



"FINANCIAL MARKETS AT THE CROSSROADS"

REMARKS OF

**RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES INDUSTRY ASSOCIATION
& FUTURES INDUSTRY INSTITUTE CONFERENCE
WASHINGTON, D.C.**

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**U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549**

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It is my pleasure to join the SIA and the Futures Industry Institute to discuss "Financial Markets at the Crossroads -- A Day in Washington." This cooperation between the securities and futures industries is very constructive, and I congratulate you on your ecumenical spirit. On the subject of crossroads, I am reminded of a commencement speech in which the speaker told the graduates: "We stand at a crossroads. In one direction lie despair and desperation, in the other, utter chaos. Let us hope we have the wisdom to choose correctly."

Being more of an optimist, I believe there are a few better alternatives leading from the financial crossroads at least. They include greater market efficiency, lower costs of capital, enhanced capital availability and prudent risk management. Many of the issues and tradeoffs that we face in regulation are presented by the new derivative instruments -- particularly the so-called "OTC derivatives" that have grown so rapidly in recent

years. However, since many of your speakers have been focusing on those specific products, I would like to look more broadly at the issues that apply to the wider spectrum of products traded in the nation's securities and options markets.

Financing for Business and Economic Growth

At the outset, it's worth remembering that the most important goal of our capital markets is to provide financing for the "real" economy. Every business from the corner grocery to the largest multinational corporation has to have the ability to finance its activities. The more flexible and efficient our capital markets, the more economic growth can occur -- and the greater the standard of living we can create for society. Currency and interest rate swaps, for example, are not just something else to trade. They are increasingly important tools used by businesses to create sufficient certainty relating to costs and earnings in international and domestic operations to enable coherent business planning. Far fewer businesses would be able to compete in the export businesses, for example, that now account for one out of every six U.S. manufacturing jobs (and 30% of U.S. economic growth since 1986), if they were unable to rely to some degree on the value of expected cash flow in multiple currencies.

Over the last few years, the role of securities markets in financing the broader U.S. economy has grown dramatically.

Commercial paper has almost completely replaced short term bank financing to meet the working capital needs of major corporations. Commercial paper is cheaper and more flexible than loans, and thus has helped to increase economic efficiency. Both investment grade and junk bonds have increasingly been the source for financing most of the medium and long term needs of companies. Indeed, since the advent of the Basle capital rules for banks in March, 1989, U.S. banks have been in a net liquidation mode for their commercial and industrial loans in the aggregate. Though bank assets grew almost 17% during the intervening time, loans actually declined by more than \$28 billion, while bank holdings of government bonds shot up by more than \$254 billion -- or about 64%.

This transformation of banks into government bond mutual funds with deposit insurance has significant implications in many areas. However, one result has been to make businesses far more dependent on securities markets to meet their total financing needs. For this and other reasons, in 1991 aggregate securities offerings in the United States rose about 50% to over \$700 billion. To date this year total financings are again rising considerably. Indeed, the total volume of securities registered in the first half of 1992 was up about 57% from the first half of 1991, and 1991 was the all-time record year.

In real economic terms then, the capital markets are playing an increasingly important role. However, their ability to continue doing so depends on the ability of market participants to develop new types of instruments and transactions to meet changing economic needs. Too much regulation, or regulation in too inflexible a form, can sharply reduce market efficiency by sending everyone to the law books, regulations or the courthouse rather than the marketplace. Thus, I do not share the view that because some risks are present, the burgeoning OTC derivatives markets should be laced up in a straitjacket before we have carefully considered what form and degree of regulation is needed to address specific types of risks.

While serious problems can be caused by too much regulation, too little appreciation of different risks -- and too little capacity to control risk -- can also result in enormous problems. Therefore, I would like to turn for a few minutes to the general question of risk as we view it at the SEC.

Risk

When we consider the question of risk, we divide it, like Gaul, into three parts: market risk, credit risk, and operational risk. While regulators have long experience dealing with all types of risk, the proliferation of new financial instruments, the increased competition between banks and securities firms, and the globalization of such competition

require that we re-evaluate the way in which our regulations limit the degree of risk in entities we regulate. This ongoing assessment is necessary if for no other reason than that archaic regulation can push certain types of financial activity into unregulated entities, and even across national borders.

