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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
MONDAY, SEPTEMBER 29, 1986

STATEMENT OF

WILLIAM J. ANDERSON

ASSISTANT COMPTROLLER GENERAL

GENERAL GOVERNMENT PROGRAMS

BEFORE THE

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND

URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ON

THE TREASURY SECURITIES MARKET

AND PRIMARY DEALER SYSTEM

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to discuss the work we have been performing at the Subcommittee's request concerning the strengths and weaknesses of the present government securities market.

By all available measures, the vast government securities market in which billions of dollars of transactions take place each day has served the nation well. Despite the success of the market, several unregulated government securities firms have failed over the past few years. In response to those events, both the House and Senate have passed bills that would bring all government securities dealers and brokers under a basic regulatory framework. The proposed legislation, if enacted, should reduce opportunities for fraud and should increase the flow of information about the market to both regulators and the public. Although the Senate bill would formalize practices that have developed over a period of years, both bills would essentially leave intact the business relationship that exists between the Federal Reserve and a group of dealers known as primary dealers.

My testimony today is designed to bring to your attention some concerns we have about the use made in the market of the primary dealer system. These concerns are a result of work we have completed as well as work we still have underway.

Primary dealers currently consist of 35 firms, active in government security trading, designated by the Federal Reserve Bank of New York (FRBNY). The FRBNY uses them exclusively in conducting monetary policy. Monitoring of the market is conducted through FRBNY oversight of primary dealers who provide daily reports on their volume of transactions and financial positions.

There are advantages to being designated a primary dealer. Of most importance, the market has come to regard the primary dealer designation as a measure of creditworthiness. In today's market environment of volatile interest rates and high trading volume, it has become clear that the financial integrity of dealers is of paramount importance in deciding who to conduct business with. After each market disturbance over the past several years it was common to read about customer concerns over maintaining relationships with non-primary dealers. The status accorded primary dealers is also evident in a recently enacted Florida statute that exempted primary dealers from certain state requirements because they were perceived to be "regulated" by the Federal Reserve System.

The special status accorded primary dealers also appears to significantly influence who has access to what is known as the interdealer broker system of secondary market trading. This system helps to give the government securities market its characteristic depth and liquidity. Participation in this system enables dealers to execute transactions quickly with other dealers on an anonymous basis. Participating dealers can trade with one another without revealing their market strategies and also have access to the most current information on market developments.

There are obligations associated with primary dealer status. These dealers must adhere to standards of conduct relating to financial strength and market participation that have been prescribed by the Federal Reserve. According to these standards, primary dealers are expected to participate in auctions of government securities which the Federal Reserve manages as fiscal agent for the Treasury. They also are expected to participate actively in the secondary market which the Federal Reserve uses for the conduct of monetary policy. Primary dealers also must maintain prescribed levels of capital strength, and subject themselves to daily reporting requirements and on site examinations conducted by the FRBNY. Except for 9 primary dealers that are unregulated because they deal exclusively in government and other exempt securities, the Federal Reserve's oversight of primary dealers is in addition to that which Federal regulators and self-regulatory organizations provide to the 14 bank dealers and 12 diversified securities firms that are also primary dealers.

We have recently completed work soliciting the views of primary and nonprimary dealers on various aspects of the oversight of the government securities market. We are releasing the results of this work today in the form of a fact sheet.[1] In addition, we have work underway that addresses various aspects of the interdealer trading system. As a result of this

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[1]U.S. General Accounting Office, U.S. Government Securities: Dealer Views on Market Operations and Federal Reserve Oversight (GAO/GGD-86-147FS, September 29, 1986).

and other work, we believe that certain questions need to be explored regarding the relevance of the standards used to designate primary dealers as well as the uses which certain market participants make of the primary dealer designation. We have found that:

--At least one standard, that for participation in auctions, appears not to have been rigidly adhered to by primary dealers nor rigidly enforced by the Federal Reserve. In light of this, we believe it important to assure that all primary dealer standards still make sense given the benefits that accrue to primary dealers.

--As I indicated, the primary dealer designation is used by the market to grant access to the interdealer trading system. We have concerns about the reliance on <u>all</u> primary dealer standards as a condition for participation in this system, when the major consideration for those conducting business on the system is the creditworthiness of trading counterparties.

