AT CIRCULAR NO. 10647d

FEDERAL RESERVE BANK
OF NEW YORK

July 19, 1993

PURCHASE AND SALE OF U.S. GOVERNMENT SECURITIES IN THE SECONDARY MARKET

To All Depository Institutions in the Second Federal Reserve District, and Others Concerned:

The Board of Governors of the Federal Reserve System has requested comment on a proposal to consolidate at the Federal Reserve Bank of Chicago the purchase and sale of securities in the secondary market. This Bank does not currently offer the service to depository institutions in this District. Consequently, this proposal will be a new service for those institutions who wish to obtain that type of service from the Chicago Fed. The new service will be included as part of the Federal Reserve's priced book-entry securities services, beginning January 1, 1994.

Printed on the following pages is the text of the Board of Governors' notice, as published in the *Federal Register* of July 7. Comments on the proposal should be submitted by August 6, 1993, and may be sent to the Board, at the address indicated in the notice.

Questions regarding this matter may be directed to Whitney R. Irwin, Vice President (Tel. No. 212-720-5810).

E. GERALD CORRIGAN,
President.

FEDERAL RESERVE SYSTEM

[Docket No. R–0804]

Consolidation of Purchases and Sales Service at Federal Reserve Bank of Chicago

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: The Board requests comment on a proposal by the Federal Reserve Banks to consolidate the priced secondary market purchases and sales of securities service, which is currently provided by eight Reserve Banks, at the Federal Reserve Bank of Chicago. The Reserve Banks propose consolidation at the Chicago Reserve Bank to improve efficiency and contain the costs of providing this service to depository institutions nationwide. The service will be included as a part of the Federal Reserve's priced book-entry securities service, beginning January 1, 1994.

DATES: Comments must be submitted on or before August 6, 1993.

ADDRESSES: Comments, which should refer to Docket No. R–0804, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Comments addressed to Mr. Wiles may also be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m., and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected on room B–1122 between 9:00 a.m. and 5:00 p.m., except as provided in § 261.8 of the Board's Rules Regarding the Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Charles W. Bennett, Assistant Director (202/452-3442), Gerald D. Manypenny, Manager (202/452-3954), or Michael L. Bermudez, Financial Services Analyst (202/452-2216), Division of Reserve Bank Operations and Payment Systems, Board of Governors of the Federal Reserve System. For the hearing impaired *only*, Telecommunications Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Background

The purchases and sales service consists of the secondary market purchase or sale of U.S. Government securities, which are eligible to be held in Federal Reserve book-entry. Purchases and sales are conducted for institutions' own securities as well as for those of customers. Prior to the passage of the Monetary Control Act of 1980, eleven Reserve Banks[1] offered the service to member banks. Generally, smaller depository institutions with no direct relationship with a securities broker or dealer have relied upon Reserve Banks. With the increased acceptance of book entry and the declining availability of Federal agency securities in definitive form, the requests for purchases and sales evolved from the purchase and sale of definitive securities to primarily book-entry securities. Demand for purchases and sales has declined steadily over the past few years, from 74,000 transactions in 1980 to 18,400 transactions in 1992. The service is currently offered by eight Reserve Banks; these are Boston, Philadelphia, Cleveland, Richmond, Chicago, Minneapolis, Kansas City, and Dallas with the Chicago Reserve Bank processing more than half of the System's annual volume.

Consolidation of the purchases and sales service provides an opportunity to reduce cost with little, if any, impact on the level of service offered to depository institutions. All seven Reserve Banks now offering the service are expected to consolidate by the end of 1994. Two Banks (Cleveland and Kansas City) have asked to consolidate as early as possible.

The Chicago Reserve Bank is prepared to support a consolidated purchases and sales operation at Chicago. A toll-free telephone number would be available nationwide for depository institutions to initiate transactions with the Chicago Reserve Bank. A depository institution's representative, with proper authorization on file with the Chicago Reserve Bank, would initiate orders to purchase or sell securities by telephoning the Chicago Reserve Bank on the recorded toll-free line. After determining that an order to *sell* securities is authentic, the Chicago Reserve Bank would confirm that the securities are held in book-entry form at a Federal Reserve Bank;[2] a minimum of two dealers would be contacted if the transaction is an odd lot; and a minimum of five dealers would be contacted for round-lot transactions. The dealer submitting the best price (bid) generally would be given the order.[3] Orders for the *purchase* of securities for depository institutions also would be received via recorded telephone line and verified for authenticity.[4] Like-securities issues (by CUSIP number) would be combined by Chicago, whenever possible, to obtain the best price. For purchases, the dealer submitting the best price (offer) generally would be given the order.

