTIME IN THE FUTURE AT PRICES WHICH ARE CLOSE TO THE THEN PREVAILING MARKET PRICES. THE MAINTENANCE OF MARKET LIQUIDITY IS VERY IMPORTANT TO AVOID A FEAR MENTALITY IN TRADING SYSTEMS.

THE LAST OF THE THREE GOALS IS PROTECTING CONSUMERS FROM INAPPROPRIATE RISK TAKING SITUATIONS.

THESE THREE GOALS -- SOUNDNESS OF INSTITUTIONS, MARKET LIQUIDITY, AND CONSUMER PROTECTION -- ARE RESPONSES TO MARKET FORCES. THEY DO NOT DIRECT THESE FORCES, BUT RATHER GIVE STRUCTURE TO THEM IN ORDER TO ACCOMPLISH IMPORTANT PUBLIC POLICY OBJECTIVES.

THERE ARE SEVERAL TOOLS THE GOVERNMENT CAN USE TO ACCOMPLISH ITS POLICY OBJECTIVES. FOR EXAMPLE, THE GOVERNMENT CAN DEFINE LEGAL RELATIONSHIPS. THIS INCLUDES SUCH THINGS AS DEFINING TRUST AND FIDUCIARY RESPONSIBILITIES OF FINANCIAL INSTITUTIONS, DEFINING CONSUMER RIGHTS, AND RESTRICTING INSIDER TRADING ACTIVITIES. THE GOVERNMENT CAN ALSO DEFINE THE MARKET STRUCTURE. THIS INVOLVES SETTING LIMITS ON THE POWER OF FIRMS SUCH AS GLASS-STEAGALL ACT RESTRICTION'S.

SIMILARLY, THE GOVERNMENT CAN REQUIRE THAT CERTAIN TRADING TAKES PLACE IN PUBLIC MARKETS, WHETHER THEY BE PHYSICAL LOCATIONS (SUCH AS THE NEW YORK STOCK EXCHANGE) OR ORGANIZED OVER-THE-COUNTER MARKETS. PUBLIC MARKETS PROVIDE AN OPPORTUNITY FOR THE PUBLIC TO HAVE ACCESS TO IMPORTANT INFORMATION AND OTHERWISE HELP TO ACHIEVE FAIR AND ORDERLY MARKETS. THE GOVERNMENT CAN ALSO DEFINE A REGULATORY STRUCTURE. THIS INCLUDES THE REGISTRATION AND SUPERVISION OF INDIVIDUAL FIRMS AND SETTING RULES THAT SUCH FIRMS MUST FOLLOW. FINALLY, WITHIN THE ALTERNATIVES WE HAVE JUST

DISCUSSED, THE GOVERNMENT CAN TAKE SPECIAL PROGRAM INITIATIVES.
EXAMPLES WOULD BE REDEFINING THE REQUIREMENTS FOR CAPITAL
ADEQUACY FOR FIRMS OR IMPROVING CERTAIN SUPERVISORY ACTIVITIES.

IT IS HOWEVER, DIFFICULT TO REACH A CONSENSUS ON HOW TO
APPLY THESE TOOLS TO ACHIEVE THE PUBLIC POLICY OBJECTIVES. I
WANT TO TALK ABOUT SEVERAL REASONS WHY THIS IS TRUE. ONE REASON
IS POLITICS. WHENEVER THE POSSIBILITY ARISES THAT A LAW MIGHT BE
CHANGED THAT AFFECTS ONE INDUSTRY OR ANOTHER, WE ARE ALL FAMILIAR
WITH THE INTENSE LOBBYING EFFORT THAT TAKES PLACE. THIS IS WELL
ILLUSTRATED BY THE CURRENT DISCUSSION ABOUT AMENDING THE GLASS-
STEAGALL LAW.