--Finally, a group of government securities dealers who are aspiring to be primary dealers have been granted access to the interdealer brokering system even though they are not subject to the same daily reporting and oversight requirements as primary dealers. This condition is creating a potential oversight gap in the market.

I would like to briefly discuss each of these issues in turn.

REVIEW OF THE PRIMARY DEALER AUCTION PARTICIPATION STANDARD, AND POSSIBLY OTHER STANDARDS, SEEMS APPROPRIATE

There is no doubt that the Federal Reserve needs to check the creditworthiness of the dealers with which it has business relationships. Our work suggests, however, that review of at least one of the standards not related to creditworthiness--participation in auctions--appears warranted. We have been examining this standard, as well as that related to volume of customer transactions, because they represent responsibilities that primary dealers are asked to assume in being accorded primary dealer status, and they also are subject to quantitative analysis. My testimony will discuss the auction participation standard.

Our analysis shows that the smaller primary dealers appear to be making only a marginal contribution to Treasury auction bidding. Our analysis also shows that not all dealers have complied with the standard and that the Federal Reserve's enforcement of the standard is limited. This being the case, we are concerned about how much weight this standard should be given in determining primary dealer status.

We have analyzed primary dealer bidding for 3-year, 10-year, and 30-year issues at quarterly auctions between August 1983 and May 1985. As a group, primary dealers accounted for 73 percent of the successful competitive bids, but there was great variation in the bidding performance of individual dealers. The FRBNY expects dealers to submit "... bids of a size commensurate with the dealer's capacity and in a realistic price range relative to current market conditions." We found, however, that it was hard to reconcile some of the bidding with this standard. One group of 9 dealers with a 7.6 percent share of all primary dealer trades with customers accounted for just 2.6 percent of the successful primary dealer bids. Furthermore, the majority of this group's bids were relatively far from the average winning bid.

In its response to our inquiries about the results of our auction analysis, the Federal Reserve said that it has taken steps to monitor dealers' auction participation more closely. However, the Federal Reserve also said that other aspects of primary dealer responsibility, such as financial strength and level of market making activity, are generally considered to be of greater relative importance than auction participation in evaluating primary dealers. It also stated that it did not feel that the standard should be made more rigid, and that it would be very unlikely for a dealer to be removed from the list of primary dealers on the basis of just the auction participation factor. Furthermore, our survey showed that most dealers rated the auction participation standard lower in relevance to the efficient functioning of the government securities market than standards related to creditworthiness.

The Federal Reserve System makes a plausible case for its flexible approach. However, when placed in the context of the perceived importance of the primary dealer designation, we believe that further review of the standard is appropriate. The auction participation standard may have had a special role to play when the market was much smaller and there was concern about the sale of an entire Treasury issue. However, now that the government securities market has become so large, with so many players trading on a continuous, world-wide basis, is it possible that this standard has lost some of its relevance? If it is less important than other standards, is unlikely to be used to remove a dealer from the primary dealer list, and can only be administered on a flexible basis, should it still be retained as a standard for primary dealer designation?

We do not know the answers to these questions. However, we believe that it is appropriate to consider these questions carefully in the context of the current market environment.

THE PRIMARY DEALER DESIGNATION IS NOT NECESSARILY THE MOST RELEVANT MEASURE FOR DETERMINING ACCESS TO THE INTERDEALER TRADING SYSTEM

The limited access interdealer trading system that we have referred to encompasses the activities of seven interdealer brokers. Our work shows that these seven brokers use the primary dealer designation to serve as a basis for deciding who may and who may not participate in limited access interdealer trading systems. All of these brokers have essentially the same customer base of 35 primary dealers and 13 dealers who have stated that they aspire to be primary dealers. This creates an equity problem because the number of firms that are creditworthy enough to gain access to these systems could well be greater than the number of firms the Federal Reserve has already designated as primary dealers or is likely to in the future.

Interdealer brokers operate what amounts to an electronic market in which trades are executed on a "blind" basis. Bid and ask prices are anonymously arrayed on video display screens and trades are executed by the brokers on behalf of the dealers. No participating dealer knows the identity of its counterparty in a transaction, and brokers do not guarantee the trades. It is, therefore, important that the creditworthiness and integrity of all participants in such a system be held to some standard.

