

Changes in the Government Securities Market

by *E. Gerald Corrigan*

I am pleased to have this opportunity to appear before you this morning to share with you my observations on the *Joint Report on the Government Securities Market*, with particular emphasis on those aspects of the report that relate directly to the activities or responsibilities of the Federal Reserve Bank of New York.

Let me say at the outset that I strongly support the overall thrust of the joint report. Taken as a whole, the changes and legislative recommendations outlined in the report represent a comprehensive yet well-balanced approach to the problems that surfaced in the government securities market last year. Let me quickly add that the changes are at or near the outer threshold of what I believe the market can reasonably absorb in the near term without running undue risks to market efficiency, Treasury debt management practices, or the flexibility of Fed open market operations.

With those general observations in mind, let me turn to the specific aspects of the report that relate directly to the responsibilities of the Federal Reserve Bank of New York. There are three such major areas: first, the changes in the Bank's administration of relationships with primary dealers; second, the Bank's role in the development, testing, and implementation of new automated systems for Treasury auctions and Fed open market operations; and third, the Bank's expanded role with regard to day-to-day surveillance of the government securities market. The statement concludes with a

brief status report from the Fed's standpoint on the Salomon Brothers situation, as requested by the Committee.

Administration of relationships with primary dealers

Attached to this statement is a paper issued late last month by the Federal Reserve Bank of New York outlining revised procedures for the administration of the Bank's relationships with primary dealers (see appendix). While that document itself represents a careful balancing of many considerations and viewpoints, it is based on a number of key and interrelated considerations, including the following.

First, while change was needed, the complete dismantling of the primary dealer system—including the responsibility of dealers to make markets for Fed open market operations and to participate meaningfully in Treasury auctions—would not have been a prudent step.

Second, in part because the existing approach has been viewed as conferring special status on dealer firms that carries with it elements of "franchise" value, and in part because of fairness and equity considerations, it was important to provide for a more "open" system of primary dealers. This has been accomplished by the elimination of the so-called 1 percent market share requirement and the use of straightforward and objective capital standards for eligibility as a primary dealer. Taken together, these changes will substantially increase the potential number of firms that can become primary dealers.

Third, in part because of "moral hazard" considera-

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tions and in part because of legal and regulatory realities, it was important that the Federal Reserve Bank of New York make absolutely clear to the marketplace that the New York Fed does *not* regulate the primary dealer firms. For this reason we are disbanding the Bank's *dealer* surveillance unit.

Fourth, for obvious reasons, it was necessary to clarify the reasons and the conditions under which the New York Fed would alter its relationship with a primary dealer firm. Under the new administrative procedures, there are three independent sets of circumstances under which that might occur:

- A dealer firm's status will be altered if the firm fails to meet its responsibilities to make reasonable markets for Fed open market operations *or* it fails to participate meaningfully in Treasury auctions *or* it fails to meet its responsibilities to provide the Fed with meaningful market intelligence over time. To the extent a firm's dealer status is altered for any or all of the above reasons, that action by the Fed will reflect considerations relating to the business relationship alone and will carry no implication as to the creditworthiness, financial strength, or managerial competence of the firm.
- A dealer firm's status will be altered if its capital falls below the relevant capital standards and it does not, in the eyes of its primary federal regulator, have a credible plan to restore such capital in a reasonable period of time.
- A dealer firm's status will be altered if the firm is convicted of a felony under U.S. law or pleads guilty *or nolo contendere* to a felony under U.S. law for activities directly or indirectly related to its business relationship with the Federal Reserve. This should create powerful incentives for a firm—when faced with wrongdoing by individual employees—to take immediate and strong actions to root out the source of the problem so as to minimize the risk to that firm.

While major elements of the changes in the administration of the relationships with primary dealers will begin to take place immediately, the full benefits of these changes will occur only as the automation of Treasury auctions and Fed open market operations takes place and as the other changes contemplated by the joint report take hold. Over time, however, the automation efforts may prove particularly important. These initiatives are described below.

