For release on delivery
10:00 A.M., E.D.T.
April 28, 1992

Statement by

David W. Mullins, Jr.

Vice Chairman, Board of Governors
of the Federal Reserve System

Before the

Subcommittee on Domestic Monetary Policy

U.S. House of Representatives

April 28, 1992

Mr. Chairman, members of the Committee, thank you for this opportunity to communicate the Board of Governors' views on proposed legislation concerning the government securities market. The Joint Report on the Government Securities Market suggested comprehensive administrative changes, some already made and others proposed, that will significantly increase openness in this market and sharply limit the possibility of a replay of recent events. The Board supports these changes, which are targeted to the problems and opportunities identified to foster fair and efficient markets. In the Board's view, this progress makes it inadvisable to enact either H.R. 4450 or 3927.

This decision was made after carefully weighing the costs and benefits of further change, as we see them at this time, in accordance with our legislated role in the oversight of financial markets. In 1789, President Washington and the first Congress charged the Department of the Treasury with the responsibility of borrowing in the name of the new republic. In 1913, the drafters of the Federal Reserve Act assigned the Federal Reserve District Banks to serve as fiscal agents for the Treasury, facilitating the nationwide distribution of the debt. Later, in 1934, Congress created the Securities and Exchange Commission to enforce securities laws that were targeted to counter the considerable problems at hand in private financial markets by nurturing fairness and openness. While the Board works closely with the various agencies and has general oversight responsibilities for the activities of the District Banks, we have little direct regulatory authority for the U.S. government securities market.

We think that this arrangement is wise and gives the Board of Governors a unique perspective, allowing us to examine important issues regarding this market from an economy-wide perspective. Freed of the specific responsibilities of managing the debt, distributing securities, or policing trading activity, we can evaluate the consequences of proposed reform against broad public policy standards.

Our overall evaluation of both pieces of legislation started from a fundamental question: what are the problems that need to be addressed? In the Board of Governors' view, the government securities market ably performs an important allocative role in the U.S. economy, matching a voracious borrower, the federal government, with investors across the nation and around the world. The U.S. government has been able to tap this market with record issuance time and time again. This market is deep and liquid, routinely permitting participants to execute trades of huge size with remarkable rapidity at paper-thin bid/ask spreads. Consequently, the market serves as an important source of liquidity for individuals and financial institutions.

The trading community commits large sums of risk capital to provide these services in the pursuit of profits. But there are economy-wide benefits as well. The government securities market has an impressive ability to digest news, translating the daily barrage of economic releases and political commentary efficiently into prices. In doing so, it provides real-time quotes on a host of issues that serve as benchmarks for the pricing of non-government securities. That responsiveness also serves monetary policy well, as it gives us a reliable gauge of financial markets in general and a liquid and efficient venue to conduct open market operations.

However, we sit here today as the result of identifiable problems with the market. The problems that have come to light so far--evidence of lying in the issuance of government securities and episodes of price distortions, perhaps related to attempts to manipulate the market--clearly signalled the need to act. And we have acted, all of us. The Joint Report provides a blueprint for the thoughtful and comprehensive renovation of this market. Taken together, these changes open the government securities market, significantly altering the way that business is conducted. They enhance our surveillance in the primary and secondary markets, establish more systematic lines of communication among the agencies, promise to broaden direct participation at auctions, and, by warning that there will be active Treasury supply management to shave outsized profit owing to price anomalies, put market participants on notice that there is no tolerance for manipulative acts. Frankly, a failure of the primary market to keep pace with the technical advance in the secondary market likely contributed to the problems that were identified. We still rely on slips of paper and ballot boxes around the country to place government debt, while secondary market traders sit before banks of computers, able to transact in size on a word or a few keystrokes. We must automate and we must do it quickly.

Moreover, as endorsed in the Joint Report, alternative auction designs may help to channel the force of competition in our favor. One such alternative, a single-priced and open auction, holds the promise of enhancing participation in the auction and exposing attempts to manipulate the market, thereby narrowing the possibility of manipulation and producing lower Treasury borrowing costs.

H.R. 4450

With this common ground, it is clear that the Board shares many of the objectives of H.R. 4450. This proposed legislation calls for the broad reconstruction of the auction process, instructing the Board of Governors to direct automation in a way that increases public access, to conduct experiments with single-priced awards, to attempt additional experiments with a tap issuance technique, and to produce a study of the results for Congress within two years. Additionally, H.R. 4450 would require that any advisory committee established to advise the Board or the Secretary of the Treasury or any Federal Reserve Bank on the marketing or sale of Treasury securities include as large a number of members as is feasible and hold open meetings.

We agree that automation of and experimentation with selling techniques potentially could serve the Treasury and the U.S. taxpayer well. However, we do not believe that H.R. 4450 is the means to effect that change. Following the Joint Report blueprint, the Treasury is in the process of a rigorous examination of auction reform with academic experts, market participants, and others to design a new system and frame an experiment that will test it fairly. Indeed, we are giving the Treasury all the aid we can, jointly sponsoring a conference in early June to bring together interested parties to examine these issues in detail.

I believe that the Joint Report motivated the careful examination of innovative techniques for selling securities and combatting manipulation. The Board would prefer to see this process run its course. Legislating experiments now would be premature, perhaps forcing the Treasury to implement procedures that were inefficient or which created undesirable incentives, to the detriment of overall funding costs. If, at a later date, Congress deemed that the Treasury's experiment was poorly designed or did not give adequate consideration to alternative auction techniques, then the matter could be revisited. We feel it is unwise to attempt to legislate the path that progress should take. The Board fully intends to take an active consulting role in this process and would welcome an invitation to return here to keep the Committee fully informed.

