

FROM: [REDACTED]
DATE: 2 March 1988

[REDACTED] BRADY REPORT

The discussion over dinner at [REDACTED] last night was animated and, in parts, quite illuminating.

The Problem

2. A key underlying issue is the one we discussed with the Stock Exchange: what precisely should concern us about the events of October 17/18? [REDACTED] assumed it was sufficient answer to point to the speed and sharpness of the market break. Pressed, he made two points, First that crash was bad for investor confidence. However, it turns out that turnover in New York - in sharp contrast to London - is back to pre-crash levels (do we know what has happened to turnover elsewhere, by the way?) In any event, presumably investors learn from experience. And, arguably, the long drawn out agony of a 1974/5 type bear market is even worse for investor confidence. Second, the sheer volume of trading clearly stretched market capacity close to breaking point, highlighting particular points of weakness (eg in the clearings).

3. On the other hand, however, a sudden fall is not obviously worse for the economy; and, remarkably enough, it produced virtually no casualties, even within the financial sector. Admittedly, the Fed rose magnificently to the occasion: but in truth it did no more than discharge the central bank's traditional role in moments of financial crisis.

4. [REDACTED] clearly felt unhappy that he could not explain why markets turned again on the Tuesday. We suggested that it might be because markets do eventually find a floor, left to themselves. Some of the mechanisms involved are clear, with the benefit of hindsight: stocks began to look cheap, and [REDACTED] and their like got on the telephone to their clients, including leading companies, who duly announced buy-back programmes. It is not necessary to cite the Wall Street Journal's theory that the MMI was manipulated.

5. Should we go along with the conclusion that we have had a lucky escape? That was one of the thoughts that [REDACTED] wanted to leave with us. We argued that it deserved critical examination. Playing safe comes naturally to regulators, but it has a cost, in terms of market efficiency. There is another line of argument, which starts from Greenspan's observation that the break was "an accident waiting to happen". Arguably, major players were simply waiting for the market to turn by October 17, and they had made their dispositions accordingly. [REDACTED] freely acknowledge that - BP aside - they were "storm-rigged", and thought others were too. This might explain why the fall was so sudden, when it started (the real news by October 17 was not any snippet of macro-economic or political information, but the fact that everyone else was selling); and why, relatively speaking, it did so little damage. Of course, it would be unsafe to assume that a genuinely catastrophic event coming out of the blue would not do a great deal more damage. But there is nothing new about that; normal supervision can never attempt to cope with Armageddon.

BP

6. Incidentally, as [REDACTED] is no doubt aware, the BP episode has clearly prompted [REDACTED] to do some very hard thinking. They said, revealingly, that they regarded themselves as primarily providing "distribution capacity", and BP had made them ponder anew on the insurance aspect of underwriting. I sensed that they felt they had been careless, but they also claimed that it was not possible for them to hedge their exposure satisfactorily. They had considered some options, but had

rejected them on cost grounds (I found this a slightly unsatisfactory reply, but did not get the opportunity to pursue it). Above all, they simply had not understood the political and fiduciary aspects of the Chancellor's position.

Brady recommendations

7. Turning to the Brady recommendations, we all agreed that regulatory reform should happen anyhow in the US; the case for it did not depend on the October crash. I thought [REDACTED] was rather over-optimistic about the Fed's potential role: he had some difficulty in grasping the "moral hazard" point, and seemed to feel that Greenspan was simply being coy for political reasons. There was no enthusiasm anywhere around the table for significantly increased capital requirements. And [REDACTED] thought it was positively Luddite to contemplate measures that would stifle the development of derivative product markets - an approach which was anyhow not in the realm of practical politics in the US though it might be in the UK. Nor did he think it worth attempting to outlaw portfolio insurance, or whatever the next thing turns out to be. Indeed, he felt strongly, with the Stock Exchange, that we needed more not less index arbitrage.

8. Which left circuit-breakers, about which [REDACTED] was positively enthusiastic, while accepting that they were a second-best solution. He made two points: first that "unacknowledged" and hence even more arbitrary circuit-breakers already existed, for example in the form of discretionary trading halts; his current circuit-breaker would be fairer. And second, that they would only be used in a crisis, and would be a highly cost-effective regulatory device. Nevertheless, he accepted that existing circuit-breakers were less easy to identify in an over the counter market, like London. And he freely acknowledged that the real technical problem lay not in stopping the market, but in getting it going again, in an orderly way after a break. It was not clear to me that he had any ready-made technical solutions to this fairly fundamental problem. (He did however comment that volume limits would work better than price limits, which Brady did not recommend).

Other Issues

9. Finally, we failed to get [REDACTED] to say anything interesting on the "global market" theme though we argued, for example, that for the UK one serious problem raised by October 17/18 was virtually ignored by the Brady Report. The US market collapse could, arguably, be regarded as home-grown. But both the Japanese and the UK economies had clearly been doing well: there was a temptation to see ourselves as standing in the path of a world-wide bush fire that had been set alight the other side of the Atlantic. On reflection, I do not think there is much in this; arguably the speculative bubble was at least as fully inflated in the UK as in the US. ([REDACTED] seemed very ill-informed about events outside the US. But we left him in no doubt that his circuit-breaker proposals would not be taken up in London, whatever happened in New York.)

10. Finally, one interesting snippet: [REDACTED] was quite confident that the New York Stock Exchange would introduce a spot index product in the fairly near future. Work is apparently well advanced: perhaps [REDACTED] might note it down as something to look into, if there is time, when he goes to the States.

