SPEECH

Kos: The Repo and Securities Lending Markets

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Executive Vice President Dino Kos before the Bond Market Association Repo and Securities Lending Conference It is a pleasure for me to be here this morning and to share with you some of my views related to the repo and securities lending markets. I would like to thank the Bond Market Association for organizing this event and for inviting me to participate.

Let me begin on a personal note. As this audience knows better than most, we, as a country and as a financial community, suffered an immense trauma on September 11th and the days following. This community in particular has borne a disproportionate share of the loss. You and your firms showed great resolve, flexibility, and creativity in addressing the many difficulties that arose in that period. As funding market professionals, you moved quickly to find ways to continue operating despite the disruptions in segments of the financial infrastructure. All the while, you made many personal sacrifices in your efforts to keep the market functioning. You are to be commended for persevering in the face of extraordinary circumstances.

During this period, the Federal Reserve System attempted to do its part to ease the strains on the financial system by providing considerable liquidity through the discount window and open market operations. As I'll discuss in more detail later, the New York Fed also conducted a record volume of securities lending in the days and weeks after September 11th.

Of course, in implementing monetary policy, the New York Fed operates through the private sector, underscoring the importance of the close cooperation between the private and public sectors not only under normal conditions, but also and particularly, in times of stress.

This morning, I would like to say a few words about some of the Federal Reserve's actions in the financing market, and our securities lending in particular, that were in response to the challenges faced after September 11th. I also want to highlight instances where we were constrained by our other central bank objectives, in particular our primary objective, which is to implement monetary policy.

But first, I'd like to take a step back from September 11th and talk more broadly about preserving the efficiency of the government securities market. I think this topic is particularly relevant as we have all been reminded recently of the central and critical role that the funding markets play.

Specifically, I'd like to address two topics that relate to the Desk: our market surveillance efforts and our securities lending program.

Market Surveillance

As many of you know, the inter-agency working group on market surveillance is comprised of representatives from the Treasury, the Federal Reserve Board, the Securities and Exchange Commission, the CFTC, and the New York Fed. When established, the working group was given the primary mandate to "monitor" the U.S. Treasury market -- including the cash, repo, and futures markets -- for incidences, behaviors, or market developments that could impede the overall efficiency or liquidity of the market. The New York Fed convenes a bi-weekly meeting, but each member can initiate a meeting outside of the regular schedule whenever a particular concern or issue arises.

The primary responsibility for monitoring conditions in both the financing and cash markets for Treasury securities lies with the New York Fed. We report these observations and analyses to the working group, paying particular attention to anomalies in price movements and activity levels that may be difficult to explain by market fundamentals. In the specials market, for example, an issue that suddenly drops from the GC rate to the fails rate without any obvious change in cash market short positions, or distribution among end users, would catch our attention. We would then seek to understand the situation better by analyzing available data and speaking with market participants.

The New York Fed periodically passes along information to members of the working group. In the vast majority of instances, anomalies can be understood as the dynamics of the market at work. Typically, there is no follow up action in these cases. If the matter raises more significant concerns, further actions may be taken. For example, the Treasury Department may decide to increase its own market surveillance activities by requesting a large position report; or the Federal Reserve may consider asking primary dealers for daily position and volume information on specific issues. In the most troublesome cases, the appropriate regulator may initiate an enforcement investigation. I should note that the New York Fed itself does not have any legislated enforcement authority.

Since 1992, we have gained experience and knowledge of the market under normal trading conditions, as well as under stress. We have come to understand better the positioning and price data we collect from the primary dealers as well as the ebbs and flows that influence trading in the specials market.

Over the years, we have identified three parameters that we use as warning signs for activities that may have the potential to affect adversely broader market functioning. These continue to be useful guideposts for the type of behavior we think can be detrimental to efficient market functioning, and will be familiar territory for many of you. When we analyze a particular anomalous situation in the financing market, we consider position size, transaction volume, and the specials rate. These three factors, when viewed together, provide a threshold indication of instances where a firm may be using its market position in a specific security in a way that may hinder market functioning.