Federal Reserve Bank of New York automation efforts

The design work for the automation of the competitive bidding portion of Treasury auctions based on existing

auction techniques has been under way for some time and should be completed late this year. The software for the automation of the auctions is not particularly difficult to develop. The difficult aspects of this task relate more to its communications system—particularly as the number and nature of prospective direct participants in the auctions change. But what makes this automation effort especially difficult is the need to build into the computer systems and the communications system a very high level of operational integrity, as well as multiple levels of backup for various contingencies.

If the Treasury were to decide to move to a different auction technique, the strategy would be to enhance the system presently being developed to accommodate both types of auctions. While important elements of the work being done for the current auction procedures can be used with a new auction technique, the enhancement of the system being developed to accommodate the new procedures will take some time after the requirements have been defined. This will not, however, delay the planned implementation of automated procedures for the current auction by the end of this year.

In order that the Committee might gain a more useful insight as to exactly how the automated Treasury auction system will work in practice, and at the risk of a great oversimplification, the major characteristics of the system can be thought of in the following terms.

First, each institution that is "eligible" to submit competitive bids in Treasury auctions would have a terminal-based telecommunications link to the Federal Reserve Bank of New York, either directly or through another Federal Reserve Bank. The basic "hardware" used for this purpose will be the FedLine terminal that is presently in use in over 9,000 depository institutions nationwide. The communications network will be the proven and highly reliable Fedwire telecommunications system. Finally, the new auction system will utilize the same security and encryption devices that are currently used for Fedwire operations.

Second, for each such "eligible" bidder, certain data—including any affiliations with other "eligible" bidders—would have to be housed in our data base, as would acceptable methods for making payment for securities and for receiving delivery of securities awarded in the auctions. Since payment and delivery must be made in electronic form, nonbanks would have to have suitable "auto-charge" agreements in place with banks for this purpose.

Third, following electronic announcements of notices of auctions, bidders would be able to submit bids electronically up until the auction cutoff time, which currently is 1:00 p.m. eastern standard time. In order to provide adequate backup for contingencies, however, the system must be designed such that all bids can be

routed to *both* the Federal Reserve Bank of New York's main data processing center in lower Manhattan and its remote backup processing center.

Fourth, the computers would then sort through the bids on the basis of the highest prices (lowest yields) received in much the same fashion as today's manual procedures do. As a part of this process, a number of internal audit and control procedures are planned to ensure compliance with Treasury auction rules and to flag outlier bids, including those resulting from clerical errors in message preparation.

Fifth, once the proper audits have been performed, the information has been sent to the Treasury, and the "awards" have been made, the payment for and delivery of the securities must be initiated and completed. This will be achieved through the Fed's money and securities transfer systems (Fedwire).

Finally, and in the normal course, after the initial delivery and payment for the securities in question are completed, end-of-day verifications and reconciliements must be made as a part of the overall controls on operating systems that often handle more than \$1 trillion of transactions per day.

The full automation of Fed open market operations is an even more complex and time-consuming task, especially since it is impossible to prejudge with any precision the number, location, and other characteristics of potential counterparties for such operations. Moreover, the operating systems and communications systems associated with this effort must be integrated with a number of other highly complex automated systems, including the Fed's existing money and securities transfer systems. Because of this, an extraordinarily high level of reliability and integrity will be needed. To appreciate the concerns I have in mind, just imagine for a moment what might have occurred on the morning of October 20, 1987, had the Fed been unable—due to technical problems with such a system—to furnish substantial liquidity through open market operations as a part of the effort to stabilize financial markets in the wake of the stock market crash.

The role of the Federal Reserve Bank of New York in the market surveillance process

There is little that needs to be added to what is contained in the joint report as it pertains to the expanded role of the Federal Reserve Bank of New York—in cooperation with the other agencies—with regard to day-to-day surveillance of the government securities market except (1) to emphasize that *market* surveillance is quite distinct from *dealer* surveillance, which we are

discontinuing; and (2) to emphasize that it will take some time to put in place the new or altered statistical reporting arrangements that might be agreed upon by the interagency surveillance working group over the period immediately ahead.

