Testimony by

FELIX G. ROHATYN

Partner, Lazard Freres & Co.

Chairman, Municipal Assistance Corporation

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Mr. Chairman, Members of the Subcommittee, I am Felix Rohatyn, Partner at Lazard Freres & Co., and Chairman of the Municipal Assistance Corporation and I welcome the opportunity to appear before you today. The questions you are addressing here are of vital importance, not only to investment bankers like myself, but to all of America.

It is no exageration to say that this Country's securities markets are a cornerstone of the free market principles upon which America is built. They were integral to making the American economy the strongest in the world. Today, however, this Country faces the unprecedented challenge of regaining its worldwide economic dominance. The global competitiveness of our private sector has been called into question, and it is one that remains unanswered. How we answer will depend, among other things, on what steps we take to ensure that U.S. Corporations receive the capital investments necessary to compete. The main sources of these investments are our securities markets. It should go without saying that the positive repercussions of healthy markets will resound far beyond Wall Street to Main Street. They would be one key to the creation of jobs, higher standards of living, increased corporate tax dollars. . .the list goes on. That is why it is important that reasonable answers be found to the questions the Subcommittee is investigating today, and why they must be developed thoughtfully and carefully.

Fortunately, the timing of the Subcommittee's deliberations presents a unique opportunity toward assuring that constructive answers are developed. The dust of last October's market crash is settling; some lessons are emerging. At the same time, an election year is upon us and political agendas are taking shape. As we seek to buttress our securities markets, the juncture of these two events provides an occasion we should not pass up: to pause and reflect upon what this Country wants its financial markets to be. There is a choice. And, I would suggest that it is a choice that this Country can and should make before events make them for us.

There are two roles our exchanges can play. They can be casinos where the lucky -- and sometimes the unscrupulous -- take all, at the expense of the majority. Or, they can be the lifeblood of this Country's future economic growth.

Either choice is achievable. By returning to the fundamental question of what this Country wants its stock markets to be and letting that answer guide our course of action, our chances of constructively rebuilding a system that has gone awry will be greater.

Unfortunately, nine months after the near collapse of our financial system and six months after the publication of the Brady Commission report, the question is asked, not only here, but all over the Western world, as to what we are going to do to prevent a recurrence of October 19-20, 1987. The answer, by now, is obvious: Practically nothing. The study group set up by the Administration to review the Brady Commission's report could not find even a modest area of agreement. The Brady Commission report is now a dead letter. The only firm recommendation appears to be the adoption of so-called one-hour "circuit brakers" across the various stock markets if the Dow Jones index goes up or down by more than 250 points, or two hours if the move is more than 400 points. It may well be that temporarily suspending the trading of individual stocks, to relieve an overloaded and undercapitalized specialist, may be a useful part of an emergency plan. But the notion that a one-hour, or two-hour cross-market shutdown is an appropriate, and exclusive, cure to the disease that brought us October 19 is not responsive from a public policy point of view.

Since it is obvious that no meaningful action will be taken before the next market crisis, I would like to look at the overall aspects of this issue, instead of being limited to technical market questions, and to suggest somewhat broader perspectives.

It is well to remember, to begin with, that last October's crisis was not one, but a series of interconnected collapses, by securities markets all over the world. Second, it was preceded by a serious break in the credit markets. Third, it was accompanied by great volatility in the foreign exchange markets.

And it is equally important to remember that what saved the situation on October 20 was a virtual banking guarantee of the securities industry by the N.Y. Fed; support of the Japanese stock market by the Japanese government; and massive buybacks announced by over 150 U.S. companies.

I would suggest that the fundamental weakness in the securities markets, world-wide, is the result of excessive speculation, excessive use of credit and inadequate regulation. This speculative behavior is not driven by individual speculators or manipulators, as was the case in the 1920s and 1930s, but by institutions such as pension funds, banks, S&L's and insurance companies backed, in many cases, by State and U.S. government guarantees. Curbing speculation and promoting investment must be the objective of reform.