The same argument applies with greater force to the provision of H.R. 4450 requiring an experiment with tap issuance. Any means of broadening participation in the auction should be the subject of rigorous analysis and consideration. It is not clear that legislated mandates are either necessary or useful. For example, in a tap issuance, the Treasury would have to set prices. Moving away from letting markets set prices in an auction presents new problems in establishing and changing the prices at which the securities would be sold in order to manage the Treasury's cash flow. As these are complex issues and mistakes in even a modest experiment are potentially very costly, the focus should be on doing what is best for taxpayers rather than meeting rigid legislative mandates and deadlines.

While we appreciate that H.R. 4450 would grant the Board significant responsibilities in reforming the auction, we are concerned that this would confuse and potentially disrupt the longstanding relationship among the Treasury, the Board, and the Federal Reserve Banks. The proposed legislation would appear to require the Board to take authority long granted to the Treasury, namely acting as principal with respect to the structure of Treasury auctions. Moreover, the degree to which the Board's rôle under H.R. 4450 would supplant Treasury direction in the specified areas, let alone peripheral areas, is unclear. Such conflicting authorities could serve to slow the development of an automated auction system and could create other difficulties in the fiscal agency relationship. Monetary policy is difficult enough without the further entanglement of substantive decisions about debt issuance.

The Board also is concerned about H.R. 4450's requirement that it prescribe regulations concerning internal controls for participants in the automated system. It is essential that firms maintain an effective system of internal controls. But once legislation proposed in the Joint Report is enacted prohibiting misleading statements to issuers of government securities, the authority of the self regulatory organizations in this area will be adequate, rendering it superfluous to enact additional legislation to mandate internal controls.

Lastly with regard to H.R. 4450, the requirement for public advisory committees on debt issuance directly concerns the Treasury, and we defer to its judgment on this matter. I would caution, however, that mandating access may erode the usefulness of these meetings. As a result, the Treasury may need to turn more to informal contacts beyond the scope of the legislation to maintain their market knowledge. Thus, the public could know less than under present arrangements.

H.R. 3927

In the last nine months we have made much progress in designing and implementing fundamental improvements in the government securities market. Unfortunately, I see little of that progress reflected in H.R. 3927. This bill would allow the erection of elaborate reporting requirements, under various rationales, that have the potential to impose upon the government securities market the enforcement structure of the equity market with little regard to appropriateness.

The government securities market provides for the wholesale and large-scale exchange of homogenous securities among sophisticated market professionals. It is not subject to the types of insider-trading abuses that roil equity markets with a distressing regularity. The abuses in the government securities market that have cropped up so far as we are aware--attempts at price manipulation and violation of auction rules--have simple, targeted remedies appropriate to their relatively infrequent occurrence. Markets differ and regulation should reflect that difference. With each basis point in borrowing cost adding over $200 million a year to the deficit, the stakes are too high to legislate for the sake of mere consistency among securities laws.

In the Board of Governors' view, no compelling cost-benefit case has been made to impose broad-based reporting requirements in the government securities market, either directly or through audit trails or so-called "transparency" requirements. Without question, increased reporting would deter manipulation and facilitate the investigation of abuses. But does that high level of vigilance warrant the substantial cost ultimately borne by taxpayers? Aren't the proposals in the Joint Report equally efficacious and far less costly in dealing with these problems?

The Board has not yet been shown the evidence of widespread malfunctions in the government securities market that would give reason to impose the substantial costs that likely would follow from the passage of H.R. 3927. The reporting burden, falling on all traders, would boost the cost of every trade. True, the direct costs of additional recordkeeping might be kept manageable by the adroit application of the law by regulators. But it might not. H.R. 3927 turns that decision over to the regulators once nominal hurdles are passed.

We fear that an indirect cost of reporting requirements may loom even larger in the long run. Rather than risk divulging their finances and trading strategies, participants might reduce their presence or withdraw entirely from the domestic market, leaving the Treasury fewer willing customers for its mounting debt. Even backup authority, because it might be difficult to resist implementing, sends the same chilling message about the U.S. market to 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. Market participants will not bear that cost: ultimately, it must be passed on to the U.S. taxpayer.

My colleagues and I feel that further fundamental changes in this vital market are too important to be made without explicit Congressional approval. While some supported backup authority in the Joint Report, the agencies generally agreed that extensive reporting requirements need not be implemented at this time. If it is the case that the other substantial changes already in motion fail to increase openness in the government securities market, allowing manipulative practices to lurk in the shadows, then Congress should make the explicit decision to impose reporting requirements. Since H.R. 3927 potentially could allow regulators to reach into every aspect of trading behavior, it is a wiser course of action to return here for enabling legislation in the future should such authority appear necessary.

Conclusion

Substantial progress has been made in exploring, identifying, and implementing approaches to improve Treasury auctions. The Board staff has been in almost continual contact with their counterparts at the Treasury, and we are confident that good-faith efforts on auction reform will continue. We believe that this process should be allowed to run its course. If the progress is deemed insufficient, Congress can then return to legislative approaches to reform. In our view, H.R. 4450 is not necessary, possibly detrimental, and risks entwining debt management authority and monetary policy.

Similarly, it is unwise to confuse the equity and government securities markets. The latter has served the national interest by efficiently placing the federal debt with few evident problems. If we let the force of competition work to our advantage, the government securities market can continue to provide substantial benefits. H.R. 3927 risks imposing large costs in the search for elusive and, given the information that we now have, perhaps limited benefits.