The confluence of these factors together provides better insight than looking at these individual factors in isolation. Our concerns become most acute when specific issues trade deeply and persistently on special and we see persistent patterns of both large position size and low lending volume in the market for those securities.

Buyers and sellers will regularly have different views about an appropriate market-clearing price in the specials market. As a result, on occasion, a clearing price may not

be found easily for that issue and fails will result. We have a healthy respect and understanding of such circumstances and the associated profit-making opportunities. However, concerns arise when a market-clearing price is repeatedly not found, resulting in significant long positions continually financed outside of the specials market, generating an unnecessarily elevated level of failed trades.

If a firm holds itself out as an active market maker, we believe it should make issues in which it holds a net-long position generally available in the financing market, either on a term or overnight basis. Ultimately, the proof as to whether an issue is made available is how much actually gets out in the specials market over time. Taking that one step further, we also believe major market participants should make the security available at times of the day when the market is more active. In other words, making the issue available shortly before the wire closes would not be considered making the issue sufficiently available.

While we tend to focus our attention on holders of net long positions, firms on the short side also have responsibilities in preserving efficient market functioning. At times, we find it difficult to understand dealers extending short positions when that particular issue is already known to be in short supply and fails are accumulating. As you might expect, such behavior does not generate a great deal of sympathy within the official sector. One step senior management at firms can, and should, take is to assure itself that cash and repo desks are communicating on a strategy that will not exacerbate strained conditions in specific issues.

Not all situations involve large positions. Dislocations can also emerge without evidence of large concentrated long or short positions. Interestingly, we've experienced instances when scarcity value resulted from many participants withholding small amounts of collateral, which can have the same impact as one participant withholding one large net long position from the market. While each individual participant may perceive that his or her position will not affect market dynamics, if all such participants behave in the same way contemporaneously, the aggregate effect will be equally pronounced.

In talking about these topics, I do not want to suggest that we can or should tell you and your firms what positions to take or how to trade them. Rather, our goal is to promulgate best practices for the financing market. What we want to avoid is market practices that instigate or exacerbate difficult market conditions that may put firms' reputations at risk, or on rare occasion lead to enforcement actions. This seems in the best interest of both the private and public sectors. It is my belief that the market will function most efficiently when there is a healthy competitive dynamic between the risks of holding long and short positions.

Central banks and other regulators have a role to play in creating an environment for a smooth functioning marketplace. But the defining factor that influences how well a market functions lies not with the central bank or other public officials, but rather with the firms themselves.

And that brings us back to management. It is the management that is the ultimate guardian of a firm's reputation. Management has to remain vigilant and understand on an ongoing basis the risks being undertaken by its traders. It is management that has to scrutinize the strategies that the trading desk is using. We have seen how the absence of such scrutiny can have sharply adverse effects on both the reputation of individual firms and of the marketplace as a whole.

I applaud your ongoing efforts because I am confident that such careful effort and attention by senior management directly leads to a better functioning market. I know that there are no simple answers, formulas, or limits that can put this task on automatic pilot. But it is in all our interests to make sure that sufficient management attention and resources are expended to assure well functioning and competitive markets as the norm.

Securities Lending

I want to turn now to another area in which we at the New York Fed have a common interest with this audience – our securities lending program.

The terrorist attacks of September 11th impacted the market in many remarkable and unforeseen ways. In the aftermath, market participants faced a financing system with reduced inter-dealer activity, disrupted broker services, problematic clearing and settlements, and an extraordinary rise in the level of fails.

In order to help alleviate some of these strains, we instituted a number of changes -- some temporary, some more permanent -- to our securities lending program. At various points after September 11th, we raised the limit on dealer borrowing. We reduced the minimum bid rate from 1.5 percent to 1.0 percent. And we raised the supply available to lend of any single issue from 45 percent to 75 percent of our holdings. By mid-October these modifications reverted back to normal, except the minimum bid rate, which remains at 1.0 percent.