As a first step in the overall process of gearing up for this effort, the Federal Reserve Bank of New York expects to have the initial redeployment of key personnel necessary for this effort in place later this month. Final decisions as to the number and mix of personnel needed for this effort will have to await agreement among the agencies as to the precise scope and nature of the statistical reporting and other aspects of the market surveillance effort, which should be essentially completed in a month or two.

The Salomon Brothers situation

Since the official investigation into the Salomon Brothers wrongdoings is still under way, there is very little that can be said at this time regarding the particulars of that situation. The firm, in response to inquiries by the Federal Reserve Bank of New York, has provided the Bank with several reports over the period from September through December 1991. In general, these reports cover (1) the sweeping changes in management and management structure that were put in place following the disclosures made by the firm last August, (2) the major changes in internal control procedures and compliance systems that have been put in place over the period in question, (3) various estimates of the profits associated with the auctions in which irregularities have been acknowledged by the firm, and (4) further details regarding the firm's financing activities in certain of the Treasury issues. Where relevant, all such materials have been made available to the Securities and Exchange Commission and the U.S. Attorney.

It is contemplated that any decision regarding Salomon Brothers' status as a primary dealer by the Federal Reserve Bank of New York will be made in the context of the findings reached by the Securities and Exchange Commission as a result of its ongoing investigation of the matter. This approach, which has the support of the other agencies, is being followed in deference to fairness and due process considerations and in order to minimize uncertainties that might follow from multiple and uncoordinated announcements of this nature. The timing of the Salomon Brothers episode is such that certain Federal Reserve Bank of New York sanctions might apply even if the firm is not convicted of, or pleads guilty or *nolo contendere* to, a felony under U.S. law.

Appendix: Administration of Relationships with Primary Dealers

The Federal Reserve Bank of New York (FRBNY) is adopting certain changes in the administration of its relationship with primary dealers in U.S. Government securities. The primary dealer system has been developed for the purpose of selecting trading counterparties for the Federal Reserve in its execution of market operations to carry out U.S. monetary policy. The designation of primary dealers has also involved the selection of firms for statistical reporting purposes in compiling data on activity in the U.S. Government securities market. These changes in the administration of these relationships have been developed after consultation with the Federal Reserve Board, the Federal Open Market Committee, the Treasury and the Securities and Exchange Commission.

The changes announced today have been prompted by two related factors:

First, decisions have been made to accelerate the automation of Treasury auctions and Federal Reserve open market operations with a view toward increasing the efficiency of the auction process and open market operations, and providing the potential for further broadening the base of direct participation in these operations. These automation initiatives are major undertakings, as they must be planned and executed with extreme care to ensure operating and communications systems of the highest level of reliability and integrity. They will require back-up systems comparable to those now in place for the Fed's funds and securities transfer systems. Planning for automation of the existing Treasury auction format is well under way and automation is scheduled for completion by the end of this year. Automation planning for Federal Reserve open market operations is just getting started, and completion of this automation will probably take about two years.

Second, and more important, while the system of designating primary dealers on the whole has served the Federal Reserve, the Treasury, and the nation well for many years, there also have been some drawbacks to the existing arrangements. Prominent among these is the public impression that, because of the Federal Reserve Bank's standards for selecting and maintaining these relationships, the Fed is in effect the regulator of the primary dealer firms. Moreover the primary dealer designation has been viewed as conferring a special status on these firms that carries with it elements of "franchise value" for the dealer operation and possibly for other aspects of the firm's standing in the marketplace.

The net result of these interrelated factors is that the Federal Reserve is amending its dealer selection criteria to begin providing for a more open system of trading relationships, while still exercising the discretion that any

responsible market participant would demand to assure itself of creditworthy counterparties who are prepared to serve its needs.

For the most part, the changes in the administration of the primary dealer relationships will have no immediate effect on existing primary dealers—recognizing, of course, that they will, over time, be subject to the requirements noted below for maintaining a counterparty relationship with the Fed. However, existing as well as any new primary dealers will *no longer be required* to maintain a one percent share of the total customer activity reported by all primary dealers in the aggregate; this requirement is no longer deemed necessary given the active and liquid state of development now achieved in the U.S. Government securities market, and its retention could be an obstacle to achieving more open trading desk relationships. In addition, while continuing to seek creditworthy counterparties, and while continuing to exercise market surveillance, the FRBNY will discontinue its own *dealer surveillance* activities relating to primary dealer firms' financial characteristics.