It is worth saying a few words about each of the three categories of risk because, notwithstanding our more complicated instruments and markets, they have always existed. Most financial market regulators have attempted to maintain prudent levels of leverage, and thus risk, in financial markets with margin and capital requirements. It is obvious that market participants and regulators have different interests in this regard. Regulators have as a priority safety, and at least this regulator believes in erring on the side of resiliency in a market to make sure that the inevitable market downswings can be absorbed without waves of failures among firms in the market.

On the other hand, market participants seek low costs, and certain academic economists have suggested that regulators should have a reduced role in determining capital requirements (and none at all in margin requirements), leaving the job to market forces. We disagree, since more than 140 years of experience relying on market forces alone saw repeated cycles of expansion followed by complete market collapse. However, we do agree that wise regulators must recognize that both prudence and efficient use of

capital are valid goals in setting capital and margin requirements.

Of the first two types of risk, it is market risk that will be easier to address in the coming decade. The SEC's net capital rule has served the industry and the public well over past decades, as evidenced by the very low number of brokerage firm failures, especially when compared with the number of failures of other financial institutions. But we know that there are areas where, with careful study, there is room to give greater recognition to certain empirical evaluations of the market risk in various types of securities. Inevitably, our progress will be slower than the industry would like, but we will get there, and I hope we will do so in a manner that preserves market stability while improving the efficient use of capital.

The harder problem for us is credit risk, which our capital rule treats very harshly, and generally for good reason in my view. The past five years have seen an increase in off-exchange instruments which our capital rule treats as unsecured receivables, much like loans. These items are considered "non-allowable" assets, with a 100% capital charge. This is done to protect public customers of brokerage firms. However, in order to compete with banks, which are, after all, in the business of making loans and whose capital requirements do not impose a penalty for unsecured loans, brokerage firm groups have conducted

many of these activities in totally unregulated affiliated entities. A challenge we face is to regulate these activities sensibly and yet maintain a level playing field, and we are exploring ways to do this. Our recent holding company risk assessment rules should hopefully result in a major improvement in our information in this area.

The third area of risk is what I would call "operational" risk, consisting of both clearance and settlement risk and "disaster" risk. Improving clearance and settlement is a particular challenge to regulators, since in many ways the most dangerous aspects of the 1987 market break were the uncertainties about the clearance and settlement system. Paradoxically, in certain ways the clearance and settlement system for the most "advanced" instruments is the least "advanced." The evolution of securities settlement has been from bilateral (i.e., trade by trade) settlement, to bilateral netting (where two counterparties net the obligations created by all their trades in the aggregate), to today's multilateral continuous net settlement (where a clearing house becomes the counterparty to every trade). However, the proliferation of off-exchange, non-clearing house instruments has, with respect to an increasing amount of the obligations of firms and institutions, returned us to the days of bilateral settlement, re-introducing a great deal of credit risk into the system. Indeed, many of the "innovative" derivatives have turned market risk into credit risk. Admittedly, groups

such as the International Swap Dealers Association are working to provide for bilateral netting, and market participants are beginning to talk of clearing houses for some of these contracts, to the extent they can be standardized for settlement purposes, but there is much to be done in this area.

Progress has been made on strengthening the mechanical aspects of the securities clearance and settlement system. In 1987, a lack of synchronization of margin collection and payment across markets led to market participants being required to pay out margin to one clearing agency before being able to collect from another, thereby squeezing liquidity from the system at the time when it was most needed. This problem was worsened by the fact that the futures exchanges were simultaneously raising the level of margin required, since margin levels were dangerously low at the onset of trouble.

Since that time, we haven't solved the issue of margin on stock index futures. However, we have worked with the CFTC and the securities and futures industries to facilitate implementation of cross-margining arrangements. Cross-margining enables market participants to reduce their margin obligations by posting a single clearing system margin requirement for intermarket portfolios consisting of securities options and futures positions. These arrangements have been a resounding

success and continue to be expanded to include more markets and more products.

In addition, the Group of 30 has undertaken an extensive project, in which the SEC has participated, to harmonize international settlement practices. In the U.S. we comply with substantially all but two of the nine recommendations of the Group of 30: shortening the settlement cycle to three business days after the trade ("T+3) and using same day funds to settle securities transactions among financial intermediaries.