THERE ARE ALSO INFORMATION GAPS. WE DON'T KNOW THE FULL
DIMENSION OF THE RISKS THAT EXIST IN INTERNATIONAL MARKET TRADING
OR THE VOLUME OF TRANSACTIONS THAT MIGHT ACTUALLY OCCUR IN THE
NEXT 3 TO 5 YEARS.

THERE ARE ALSO LIMITATIONS IN THE ABILITY OF REGULATORY AGENCIES TO ACCOMPLISH THEIR OBJECTIVES. THE RESOURCES OF REGULATORY AGENCIES ARE ALSO QUITE LIMITED. FOR EXAMPLE, THERE IS LESS THAN ONE FEDERAL BANK EXAMINER FOR EVERY COMMERCIAL BANK IN THE UNITED STATES.

TO MOVE TO ANOTHER AREA, TAKE THE CHALLENGE FACED AS A RESULT OF GLOBALIZATION OF MARKETS. IT IS ONE THING TO RECOGNIZE THE INTERNATIONAL DIMENSION OF CURRENT MARKET DEVELOPMENTS, BUT ITS QUITE ANOTHER TO ACCOMPLISH THE INTERNATIONAL COORDINATION THAT WILL BE NEEDED. INDIVIDUAL NATIONS ARE IN COMPETITION WITH EACH OTHER TO TRY TO ATTRACT FINANCIAL SERVICES ACTIVITY, AND EACH NATION ALSO HAS DIFFERENT RULES WITH RESPECT TO ACCOUNTING AND CAPITAL REQUIREMENTS AND PRACTICES THAT ARE CONSIDERED ACCEPTABLE.

EVEN WITH THE BEST WILL IN THE WORLD, THERE ARE ALSO A NUMBER OF JUDGEMENT FACTORS OR AMBIGUITIES THAT MAKE IT DIFFICULT

TO ACHIEVE A CONSENSUS. ONE IS THE TRADE-OFF AMONG GOALS WHICH MUST BE CONSIDERED, AN AREA IN WHICH VALUE JUDGMENTS ENTER IN. NOT ONLY ARE THERE TRADE OFFS AMONG THE THREE GOALS THAT I'VE ALREADY MENTIONED -- SAFETY AND SOUNDNESS, LIQUIDITY, AND CONSUMER PROTECTION -- BUT THERE ARE OTHER GOALS AS WELL. THESE OTHER GOALS INCLUDE THE EFFICIENCY OF THE SYSTEM AND EQUITY AMONG MARKET PARTICIPANTS. THERE ARE ALSO DIFFERENCES IN THE PERSPECTIVE THAT CAN BE BROUGHT TO BEAR ON THE SUBJECT OF CONSUMER PROTECTION. IN THE SECURITIES INDUSTRY, THE PRIMARY PRINCIPLE IS FULL DISCLOSURE. IN BANKING, HOWEVER, WE SEE ANOTHER PRINCIPLE -- THE PROTECTION OF CONSUMER DEPOSITS THROUGH DEPOSIT INSURANCE AND VERY CLOSE SUPERVISION OF THE SAFETY AND SOUNDNESS OF INDIVIDUAL BANKS. WHICH PHILOSOPHY SHOULD APPLY, PARTICULARLY AS WE TALK ABOUT NEW PRODUCTS AND NEW MARKETS?

WE ALSO ARE OFTEN NOT CLEAR AS TO WHO REALLY SHOULD BE BEARING SOME OF THE RISKS IN THE FINANCIAL ENVIRONMENT. THE ISSUES ARISE WITH RESPECT TO PUBLIC VERSUS PRIVATE RISK BEARING.