In reviewing how the program worked during this period, it is helpful to recall the program's original objectives. The primary goal is to provide a secondary and temporary source of liquidity to the financing market, to the extent that we own the securities in demand. We are not trying to compete with traditional securities lenders. We want to be viewed as a backstop.

However, in the aftermath of September 11th, we found ourselves becoming a primary and ongoing source for many dealers to cover short positions. Given the extraordinary circumstances, we were comfortable loosening the program's constraints and temporarily moving away from the original goals of the program.

Our post-September 11th lending was extraordinary in many dimensions. Prior to September 11th, the Desk lent about $1.5 billion per day during the first eight months of the year. In the days following September 11th, we frequently lent multiples of that number, and at the peak, we lent $13.4 billion, more than 2.5 time the previous record. The lending was also extremely broad. On a typical day prior to September 11th, we might lend four or five issues. On September 11th we lent 69 issues. By taking this activist approach, we hoped to provide confidence in the financing market, and encourage some traditional lenders to return to the lending market.

While the securities lending program helped, it was not able – by itself -- to solve the fails situation that was building. At the same time, we don't know the counterfactual: that is, what would the market have looked like without the expanded securities lending volumes?

Two more points are worth noting here. First, during the post-September 11 period, we noticed that primary dealers frequently did not borrow up to their limit on securities that were trading with high scarcity value, despite the relaxed program constraints. In other words we were ready to lend even more that we did. That additional supply could have been re-distributed to others who needed those securities and thereby help further alleviate the situation. In fact, even today, dealers do not always borrow securities that are trading with high scarcity value to redistribute to those who may need them.

Second, while promoting liquidity and market functioning is important, the Desk's primary responsibility is to implement monetary policy. While we share with you a broad interest in operating an effective securities lending program, we are limited by the size and composition of the System Open Market Account (SOMA), which itself is influenced by other monetary objectives.

This is an important point and one that will take on more importance in the coming quarters. Given the small size of some Treasury issues scheduled to mature over the next several years, SOMA will reinvest its correspondingly small maturing holdings of these issues in limited supplies of new on-the-run securities. This of course

impacts the amount that will ultimately be available for securities lending. Therefore, I encourage the dealer community to watch our holdings on the New York Fed's website (www.newyorkfed.org), updated each week, and to be aware of upcoming reinvestments that will result in small holdings of on-the-run issues, thereby leaving us with little to lend in our securities lending program.

It has now been more than two and a half years since the current securities lending program was launched. It has operated at times of relative tranquility and at times of severe stress. In general, I think it has been successful at meeting its objective of being a secondary and temporary source of securities in the Treasury market. Average daily volume has varied with the ebb and flow of the specials market. Securities traders continue to satisfy the vast majority of their needs from traditional securities lenders in the morning, and then turn to the Fed for those they are unable to obtain in the financing market by noon.

Additionally, we are encouraged by the fact that we have not significantly altered how the specials market functions. Issues continue to trade on special and profit opportunities for matched book trading remain.

Nevertheless, this is an appropriate and opportune time to take stock of the program's overall effectiveness and evaluate what enhancements can be added to make the program even better, especially given recent experiences.

To this end, we will be looking to the funding market community for input about the way in which the program can be improved to better meet our stated objectives. As we have done before, we will be inviting our counterparties to participate in an event at the New York Fed early in the first quarter to discuss the lending program in greater detail. Of course, we welcome comments from anyone in the community on how we can improve our operations.

This morning I have spelled out some of the steps that we at the New York Fed take in promoting market efficiency, maintaining liquidity in the financing markets, and enhancing the smooth clearing of securities. I have also talked about some steps that all of you in the marketplace can take to help achieve that same objective of enhancing a vibrant and efficient marketplace. We at the New York Fed firmly believe that through such communication and cooperation between the public sector and the private sector, we will continuously improve the marketplace and thus create benefits for both.

Thank you for your attention.