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Committee on Banking, Finance and Urban Affairs

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Mr. Chairman, members of the Committee, thank you for this opportunity to present the Federal Reserve Board's views on reforms to the regulation of the government securities market. Just two weeks ago, staff of the Federal Reserve, the Treasury Department, and the Securities and Exchange Commission (SEC) released results of their exhaustive examination of this market. My prepared remarks will touch upon some of the main conclusions of this report from the particular perspective of the Board of Governors of the Federal Reserve System. Our perspective differs somewhat from the other agencies contributing to the report due to differences in legislative mandates. The Board of Governors has little direct regulatory authority for the U.S. government securities market.

While the Board has general oversight responsibility for all Federal Reserve District Banks, it is the District Banks that act as fiscal agents of the Treasury, thus sharing with the Treasury operating responsibility for the market. In addition, it is the District Banks that routinely examine those financial institutions for which the Federal Reserve System has primary oversight responsibility, virtually all of which hold and some of which actively trade government securities. It is the SEC's charge to enforce the securities laws that seek to foster a high degree of fairness in the marketplace. With neither the direct responsibilities of funding the government nor substantial regulatory oversight, the Board of Governors can view this market from a somewhat different vantage point--a policy perspective that allows us to examine these issues in an economy-wide context.

When we look to the government securities market, we see a market that works as well as any on earth. U.S. government debt is an ideal trading vehicle, since it is all closely substitutable and has none of the default risk or idiosyncratic problems of private issues. As a result, market participants, in the aggregate, willingly commit substantial amounts of risk capital and exchange a large volume of securities each day. Positions are large yet trading skills are so sharply refined that bid/ask spreads are razor thin, a small fraction of the size of spreads in major equity markets.

This market generates widespread macroeconomic benefits. The government securities market efficiently absorbs the large quantity of new issues required to finance the deficit. With real-time quotes on a range of instruments, this market serves as the foundation for private market rates and a haven for ready liquidity. Further, this deep and liquid market gives the Federal Reserve a powerful, reliable mechanism to implement monetary policy.

Nonetheless, the admission of wrongdoing by Salomon Brothers, episodes of price distortions, and other evidence uncovered in our joint study all suggest that this market has faults. It can be improved. The proposals contained in the joint report, along with other reforms announced earlier, constitute a careful, comprehensive modernization of the mechanisms and practices in the government securities market. Implementing these proposals represents a formidable, though feasible, task in our view.

Over the longer term, the most effective force in enhancing market efficiency and reducing the potential for manipulative abuses is the force of competition. And the effect of these proposals is to open up the government securities market to broad-based participation. Automating Treasury auctions; facilitating direct bidding by customers, including non-primary dealers; implementing a single-price, open auction technique; and reducing the barriers to primary dealer membership all will serve, in time, to broaden participation in the primary market and in the secondary market for newly issued securities. More depth and breadth in this end of the market should increase efficiency, reduce Treasury financing costs, and lessen the potential for manipulative trading abuses. In addition, the competitive force of broader participation will be reinforced by proposals targeted at manipulative abuse: tighter enforcement of auction rules and enhanced market surveillance by the Federal Reserve Bank of New York to identify potential manipulative episodes that could trigger SEC investigation and Treasury supply management to reopen offerings.

Taken together, these actions should serve to deter manipulative practices and quickly detect abuses should they occur. Moreover, they are relatively low-cost, market-based responses that should achieve these benefits without impairing the efficiency and liquidity of this vital market.

There are, of course, many other alternatives which could be considered to combat the potential for abuses in this market. However, the government securities market is too important a national resource and works too well to be put at risk by regulatory change for the sake of change. From the Board of Governors' perspective, a compelling case must be established that the benefits outweigh the costs.

In our view, such a compelling cost-benefit analysis has not been made with respect to proposals to establish a broad-based apparatus of reporting requirements in this market, either directly or through audit trails or transparency requirements. While increased reporting would deter manipulation and facilitate the investigation of abuses, such systems would impose substantial potential costs on this market. The reporting burden would fall on all traders--the good and the bad--boosting the cost of every trade. While the direct costs of additional record keeping might be kept manageable, an indirect cost looms larger. Rather than risk the divulging of their finances and trading strategies, participants might withdraw from this market, thereby raising the cost of Treasury finance. And, of course, the stakes are high. A tiny increase in Treasury rates aggregates into a very substantial increase in cost to U.S. taxpayers.