THUS, WE FIND FOR EXAMPLE, IN THE DEPOSIT INSURANCE SYSTEM A PHENOMENON WHICH IS OFTEN REFERRED TO AS BANKS THAT ARE TOO BIG TO FAIL. THESE BANKS HAVE UNINSURED DEPOSITS AND IN THEORY DEPOSITORS OF AMOUNTS GREATER THAN \$100,000 DOLLARS ARE BEARING THE RISK IF THE INSTITUTIONS SHOULD FAIL. BUT IN PRACTICE, VERY RARELY DO SUCH DEPOSITORS ACTUALLY EXPERIENCE ANY LOSS. THERE ARE ALSO QUESTIONS OF WHO SHOULD BEAR THE RISK BETWEEN FINANCIAL INSTITUTIONS, ON THE ONE HAND, AND INDIVIDUAL PERSONS OR BUSINESSES ON THE OTHER. VARIABLE RATE LOANS IN AREAS SUCH AS MORTGAGES AND BUSINESS LOANS SHIFT RESPONSIBILITY FOR RISK FROM THE FINANCIAL INSTITUTION TO INDIVIDUALS OR BUSINESSES.

WE MUST ALSO RECOGNIZE THAT WHILE WE ARE CONCERNED ABOUT REGULATORY GAPS, WE ALSO HAVE CONCERNS ABOUT PUTTING TOO MUCH POWER IN THE HANDS OF A SINGLE REGULATOR. I THINK MOST OBSERVERS WOULD AGREE THAT THE DIFFERENT REGULATORY STRUCTURES, BOTH WITHIN THE FEDERAL SYSTEM AND BETWEEN THE FEDERAL GOVERNMENT AND THE STATES, HAVE ALLOWED MANY OF THE FINANCIAL INNOVATIONS TO TAKE

PLACE WHICH HAVE BEEN BENEFICIAL TO CONSUMERS, A GOOD EXAMPLE IS THE PAYMENT OF INTEREST ON CHECKING DEPOSITS. IT IS QUITE LIKELY THAT FEDERAL REGULATORS WOULD NOT HAVE AUTHORIZED THE PAYMENT OF INTEREST ON TRANSACTIONS DEPOSITS, BUT STATE AUTHORITIES DID.

FINALLY, THERE IS A FACTOR KNOWN AS MORAL HAZARD. THIS ESSENTIALLY MEANS THAT IF THE GOVERNMENT IS QUITE DEFINITE ABOUT THE TYPES OF ACTIONS ITS LIKELY TO TAKE -- FOR EXAMPLE THE TYPES OF LENDER OF LAST RESORT ACTIVITY THAT IT WILL UNDERTAKE IF A PROBLEM ARISES -- MARKETS WILL ANTICIPATE THIS. AS A RESULT, PRIVATE MARKET PARTICIPANTS WILL DO LESS TO AVOID RISKY SITUATIONS, AND WILL COUNT ON THE FACT THAT THE GOVERNMENT WILL COME TO THEIR RESCUE.

GAO'S APPROACH

WHILE ITS IMPORTANT TO RECOGNIZE THAT THERE ARE MANY REASONS WHY ITS DIFFICULT TO ACHIEVE A CONSENSUS, THE FACT REMAINS THAT DECISIONS MUST BE MADE. THE PROBLEMS WE FACE ARE REAL ONES, AND

WE CAN'T JUST SIT BY AND DO NOTHING. I'D LIKE TO TURN NOW TO THE TYPES OF JUDGMENTS THAT WE HAVE MADE IN GAO IN ADDRESSING SOME OF THESE QUESTIONS. I WILL DISCUSS WORK THAT WE HAVE COMPLETED AND ALSO SOME OF THE ISSUES THAT WE'RE WRESTLING WITHIN ONGOING WORK.

LETS TURN FIRST TO OUR REPORT ON THE 1987 MARKET CRASH.