The Monetary Control Act of 1980 requires that the Federal Reserve price its services to depository institutions to recover the costs incurred in providing those services. Based on the analysis which follows, consolidation of the handling of purchases and sales transactions will provide scale economies and other efficiencies not available at eight separate locations.

The Board, after soliciting public comment, approved in October 1992, a set of factors to be used in its analysis of Reserve Bank requests to withdraw from a priced service line. The Board applied these factors in determining whether the System should withdraw from the definitive safekeeping service, which consists of the definitive securities safekeeping service and the purchases and sales service. Also, after soliciting public comment, the Board, in October 1992, approved the request by the Reserve Banks to withdraw from the definitive safekeeping service line by

[1] In 1980, the eleven Reserve Banks offering the purchases and sales service were Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco. However in some districts, such as San Francisco, demand for the service disappeared following the implementation of service pricing.

[2] When depository institutions located outside of the Chicago Head Office region wish to sell securities, Chicago would request that the institution selling the securities or the Reserve Bank holding the book-entry account for the requesting depository institution transfer the securities to Chicago, thus reducing the book-entry holdings at the sending Reserve Bank and increasing the book-entry holdings at Chicago. The offsetting payment is settled through the Inter-District Settlement Fund on settlement day.

[3] Settlement of transactions in United States Treasury or Agency securities of $100,000 or more normally occurs on the business day following the date of execution of the order. Upon request, if an order is received before 11:00 a.m. (Central Time), the Chicago Reserve Bank endeavors to execute the orders for settlement on the same day as the orders are placed.

[4] Purchases for $500,000 or more are authenticated by telephoning another authorized person of the requesting depository institution other than the original caller.

the end of 1993. Secondary market purchase and sale of securities would continue to be offered, but would no longer be included under the definitive safekeeping service line after 1993.

With the declining volume and consequent prospects for cost recovery, the Federal Reserve Banks have requested approval to consolidate the purchases and sales service at the Chicago Reserve Bank. To ensure that appropriate consideration is given to any public policy issues arising from a proposal to consolidate a priced service across district lines, the Board adopted the following factors to be considered when evaluating proposals to consolidate Reserve Bank priced services across district lines. This proposal has been evaluated against those factors as follows:

A. Maintenance or improvement of cost recovery in a service.

The total savings to the System once consolidation is completed will be at least $100,000 per year, primarily as a result of staff reductions.

B. Improvement of the efficiency of Federal Reserve Bank operations.

The Chicago Reserve Bank has the most automated purchases and sales operation and currently has excess capacity. As a result, it will be able to absorb the System's entire volume without increasing staff.

C. Maintenance or improvement of the level or quality of service.

Through consolidation, the level and quality of service are expected to improve. The Chicago Reserve Bank's purchases and sales staff monitors the secondary securities market electronically throughout the day and times its trades according to the movement in that market in order to obtain the best price for the depository institution. Also, because of its level of volume, the Chicago Reserve Bank has more opportunities to combine small trades in order to obtain a better price and to reduce the amount of the broker's fee that must be passed on to the depository institutions; with more volume, the opportunities to combine trades is likely to increase.

D. Responsiveness to changes in the financial-services industry.

The Chicago Reserve Bank's level of automation and market monitoring make it more consistent with and more flexible in responding to changes in the industry.

E. Effect on private-sector providers of the service.

Given the small volume processed by all the Federal Reserve Banks, consolidation is expected to have no measurable impact on private-sector providers of this service.

F. Effect on users of the service.

As indicated in the comments under Factors a. through d., depository institutions will receive an improved level of service, usually at the same or a lower fee. Also, consolidation will enhance on-going cost containment efforts, thereby delaying or reducing possible future fee increases. The depository institutions will be dealing with employees of a different Federal Reserve Bank, but transactions and accounting entries from the depository institutions side will be handled in generally the same manner as before consolidation.

The Board requests comment on the Federal Reserve Banks' proposal to consolidate the purchases and sales service at the Federal Reserve Bank of Chicago. While comments in general are welcome, it would be helpful to the Board in considering this proposal to receive comments that respond to each of the factors.

Board of Governors of the Federal Reserve System, June 30, 1993.

William W. Wiles,

Secretary of the Board.

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