Because it might be difficult to resist implementing, even backup authority risks sending a chilling message about the U.S. market to all participants choosing a trading arena in the global marketplace. Moreover, in view of the extensive nature of the other changes proposed in this report, one might question the capacity of this market to absorb, at an acceptable cost, this additional change--the imposition of broad-based reporting requirements for this market. The agencies agree that large position reporting requirements should not be implemented at this time. Rather than risk slipping into this fundamental change through backup authority, the Board of Governors feels it would be a wiser course of action to return to Congress for enabling legislation in the future should such authority appear necessary.

This Committee's important mandate is to ensure that a legislative framework is in place that provides for the adequate supervision of the government securities activities of banks. In the Board's opinion, the current supervisory structure secures a full measure of prudential oversight of the activities of commercial banks and bank-related dealers in government securities. The Federal Reserve System's share of responsibility for that supervision and oversight has three components.

First, under the Government Securities Act of 1986 ("GSA"), government securities brokers and dealers that are financial institutions are subject to oversight by their primary federal supervisory agency. In this capacity, the Federal Reserve's watch extends to State member banks of the Federal Reserve System, foreign banks, State branches and agencies of foreign banks, and commercial lending companies owned or controlled by foreign banks. As a part of their annual examinations, Federal Reserve examiners review dealer compliance with all aspects of GSA-mandated rules adopted by the Treasury Department. Specifically included are rules designed for protection of investor securities and funds, recordkeeping, registration of associated persons, and rules governing custodial holdings of government securities--the latter of which are applicable to all depository institutions.

Second, the Federal Reserve examines the trading and investment practices of nonbank subsidiaries of bank holding companies that deal in or underwrite securities--including government securities--to ensure that they are being prudently managed and do not pose an undue risk to bank affiliates. These subsidiaries are registered with the SEC and are examined by a self-regulatory organization ("SRO"), such as the NASD, for compliance with all rules applicable to broker-dealers. Federal Reserve inspection procedures are designed to prevent, to the extent possible, duplication of the procedures of the various SROs. For the so-called "Section 20 subsidiaries," which have been authorized to underwrite and deal in bank-ineligible securities, the Federal Reserve also examines for compliance with its "firewall" provisions, which importantly insulate affiliated depositories and the federal safety net from the risks inherent in the securities business. Moreover, section 20 inspections check compliance with the Board's revenue test, verifying that Section 20 subsidiaries do not become principally engaged in the distribution of securities in violation of the Glass-Steagall Act. Moreover, all inspections of nonbank subsidiaries include an evaluation of their financial impact, if any, on the parent bank holding company.

Third, the Federal Reserve supervises State member banks' investment activities, which in virtually all instances include investments in government securities. Despite the diminished concerns about credit quality afforded by a portfolio of government securities, examiners still must scrutinize those holdings. For example, a portfolio's liquidity and interest rate risk must be evaluated to determine whether the investments are consistent with the institution's financial position and management's expertise. Indeed only last month, the Federal Reserve and other depository institution regulatory agencies issued a revised supervisory policy statement that describes securities trading practices that are inappropriate to be conducted in an investment portfolio.

Returning to the broader issue of the health of the government securities market, it is the Board of Governors' judgment that the reforms outlined in the interagency report--changes in auction mechanisms, active and rigorous monitoring of market rates, and the clear willingness to use relative supplies to punish manipulative behavior--will work to prevent a replay of last year's events. These are fundamental changes in market mechanisms that promise to open up this market to broad-based participation while, at the same time, enhancing regulatory surveillance and remedial capabilities. These responses are measured, targeted and commensurate to the problem at hand, and, in our view, obviate the need to punish many with reporting burdens because of the actions of a few. This strategy also offers flexibility to deal with future problems as they arise. It is perhaps ironic that the most serious abuses in the history of this market--the Salomon Brothers episode--have served as the catalyst for changes that promise substantial long-term benefits. Taken together, these proposals and those already implemented constitute a thorough, thoughtful, and feasible renovation of the government securities market and will result in a healthier, more efficient market for our U.S. government securities.