A GOOD BIT OF THAT REPORT IS DEVOTED TO DEFINING THE TYPES OF CHANGES THAT HAVE TAKEN PLACE IN THE MARKETS AND THE LINKAGES THAT HAVE DEVELOPED. WE CONCLUDE, HOWEVER, THAT CERTAIN THINGS REQUIRE ATTENTION IN ORDER TO ACHIEVE PUBLIC POLICY OBJECTIVES. ON AN IMMEDIATE BASIS, WE SINGLE OUT TWO AREAS FOR IMMEDIATE ATTENTION. THE FIRST IS CONCERN WITH THE PROPER FUNCTIONING OF THE KEY AUTOMATED TRADING SYSTEMS INVOLVED IN STOCK EXCHANGES, IN OVER-THE-COUNTER MARKETS, AND IN CLEARING SYSTEMS. THE SECOND AREA FOR IMMEDIATE ATTENTION IS THE NEED FOR FEDERAL REGULATORS, WORKING WITH OFFICIALS OF SELF REGULATORY ORGANIZATIONS, TO PUT IN PLACE ADEQUATE CONTINGENCY PLANS. WE SAID THAT PLANS SHOULD

BE PUT IN PLACE BY REGULATORS IN 30 TO 60 DAYS. WE ALSO OBSERVED THAT ON A LONGER TERM BASIS, PRIORITY NEEDED TO BE GIVEN TO DEVELOPING APPROPRIATE INTERMARKET REGULATORY ARRANGEMENTS. WE DIDN'T SAY WHAT THAT STRUCTURE SHOULD BE, BUT WE EMPHASIZED IT NEEDED TO BE CONCERNED WITH SUCH THINGS AS THE INTRODUCTION OF NEW PRODUCTS AND THE HANDLING OF RISK SITUATIONS IN LINKED MARKETS.

OUR REPORT ON GLASS-STEAGALL REFORM HAD SEVERAL OBSERVATIONS. WE EMPHASIZED THE IMPORTANCE OF USING THE HOLDING COMPANY STRUCTURE IF THE ACTIVITIES OF BANKING ORGANIZATIONS WERE TO BE EXPANDED IN SECURITIES AREAS. BY USING THIS STRUCTURE, INSURED DEPOSITS ARE NOT INVOLVED IN UNDERWRITING OR TRADING CORPORATE DEBT OR EQUITY SECURITIES. THIS STRUCTURE ALSO ENHANCES THE ABILITY OF TRADITIONAL FEDERAL REGULATORY AGENCIES SUCH AS THE SEC FOR SECURITY FIRMS -- TO OVERSEE THE ACTIVITIES OF THE FIRMS. THIS PROVIDES A MORE LEVEL PLAYING FIELD AMONG DIFFERENT TYPES OF FIRMS IN THE SAME MARKET.

WE ALSO EMPHASIZED THAT THE FIRMS ENGAGING IN NEW ACTIVITIES NEEDED TO HAVE ADEQUATE CAPITAL. THE NEED FOR CAPITAL ADEQUACY INVOLVES EVERY COMPONENT IN THE HOLDING COMPANY: THE BANK, THE SECURITY FIRM, AND THE HOLDING COMPANY ITSELF. ONE OF OUR CONCERNS WITH GLASS-STEAGALL REFORM IS THAT IF THE NEW ACTIVITIES TAKE PLACE IN A HOLDING COMPANY AFFILIATE, THE PROFITS FROM SUCH ACTIVITIES ARE AVAILABLE ONLY TO THAT AFFILIATE ITSELF OR TO THE HOLDING COMPANY AND ARE NOT DIRECTLY AVAILABLE TO SUPPORT THE BANK. THEREFORE, AS A PART OF EMPHASIS ON CAPITAL, WE CONCLUDED THAT CHANGE TO GLASS-STEAGALL SHOULD REQUIRE THAT A HOLDING COMPANY ENGAGING IN NEW ACTIVITIES SHOULD BE RESPONSIBLE FOR SUPPORTING THE BANK IN CASE THE BANK RUNS INTO DIFFICULTY.