New firms will be added on the basis of criteria listed below. As in the past, all primary dealers will be expected to (1) make reasonably good markets in their trading relationships with the Fed's trading desk; (2) participate meaningfully in Treasury auctions; and (3) provide the trading desk with market information and analysis that may be useful to the Federal Reserve in the formulation and implementation of monetary policy. Primary dealers that fail to meet these standards in a meaningful way over time will have their designation as a primary dealer *discontinued* by the FRBNY. It is contemplated that each dealer firm's performance relative to these requirements will be reviewed on an ongoing basis and evaluated annually beginning in June 1993. If a firm's relationship with the FRBNY is discontinued because of shortfalls in meeting these standards, the action by the FRBNY will be made strictly on a business relationship basis. As such, any decision by the FRBNY will carry no implication as to the creditworthiness, financial strength or managerial competence of the firm.

In evaluating a firm's market-making performance with the trading desk, the FRBNY will look to the amount of business of various types actually transacted and the quality of the firm's market-making and market commentary. Dealers that do little business with the Fed over a period of time, that repeatedly provide propositions that are not reasonably competitive, and that fail to provide useful market information and commentary add little to the Fed's ability to operate effectively and will be dropped as counterparties for at least six months.

In evaluating participation in Treasury auctions, the Fed will expect a dealer to bid in reasonable relationship

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to that dealer's scale of operations relative to the market, and in reasonable price relationship to the range of bidding by other auction participants. Any decision to suspend a primary dealer designation because of inadequate auction bidding will be taken in close consultation with the Treasury.

Finally, consistent with the Omnibus Trade & Competitiveness Act of 1988, a foreign-owned primary dealer may not be newly designated, or continue to be designated, in cases where the Federal Reserve concludes that the country in which a foreign parent is domiciled does not provide the same competitive opportunities to U.S. companies as it does to domestic firms in the underwriting and distribution of Government debt.

Criteria for accepting new dealers

New primary dealers must be commercial banking organizations that are subject to official supervision by U.S. Federal bank supervisors or broker/dealers registered with the Securities and Exchange Commission. The dealer firms or the entities controlling the dealer firms must meet certain capital standards as follows.

- Commercial banking institutions must—taking account of relevant transition rules—meet the minimum Tier I and Tier II capital standards under the Basle Capital Accord. *In addition*, commercial banks must have at least \$100 million of Tier I capital as defined in the Basle Capital Accord.
- Registered broker/dealers must have capital in excess of the SEC's or Treasury's regulatory "warning levels" and have at least \$50 million in regulatory capital. Where such capital standards do not apply to a consolidated entity controlling a primary dealer—consistent with the treatment of banks under the Basle Accord—the FRBNY will also look to the capital adequacy of the parent organization.

The minimum absolute levels of capital specified above (i.e., \$100 million for commercial banks and \$50 million for broker/dealers) are designed to help insure that primary dealers are able to enter into transactions with the Fed in sufficient size to maintain the efficiency of trading desk operations.

A bank or a broker/dealer wishing to become a primary dealer must inform the FRBNY in writing. As a part of that notification a prospective dealer must also provide appropriate financial data demonstrating that it meets the capital standards outlined above. The FRBNY will consult with the applicable supervisory body to ensure that the firm in question is in compliance with the appropriate capital standards. When new firms are accepted as primary dealers, the nature and extent of the Bank's trading relationship with the firm will, as under current practices, evolve over time. As a result of this change and the

elimination of the one percent market share criterion, there will no longer be any need for individual firms to be considered by the market as "aspiring dealers."

Of necessity, at least for the time being, the number of additional primary dealers will be relatively limited because of resource constraints on trading desk operations. The selection of this limited number will be dependent on how many can be added without adverse impact on the efficiency of Federal Reserve trading desk operations. Applications received by March 31, 1992, will be evaluated in relation to the foregoing capital standards. If it is not feasible to add all of the qualifying firms as primary dealers, a selection will be made among those firms in a manner that gives primary consideration to their relative capital positions. Following the implementation of automated communications for trading purposes, further expansion in the number of primary dealers will be feasible, and further changes in the criteria for selection also could be considered, although there is no preconception at this time as to what, if any, further changes would be made.