Regulation can be divided into two categories: Securities regulation and credit regulation. It is perfectly obvious that so-called derivative products (options, futures, etc.) are securities and should be treated as such. Their trading, and their characteristics as securities, should therefore be regulated by the SEC, and rules, such as the prohibition against selling on down-ticks, should be extended to options and futures. The fact that they are regulated and traded on the commodity exchanges has simply turned the securities markets into commodity markets. It is Gresham's law operating to perfection, with the bad money chasing the good money.

Credit, on the other hand, should be regulated by the Federal Reserve System. As I stated earlier, the banking system virtually underwrote the securities industry on October 19-20, 1987. It is therefore appropriate that the Fed determine the capital adequacy of the securities firms and the specialists. This applies even more in view of the likely lifting of the Glass-Steagall Act, now separating banks from securities houses. The greater and greater assumption of risks by the securities houses in trading, bridge loans, risk arbitrage, etc. urgently require significantly higher levels of permanent capital to support such risks. In addition, margin requirements should be uniform as to options, futures and the underlying securities; all margins should be no less than 50%. Whether index arbitrage and program trading should be abolished is probably academic; I doubt that it is a practical option. I would be satisfied with the higher margins, and overall SEC regulation, together with additional measures to limit abusive speculation.

Speculation should be reduced by trying to change the behavior of institutional investors. The term "institutional investor" is well on its way to becoming a contradiction in terms.

Institutions, today, are speculating in every type of financial vehicle, from options to junk bonds, from real estate to foreign exchange. They are active players in the takeover game, encouraging corporations either to sell out or to engage in drastic, highly leveraged restructurings aimed essentially at maximizing short-term profits. They are becoming active participants in proxy contests. "Power without property" was the name of a book written 30 years ago by Adolf Berle, referring to professional managers, managing other people's money. That power, multiplied manifold, has now been combined with speculation on the part of these managers. But the property is not theirs. They are risking the assets of retirees, depositors, and policy holders. Since many of these institutions carry the explicit or implicit guarantee of the states or the Federal Government, they are also putting the taxpayers at risk. Trying to change this behavior is difficult; the financial interests supporting such behavior are very powerful. One has only to remember that when Former Fed Chairman, Paul Volker, wanted to effect a very slight change in the margin requirements on junk bonds, the vote on the Board was 3-2 after furious lobbying going all the way to the White House. The recent 3-2 vote by the SEC on the issue of derivative product regulation is a similar phenomenom. It is obvious that the speculative behavior of institutions is affected by financial deregulation as a whole; by the laxness of regulators with respect to these regulations that remain; and by the drive for short-term performance, at the expense of long-term safety, by the asset managers.

The price that the taxpayers will pay for deregulation and laxness in oversight is deliberately murky at this time but, in the long-run, will be staggering. Bailouts such as the rescue of Continental-Illinois Bank and the present efforts to rescue the First Republic of Dallas will cost the taxpayers billions of dollars. Estimates on the ultimate cost of bailing out the

S&L's increase almost daily, with some experts estimating $50-75 billion as the possible cost to the taxpayers.

Changing institutional behavior could include the following steps:

1) Impose a 50% tax on the profit on the sale of securities held for less than one year. This tax would apply to individuals, corporations, partnerships and presently tax free institutions. At the same time, reduce capital gains taxes on securities held for more than five years to 15%, possibly on a sliding scale;

2) Sharply limit the type and the proportion of speculative investments held by federally and state-insured institutions. A lesson in speculation and the failure of deregulation is the present status of S & L's not only in Texas, but in California and elsewhere. Present estimates range from $30 to $60 billion as to the losses which will have to be made up, by FSLIC, and ultimately by the taxpayers as a result of the speculation by those institutions. These figures do not take into account additional losses which these institutions, large holders of junk bonds, real estate loans, etc. may face in the next recession, when many of these securities will face serious cash flow problems;

3) Tighten the care and diligence standards to which trustees, directors and other fiduciaries are held with respect to investments by Federally or state-insured institutions;

4) Encourage equity investment and discourage excessive debt leverage by changes in the tax laws. Eliminate the double tax on dividend payments by corporations and limit, to some extent, the tax benefits of high leverage to non-financial corporations.

