BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

March 27, 1991

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Thank you for your recent letter requesting my views on Title III of S. 207, the Futures Trading Practices Act, as reported out of the Senate Agriculture Committee. In that letter you ask several specific questions about the regulation of hybrid instruments, including swaps, prescribed by the bill. I would like to focus on those matters on which I believe I can be of most assistance to you and give special attention to the treatment of swaps and deposits.

As I have noted in testimony and previous correspondence on these issues, various problems arise from a basic principle underlying the current approach to the implementation of the Commodity Exchange Act (CEA), under which instruments with elements of futurity may be considered to be futures contracts and therefore required to be traded on futures exchanges. This approach has led to confusion in financial markets and involvement of the courts, of which the situation involving index participations is a good example. The developers of new financial instruments--including risk-shifting products--are responding to perceived economic needs, but the uncertainty about the treatment of new financial instruments in the United States under the CEA tends to discourage such efforts and to give an edge to financial centers abroad.

Clearly, these provisions of the CEA are in need of repair, and I commend the Senate for seeking to make needed changes. However, as I indicated previously, the approach taken by S. 207 will continue to preserve impediments to innovation in hybrids and risk-management products and may well forestall developments in swap markets that could reduce systemic risk. The 50 percent value test embodied in the bill is arbitrary, as will be any procedure for determining the value of the commodity component of a financial instrument, and could yield anomalous results for similarly structured instruments. The exemptive authority given to the Commodities Futures Trading Commission (CFTC) under this bill is narrow and in some cases would prohibit the Commission from making appropriate exemptions. The hearing requirement could lead to a cumbersome exemptive process which itself would pose an obstacle to innovation. Further, the use of regulatory exemptions, once granted, itself creates uncertainty, as they may be revoked at a future date.

Instead of this approach, which seeks to exempt certain hybrids from the CEA, it would be preferable, as I have noted previously, to allow such instruments to trade on markets selected by the parties. Thus, equity-related derivative products could trade on either securities or futures exchanges and banks and other financial institutions could offer commodity derivative products where appropriate prudential and investor protection safeguards are in place. In this way, owing to different customer bases, similar products could evolve in ways that best meet the needs of those customers.

In the case of the swap markets, I am concerned not only about the potential adverse effects of S. 207 on competition and innovation but also about its potential to impede the development of netting arrangements designed to reduce counterparty credit risks and, therefore, systemic risks in the financial markets. Last November, the Governors of the central banks of the Group of Ten countries released a report that concluded that netting arrangements, if properly designed, have the potential to reduce the size of credit and liquidity exposures incurred by participants in interbank and other wholesale financial markets, including the swap markets, and thereby contribute to the containment of systemic risk. However, the provision of S. 207 that limits the exemptive authority of the CFTC to swap agreements that are "not designed to and would not result in a trading market in the swap agreement" could prevent the development within the United States of multilateral netting arrangements for swap obligations. Other conditions of this swap exemption authority may also result in a failure to exempt certain existing swap transactions. The enactment of these provisions could push multilateral netting arrangements for swap obligations and the swap markets themselves offshore.

Proponents of the prohibition of multilateral netting of swap obligations have argued that such a system would, in effect, be a futures exchange and, therefore, should be subject to CFTC regulation. There are important differences, however, between a traditional futures exchange and the multilateral netting systems that have been developed in other financial markets. Participation in these netting systems generally is limited to commercial banks and other regulated financial institutions that traditionally have taken an approach to risk management that is fundamentally different from the approach used by futures exchanges. In designing multilateral netting systems, generally these institutions have adopted decentralized systems that preserve incentives for bilateral risk management (by allocating losses from a default in the first instance to the original counterparties of the defaulting participant) rather than adopting the centralized systems used in the futures industry that mutualize losses without regard to the original counterparties. For such decentralized systems, the regulatory framework developed by the CFTC for futures exchanges seems inappropriate. The case for CFTC regulation is further reduced if those other systems are subject to regulation by another federal agency.

In addition to extending the coverage of the act to swap transactions, Title III also suggests that the CFTC will have jurisdiction over some depository instruments and lending transactions. We do not believe that it is appropriate for banking activities of federally regulated institutions to be subject to the jurisdiction of the CFTC. Banks are subject to a comprehensive system of federal regulation designed to ensure the safety of the institutions and to protect their customers; there is no need to impose another layer of regulation on their activities, especially where that regulation is designed to meet concerns that are not relevant to banking activities. Further, the bill could be read to preclude banking regulators from overseeing banking transactions that are exempted by the CFTC, a situation that would be inadvisable.

I hope you find these comments to be helpful.

Sincerely,

Alan Greenspan