Interdealer brokers provide the most up-to-date information on the market that is available, they enable dealers to trade in large quantities of securities and, because trading is anonymous, they enable participating dealers to buy or sell without revealing their trading strategies to the rest of the market.

The blind trading system probably requires some means of oversight and control of the risk positions of participating dealers. To some extent, this oversight role is currently being performed on a de facto basis by the FRBNY in its oversight of primary dealers and, in the last two years, in its oversight of certain firms who aspire to be primary dealers. Thus, at no cost to the brokers, the Federal Reserve designation and surveillanceof primary dealers appears to meet the needs of the blind trading system. Market participants know that primary and aspiring primary dealers are expected to be creditworthy. They also know that positions of already designated primary dealers are monitored by the FRBNY on a daily basis. Although such monitoring is voluntary, primary dealers are likely to comply with suggestions made by FRBNY personnel in order to retain the valuable primary dealer designation.

The dealers we surveyed were by no means in agreement with each other that adherence to all primary dealer standards is essential for the operation of a successful blind trading system. They did, however, agree that adoption of creditworthiness standards acceptable to participating dealers is important.

Clearly, there are other bases for establishing the creditworthiness of treasury securities dealers. Most primary and nonprimary dealers supported use of <u>dealer-imposed</u> standards of creditworthiness, giving this alternative the highest rating among potential access criteria that we asked them to react to. On the other hand, most primary dealers felt that <u>broker-imposed</u> creditworthiness requirements would create disturbances in the market and might result in brokers having to guarantee trades because of concerns over the financial strength of new participants in the system. Because brokers would then be exposed to losses, it would probably be necessary to subject them to some form of regulatory oversight.

Currently, certain dealers who have indicated that they aspire to be primary dealers are gaining access to the interdealer broker system. Other dealers, who may be just as creditworthy but do not aspire to be primary dealers, are not being granted access to the system. We wonder whether this situation is fair.

If the primary dealer designation were not to be used as a basis for determining access to the interdealer system, who should oversee those additional entrants that are creditworthy but have no business relationship with the Federal Reserve? One possibility would be to expand the Federal Reserve's scope of oversight even though it would require the Federal Reserve to oversee dealers that are not related to its role as fiscal agent or to its conduct of monetary policy. Another would be to place more responsibility with the brokers and dealers themselves for controlling risks taken by those participating in the system. The third option might be structuring oversight of the market through a self-regulatory organization overseen by the Federal Reserve or some other federal regulator. There are pros and cons to all three options and we are not in a position today to offer suggestions about which arrangement might be most beneficial.

A GAP IN OVERSIGHT

Up until a couple of years ago, access to brokers' wires was granted exclusively to designated primary dealers. Since that time, however, brokers have granted access to certain dealers who say they aspire to become designated by the FRBNY as primary dealers. Firms aspiring to become primary dealers initially file monthly reports with the FRBNY on market positions, financial performance, and volume of customer business. When the FRBNY believes a firm is likely to qualify as a primary dealer in a reasonable time interval, it begins accepting reports on a daily basis that are the same as those filed by primary dealers. Because the FRBNY discloses neither those dealers who are daily reporting aspiring primary dealers nor does it disclose those dealers who are reporting on a monthly basis, some dealers have gained access to the interdealer broker wires for purposes of blind trading who do not submit daily reports on their positions to the FRBNY.

Our survey questionnaire results demonstrate that FRBNY primary dealers value FRBNY oversight quite highly--particularly of creditworthiness considerations. Yet it is this type of daily oversight which is currently missing for some dealers. This has potential market soundness implications if a monthly reporting dealer that currently participates in the system is unable to honor its trading commitments.

CONCLUSION

The preceding remarks have been devoted to showing why we believe attention needs to be given to primary dealer standards and the way blind trading in secondary markets is structured and supervised. In closing, I want to emphasize, as I did at the beginning, that the government securities market works well. We are not suggesting the need for precipitous changes in the activities of the Federal Reserve System or primary dealers. We are, however, suggesting that the growing size and complexity of the market make it appropriate to reevaluate some of the traditional practices associated with the primary dealer system.