If any of these tax changes result in a loss of revenue, they would obviously have to be phased in after a Federal deficit reduction plan had been adopted.

It might also be worthwhile to set up a U.S./Japanese joint study group to review the interaction between the U.S. and the Japanese capital markets. Mr. Brady indicated a direct cause and effect relationship between Japanese sales of U.S. bonds and our subsequent market crisis. The imbalance in the Japanese markets is so great and the amounts involved so huge that some coordinating mechanisms between these markets might be useful in an emergency. Ultimately, we will obviously require global financial market regulation and responsible officials in the main Western countries should accelerate their studies of that very complicated question.

I am aware of the political difficulties of such a program. I am resigned to the reality that it will not happen until the next market crisis. However, both the Administration and the Congress have to consider the likely consequences of their failure to take preventive action now. We were very lucky last October. Lucky, not only because decisive action by various governments stabilized the situation, but lucky because the market collapse did not include the bond market or the dollar. If the bond market had collapsed as a result of a run on the dollar, major securities firms would have seen their capital wiped out as a result of significant portfolio losses in their bond inventories. Although the tendency during a stock market crash is a “run to quality” and, therefore, support for the credit markets, it is far from certain that this would be the case if the dollar were to come under serious pressure in a future emergency.

It is hard to understand the complacent attitude on the part of responsible public officials who, with the noteworthy exception of the Chairman of the SEC and the President of the N.Y.S.E., seem to believe that October 19-20 were simply an aberration and that high volatility is an unavoidable fact-of-life. It is a perfectly acceptable business or public policy strategy to deliberately refuse to take certain actions because the risk of being wrong is limited and acceptable. In this particular case, however, the risk/reward ratio is overwhelmingly on the side of preventive action, both regulatory and administrative.

One does not have to be a "prophet of doom and gloom" to sketch a possible downside scenario despite current strong statistics, a strong dollar and a firm stock market. We could, in a hard landing scenario, see significant downward pressure on the dollar accompanied by a sharp break in the credit markets and a new crisis in the securities markets. Under these circumstances, the possibility of a banking crisis caused by failures in the securities industry as well as savings and other institutions would be significant and would occur under the worst possible circumstances.

There is obviously no guarantee that any actions we take now will eliminate the risk of a recurrence of the market crisis. However, by acting now, we might mitigate the damage that it will cause by limiting its impact. We have created a gigantic financial house of cards. We have had fair warning about its weakness. At the very least, we should be ready to take action after the next shock to the system. Such a shock could well be more far-reaching than the last one as a result of the delay and a less benign economic climate at the time it happens. It is no coincidence that the explosion in speculation which we have witnessed over the past few years has also been accompanied by a significant increase in the level of illegal or unethical behavior in the financial community. Charges of insider-trading, parking, market manipulation, conflicts of interest, securities fraud, etc., etc., are more and more frequent. The combination of highly volatile markets together with charges of illegal or unethical behavior on the part of many in the financial community, have undermined the confidence of the public in the fairness of the system. Confidence in the fairness of our financial markets was an enormous national asset. It fueled our economy over the last forty years and was based on landmark securities legislation of 1933 and 1934. At a time when the need for domestic investment is very great, confidence in the system must be restored. It can only be restored by strong action by the Administration, the Congress and the regulators.

And, as they undertake this mission, their decisions should be guided by a vision of the kind of financial markets this Country needs. If we follow the path of least resistance, the consequences are likely be be very destructive. Demonstrating that this Country is prepared to make hard decisions, however, will be a clear signal of commitment to the inherent validity of our economic system. I would suggest that the reward would far outweigh the risk and might be measured in the renewed investor confidence and the capital investment we so desperately need to regain our globally competitive stature. It would be a reward that all of American society could enjoy.

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