BECAUSE OF OUR CONCERN ABOUT INADEQUATE RESOURCES IN THE REGULATORY AGENCIES, WE ALSO CONCLUDED THAT EXPANSION OF POWERS OF BANKING ORGANIZATIONS SHOULD BE PHASED IN, WITH THE PHASE-IN TIED TO THE INCREASED REGULATORY CAPABILITY. THIS CAPABILITY INVOLVES NOT ONLY EXAMINATION OF THE BANK AND OF THE SECURITY

AFFILIATES BUT ALSO ADEQUATE SUPERVISION OF THE HOLDING COMPANY ITSELF BY AN ORGANIZATION SUCH AS THE FEDERAL RESERVE SYSTEM.

OUR GLASS-STEAGALL WORK ALSO RECOGNIZES THAT THERE IS ROOM FOR JUDGMENT CONCERNING THE TRADE OFF BETWEEN BENEFITS OF REPEAL ON THE ONE HAND AND PROTECTION ON THE OTHER. FOR EXAMPLE, IF WE TRY TO PROTECT THE CONSUMER BY MAKING IT IMPOSSIBLE FOR A CUSTOMER OF THE BANK TO BE OFFERED PRODUCTS FROM OTHER FIRMS WITHIN THE HOLDING COMPANY, IT ALSO MEANS THAT WE WOULD BE MAKING IT DIFFICULT IF NOT IMPOSSIBLE FOR THE CONSUMER TO ALSO BENEFIT FROM HAVING A ONE STOP FINANCIAL SERVICE AVAILABLE AT A BANK.

IN THE TWO REPORTS THAT I'VE MENTIONED, AND IN OTHER WORK THAT WE HAVE DONE IN THE FINANCIAL AREA, SEVERAL THEMES EMERGED WHICH I MIGHT SUMMARIZE AS FOLLOWS. ONE IS THE NEED FOR AN APPROPRIATE REGULATORY STRUCTURE, ONE THAT REFLECTS THE CHANGES THAT HAVE OCCURRED AND THE INTERDEPENDENCE OF MARKETS THROUGHOUT THE WORLD. SECOND, THERE'S A NEED FOR MORE REGULATORY RESOURCES,

NOT ONLY IN NUMBERS BUT ALSO IN TERMS OF BETTER TRAINING. THIRD, INSTITUTIONS NEED ADEQUATE CAPITAL. ADEQUATE CAPITAL SERVES THE INTERESTS OF SAFETY AND SOUNDNESS AND OF MAINTAINING MARKET LIQUIDITY. WE HAVE ALSO EMPHASIZED THE NEED TO PROTECT THE FEDERAL SAFETY NET FROM UNNECESSARY RISK. THE FEDERAL SAFETY NET INCLUDES LENDER OF LAST RESORT ACTIVITIES OF THE FEDERAL RESERVE SYSTEM AND THE DEPOSIT INSURANCE ACTIVITIES OF FDIC, FSLIC, AND THE CREDIT UNION SHARE INSURANCE FUND. AND FINALLY, OUR WORK HAS EMPHASIZED THE IMPORTANCE OF PROTECTING INDIVIDUAL INVESTORS. CONSUMER PROTECTION INVOLVES HAVING TRADING PROCEDURES THAT ARE FAIR TO SMALL INVESTORS, OF ADEQUATE DISCLOSURE, AND ADEQUATE SUPERVISION OF INSTITUTIONS.

ALTHOUGH THESE THEMES GIVES US A BASIS FOR APPROACHING OTHER TOPICS, THERE IS NOTHING AT ALL AUTOMATIC ABOUT APPLYING THESE THEMES. EACH JOB WE UNDERTAKE HAS MANY CHALLENGES. IT IS NOT EASY TO REACH JUDGEMENT ABOUT HOW THE PUBLIC INTEREST IS BEST SERVED IN PARTICULAR CIRCUMSTANCES. I WOULD LIKE TO ILLUSTRATE

THIS POINT BY TURNING BRIEFLY TO TWO TOPICS THAT WE ARE WORKING ON.