Maintenance of capital standards

As a result of the adoption of the capital standards for accepting primary dealers, all primary dealers will be expected to maintain capital positions that meet the standards described above on an ongoing basis. Should a firm's capital position fall below these minimum standards, the FRBNY may suspend its trading relationship until the firm's capital position is restored to levels corresponding to these minimum standards. In making such determinations, the FRBNY will look to the firm's primary Federal regulator for guidance as to whether the firm has in place an acceptable plan to restore its capital position in a reasonable period of time. However, in no circumstances will the Bank maintain a trading relationship with a primary dealer that is unable to restore its capital position to the stipulated minimum level within a year. Over time, the maximum grace period of one year may be shortened and would not apply in any event if a firm's capital position were seriously impaired.

Elimination of dealer surveillance

While the Federal Reserve Bank of New York will continue to seek creditworthy counterparties—and will continue, or enhance, its *market* surveillance—it is planning to discontinue the "dealer surveillance" now exercised over primary dealers through the monitoring of specific Federal Reserve standards and through regular on-site inspection visits by Federal Reserve dealer surveillance staff. Rather, the FRBNY will seek to act as any reasonably well-informed and responsible firm might behave in evaluating the creditworthiness of its counter-

Appendix: Administration of Relationships with Primary Dealers (continued)

behave in evaluating the creditworthiness of its counterparties. Accordingly, the Federal Reserve will expect to receive periodic reports on the capital adequacy of primary dealers, just as any other responsible market participant should expect to receive such reports.

The elimination of the Bank's dealer surveillance activities should be viewed merely as confirmation of the long-standing reality that the Bank does not have—nor has it ever had—formal regulatory authority over the Government securities market or authority over the primary dealers in their capacity as such. The Bank is satisfied that the existing regulatory apparatus over the market and the regulatory apparatus as it applies to dealer firms are adequate—especially in light of changes outlined in the joint Treasury-SEC-Federal Reserve study—and it is satisfied that it can protect itself against financial loss without reliance on formal dealer surveillance.

Sanctions of primary dealers for wrongdoing

The Federal Reserve Bank of New York does not have civil or criminal enforcement authority over primary dealers in their capacity as primary dealers. This consideration and the dictates of fairness and due process require that the disposition of allegations of wrongdoing lies with the Government bodies having such authority—including the U.S. Treasury, the Federal bank supervisor, the Securities and Exchange Commission and the U.S. Department of Justice.

In the future, if a primary dealer firm itself is convicted of a felony under U.S. law or pleads guilty or *nolo contendere* to felony charges under U.S. law for activities that relate directly or indirectly to its business relationship with the Federal Reserve, the firm will be subject to

punitive action, possibly including suspension as a primary dealer for six months. Depending on the nature of the wrongdoing the penalty could be more severe, including permanent revocation of a trading relationship.

Statistical reports on government securities activities

The current statistical reporting program is expected to continue unchanged for the time being, but a review is being undertaken to determine how best to adapt this program to an environment in which market surveillance is receiving greater emphasis and a statistical reporting relationship is not necessarily tied to a trading relationship with the Federal Reserve. This review will take into account the needs of the Federal Reserve, the Treasury and the SEC as well as the burden of statistical reporting on dealer firms.

Summary

Taken as a whole, these changes are designed to facilitate an orderly and gradual move to a more open system of primary dealer relationships with the FRBNY while at the same time preserving certain key characteristics of the current system that have been beneficial to the Federal Reserve and the Treasury over the years. Over time, the successful implementation of highly automated systems for Treasury auctions and Federal Reserve open market operations will provide the room and the opportunity for still further changes. However, the desirability of further changes will have to be evaluated against the experience with these modest changes and the need to preserve both the efficiency and flexibility of Federal Reserve monetary policy operations, and the liquidity and efficiency of the market for U.S. Government securities.