As discussion of implementation of those two recommendations progressed, it became apparent that there was sharp disagreement within the industry on whether, and if so on how and when, to adopt these recommendations. Consequently, I asked John Bachmann, Managing Principal of E.D. Jones and Co. and a former Chairman of the SIA, to form a task force of bankers, SROs and industry to identify specific changes that would achieve a safer and more efficient clearance and settlement system.

As a result of its studies, which drew on the expertise of a number of industry organizations, the task force members confirmed that "time equals risk." They concluded that the U.S. corporate and municipal securities markets can and should be made safer by shortening the settlement cycle to T+3 from the current T+5, and by adopting a same day funds payment convention. We

have sought public comment on the entire Bachmann Report, and industry organizations are now addressing some of the potential obstacles to implementation of a shorter settlement cycle, such as an acceptable electronic payment system for retail trades and an interactive affirmation process for institutional trades.

These efforts to strengthen U.S. clearance and settlement systems are very important. The Depository Trust Corporation processed 79 million separate transfers valued at almost \$14 trillion last year. The Bachmann group estimated that moving to T+3 alone would eliminate about 60% of today's risk to the National Securities Clearing Corporation in the event of a failure of a large firm under normal conditions. In this area reasonable levels of investment can pay a rich dividend in lower risk for all. Thus, I hope to see full implementation of the Bachmann Task Force recommendations -- hopefully sooner rather than later.

Secondary Market Structure

Another major challenge regulators will face is the rapidly changing structure of secondary markets. In the past few decades, the U.S. equity markets have undergone dramatic changes. Among the most important of these changes have been a vast increase in trading volume; evolutionary advances in trading technology that have increased the power, speed, and flexibility of trading and information flows; the growth and maturation of

the equity derivative products market; and the increasing globalization of equity markets. For example, the average daily volume on the New York Stock Exchange 20 years ago was less than the volume that usually occurs in the first 20 minutes of trading today. Twenty years ago, the NYSE's DOT system, the regional exchanges' automatic execution systems, and the index options and futures markets simply did not exist. NASDAQ was only a one-year-old toddler. State and local retirement funds as an entire group 20 years ago had a smaller stock portfolio than the single largest such pension plan today.

As a result of these changes, some worry whether we even have a central equity market any more, and argue that the equity markets have split into institutional and retail market places. Small retail orders are split up among several exchanges and competing dealers, with the winner often being who can pay the most for the order flow. Institutional orders are often packaged as program trades to be executed off the stock exchange, or are finalized "upstairs" and brought to the marketplace solely to be printed on the tape. Indeed, some large block orders and program trades are being faxed to foreign desks so they do not even have to be printed on the tape. Moreover, many of the alternative markets that have developed, whether for retail or institutional orders, passively base their prices off the primary market, yet do not have the regulatory responsibilities imposed on the primary markets.

These market developments reflect, to a large extent, the ingenuity and innovation that have been, and will continue to be, the hallmarks of our financial system. After all, change isn't necessarily adverse, just because it is significant. These market changes may bring important cost savings, convenience, and variety to the investing public and to businesses raising capital. However, they also raise important questions of transparency, liquidity, market efficiency and stability, and domestic and international competition.

As regulatory agencies are prone to do, the SEC has reacted to these developments in a series of case-by-case responses to particular issues or proposals. In order to respond to the technological and competitive evolution of the market in a more careful and thorough manner, I directed the Division of Market Regulation late last year to undertake a thorough and comprehensive study of the current market structure, and the role that the SEC and self-regulatory organizations play in the fairness, efficiency, and competitiveness of our equity markets. This "Market 2000" Study will focus on such issues as market fragmentation, fair competition between markets, payment for order flow, market transparency, and proprietary trading systems.

The Study's initial step was the issuance in July of a concept release seeking public comment on the major issues as we

see them. This study will probably not be completed until the middle of next year, but I hope that the SIA and FIA, the SROs and the entire market community will be active contributors to our work. Our goal will be to preserve the competitive genius and innovative spirit of our equity markets while enhancing the efficiency, safety and integrity of our national market system.

Conclusion

Today's markets are bigger, faster and more complex than yesterday's. Tomorrow's markets will be different -- but I don't know how they will change. Time will tell us that. Our job in regulation should be to develop principles that will serve us well, and to encourage growth and innovation while seeking to achieve our objectives of safe and efficient markets.