THE FIRST OF THESE INVOLVES THE PROBLEMS OF FSLIC. OVER THE PAST SEVERAL YEARS WE HAVE ISSUED A NUMBER OF REPORTS ON THE SIZE OF THE FSLIC PROBLEM; WE HAVE AUDITED THE FINANCIAL STATEMENTS OF FSLIC AS WELL AS OF FDIC, AND WE ARE CURRENTLY ENGAGED IN A REPORT THAT IS CONSIDERING WHETHER FSLIC AND FDIC SHOULD BE MERGED.

ONE ISSUE THAT WE WERE WRESTLING WITH IS WHAT IS THE SIZE OF THE PROBLEM? WE KNOW THAT AS OF JUNE 30, 1987 THERE WERE 491 THRIFTS WITH ASSETS OF 130 BILLION DOLLARS THAT ON A GAAP BASIS WERE INSOLVENT. HOWEVER, MANY OTHER THRIFT INSTITUTIONS HAVE LOW CAPITAL, AND THERE ARE MANY PROBLEMS IN THE BANKING INDUSTRY AS REFLECTED IN SUCH THINGS AS LOANS TO LESS DEVELOPED COUNTRIES AND ENERGY AND REAL ESTATE LOANS. SO THERE ARE MANY UNKNOWNNS ABOUT THE ACTUAL SIZE OF THE BILL AND WHETHER THE GOVERNMENT IS BEING

EXPOSED TO GREATER AND GREATER RISKS THAT EVENTUALLY MIGHT HAVE TO BE PAID BY THE TAXPAYER.

THE QUESTION OF WHO SHOULD PAY IS ALSO A DIFFICULT ONE.

WHAT IS THE PUBLIC VERSUS THE PRIVATE RESPONSIBILITY FOR BEARING THE COST FOR THE RISK IN FSLIC THAT HAS BEEN INCURRED? IS IT FAIR FOR COMMERCIAL BANKS TO SEE SOME OF THEIR FUNDS BE USED TO HELP SOLVE SOME OF THE PROBLEMS IN THE THRIFT INDUSTRY? WE ARE ALSO CONCERNED ABOUT THE DEPOSIT INSURANCE ARRANGEMENTS IN WHICH POORLY CAPITALIZED OR INSOLVENT INSTITUTIONS ARE ALLOWED TO GROW, THEREBY FURTHER INCREASING THE RISKS THAT HAVE TO BE BORNE EITHER BY OTHERS IN THE INDUSTRY OR BY THE GOVERNMENT. WE ARE THEREFORE DIRECTING ATTENTION TO THE KIND OF CHANGES IN THE REGULATORY STRUCTURE THAT ARE NECESSARY IN ORDER TO TURN AROUND THE INCENTIVE SYSTEM. TO THE EXTENT POSSIBLE, THE BENEFITS OF FEDERAL DEPOSIT INSURANCE TO THE CONSUMER AND TO THE STABILITY OF THE BANKING SYSTEM SHOULD NOT INADVERTENTLY PROVIDE INCENTIVES TO MANAGERS OF FINANCIAL INSTITUTIONS TO TAKE UNNECESSARY RISK.

ANOTHER AREA THAT WE AND OTHERS ARE STARTING TO GIVE INCREASED ATTENTION TO IS WHAT COULD BE CONSIDERED THE "HI-TECH" MARKET ENVIRONMENT. THIS HAS TO DO WITH TRADING AND FUND CLEARING SYSTEMS, USUALLY INVOLVING COMPUTERS AND INFORMATION SYSTEMS THAT ARE CRUCIAL TO THE MAINTENANCE OF FAIR, LIQUID, AND ORDERLY MARKETS. THERE ARE CHALLENGES IN SIMPLY UNDERSTANDING THE OPERATING CHARACTERISTICS OF THESE SYSTEMS, AND THERE ARE MANY POLICY QUESTIONS THAT NEED TO BE ADDRESSED.

FOR EXAMPLE, HOW BIG A CAPACITY SHOULD BE DESIGNED FOR THESE SYSTEMS? WE FOUND SEVERAL YEARS AGO THAT WE WERE UNABLE TO CONTINUE TO BUILD FREEWAYS THROUGH MAJOR CITIES SO THAT PEOPLE COULD COMMUTE DURING RUSH HOUR AT 50 MILES AN HOUR. NOW IN COMPUTER SYSTEMS WE HAVE THE PHYSICAL SPACE CONSTRAINTS THAT HIGHWAY SYSTEMS INVOLVE, BUT STILL QUESTIONS ARISE AS TO WHETHER OUR OBJECTIVE SHOULD BE TO ASSURE THAT ANYBODY CAN EXECUTE ANY VOLUME OF TRANSACTIONS WHENEVER THEY WANT TO UNDER ANY MARKET CONDITIONS WITHOUT EXPERIENCING ANY DELAYS OR RISK.

FURTHERMORE, THERE ARE COST CONSIDERATIONS. IF WE ARE TO BUILD SUCH SYSTEMS WHO WILL PAY FOR THEM, AND ARE THOSE COSTS ADEQUATELY REFLECTED IN THE TRANSACTION OF PRICES? AND ARE THE POSSIBLE RISKS ASSOCIATED WITH THESE SYSTEMS ADEQUATELY REFLECTED IN TRANSACTIONS PRICE? THERE ARE ALSO QUESTIONS OF REGULATORY RESPONSIBILITY HERE. DO WE WANT THE SEC, FOR EXAMPLE, TO TAKE RESPONSIBILITY FOR DETERMINING THE SIZE AND CAPACITY OF THESE TRADING SYSTEMS? IF THE SEC HAD BEEN DOING THIS IS THERE ANY INSURANCE THAT THE PROBLEM SITUATIONS IN THE MARKET CRASH WOULD HAVE BEEN AVOIDED? QUESTIONS OF MORAL HAZARD ALSO ARISE. IF WE ASSUME THE FEDERAL RESERVE SYSTEM WILL BACKSTOP THESE TRADING SYSTEMS, IS IT LIKELY THAT THE SYSTEMS THEMSELVES WILL TAKE FEWER STEPS TO AVOID THE RISKS ASSOCIATED WITH POSSIBLE BREAK DOWNS?

ECONOMIC ENVIRONMENT

I INDICATED IN THE BEGINNING THERE WERE TWO WAYS THAT GOVERNMENT COULD TRY TO SERVE THE PUBLIC INTEREST. I HAVE DEVOTED MOST OF MY REMARKS TO THE FIRST OF THESE, ADJUSTMENTS TO

MARKET SYSTEMS. I WANT TO TURN NOW TO THE SECOND OF THESE -- THE CREATION OF AN ECONOMIC ENVIRONMENT THAT ENCOURAGES MARKET STABILITY. MANY OF THE CHANGES IN THE MARKET OCCURRING OVER THE LAST FEW YEARS HAVE ENABLED MARKET PARTICIPANTS TO REACT TO MARKET VOLATILITY. THIS ABILITY OF MARKET SYSTEMS TO REACT IS A FACT OF LIFE, AND WE CAN'T REVERSE THIS CAPABILITY AND NOR SHOULD WE TRY. WE CAN, HOWEVER, TAKE A STEP BACK AND LOOK AT WHETHER WE CAN ADOPT POLICIES THAT WILL ENCOURAGE MORE STABLE MARKETS.

LETS LOOK FOR A MOMENT AT THE EVENTS THAT HAVE OCCURRED OVER THE LAST 15 YEARS. WE'VE HAD OIL PRICES THAT HAVE GONE UP AND THEN COME DOWN. WE'VE HAD INFLATION AND WE'VE HAD DEFLATION. WE'VE HAD EXPANSION AND WE'VE HAD VERY SHARP RECESSION. WE'VE HAD INTEREST RATE VOLATILITY AND INTEREST RATES THAT IN REAL TERMS THAT HAVE BEEN EXTREMELY HIGH. WE'VE HAD UNPRECEDENTED BUDGET AND TRADE DEFICITS. WE'VE HAD CHANGES IN THE INTERNATIONAL MONETARY FRAMEWORK, INCLUDING RAPID CHANGES IN EXCHANGE RATES. IN CONCENTRATING ON ADJUSTMENTS TO MARKET

SYSTEMS, WE SHOULD NOT LOOSE SIGHT OF THE DESIRABILITY OF
DEVELOPING POLICIES THAT BRING ABOUT A MORE STABLE ENVIRONMENT.

IN CONCLUSION, I THINK THAT THE ROLE OF GOVERNMENT IN
DEALING WITH MARKET DEVELOPMENTS SHOULD BE SEEN AS A BALANCE OF
TWO OBJECTIVES. THE FIRST IS TO MAKE SURE THAT THE MARKET
SYSTEMS WE HAVE CAN FUNCTION AS WELL AS POSSIBLE NO MATTER WHAT
THE ECONOMIC ENVIRONMENT. THE SECOND IS TO TRY TO PUT IN PLACE
THOSE POLICIES THAT WILL ENCOURAGE MARKET STABILITY IN THE LONG
RUN.

THERE'S A NURSERY RHYME THAT GOES LIKE THIS:

FOR WANT OF A NAIL THE SHOE WAS LOST,
FOR WANT OF A SHOE THE HORSE WAS LOST,
FOR WANT OF A HORSE THE RIDER WAS LOST,
FOR WANT OF A RIDER, THE BATTLE WAS LOST,
FOR WANT OF A BATTLE, THE KINGDOM WAS LOST,

ALL FOR THE WANT OF THE HORSE SHOE NAIL.

INSTINCTIVELY WE FEEL WHEN CONFRONTED WITH SOMETHING LIKE THE MARKET CRASH THAT THERE ARE GREAT FORCES INVOLVED, AND THAT SUCH A CATASTROPHIC EVENT MUST ULTIMATELY BE EXPLAINED IN TERMS OF UNDERLYING CAUSES SUCH AS BUDGET AND TRADE DEFICITS. AND YET, WHEN YOU READ THE STUDIES OF WHAT GAO AND OTHERS HAVE MADE OF WHAT ACTUALLY HAPPENED DURING THE CRASH, THERE ARE MANY IMPORTANT NAILS THAT REALLY NEED TO BE CONSIDERED. FOR EXAMPLE, THERE WERE BACK UPS ON THE CARD PRINTERS ON THE FLOOR OF THE NEW YORK STOCK EXCHANGE ON OCTOBER 19 AND 20 THAT LED TO DELAYS IN EXECUTING TRADES THAT HAD IMPORTANT RAMIFICATIONS. TO SITE ANOTHER EXAMPLE, THE MARGIN CALLS THAT HAD TO BE MADE IN THE FUTURES AND OPTIONS MARKETS IN THE PERIOD OF THE MARKET CRISIS WERE OF UNPRECEDENTED MAGNITUDES. THE TIME OF THE MORNING IN WHICH CLEARING BANKS WERE ABLE TO NOTIFY THE EXCHANGES THAT THEIR CUSTOMERS WOULD BE GOOD FOR THEIR MARGIN CALLS WAS EXTREMELY IMPORTANT. THE INABILITY OF CERTAIN BANKS TO MAKE THOSE CALLS AT THE USUAL 7:00 A.M. TIME IN THE MORNING OF THE OCTOBER 20 WAS

EXTREMELY IMPORTANT IN CREATING AN ATMOSPHERE OF UNCERTAINTY IN
THOSE MARKETS.

SO I CONCLUDE THAT WE MUST LOOK AT NAILS AS WELL AS BATTLES
IN TRYING TO UNDERSTAND THE APPROPRIATE RESPONSE OF GOVERNMENT TO
THE MARKET AS IT IS DEVELOPING. THE COMBINATION OF THESE FACTORS
IS WHAT MAKES WORK IN THIS AREA SO INTERESTING AND CHALLENGING.