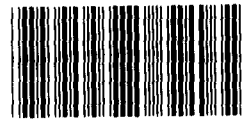


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STATEMENT OF  
WILLIAM J. ANDERSON, DIRECTOR  
GENERAL GOVERNMENT DIVISION  
BEFORE THE  
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY  
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS  
U.S. HOUSE OF REPRESENTATIVES  
ON THE  
REGULATION OF THE U.S. GOVERNMENT SECURITIES MARKET



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Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to discuss the subject of regulation of the U.S. government securities market.

My testimony today discusses matters we believe the Congress should consider in changing the regulatory framework of the U.S. Treasury securities market.<sup>1</sup> This market is essential for the orderly financing of most of the \$1.7 trillion of public debt and the soundness of other money and credit markets. I would like to emphasize at the outset that despite the recent dealer failures that we are all concerned about, we continue to believe that this market remains the world's most highly efficient securities market. No other market possesses its depth and liquidity.

This morning's hearing focuses on two bills - H.R. 1896 and H.R. 2521 - that would give the Federal Reserve System increased responsibility for regulating the government securities market. I would like to discuss three concerns that should be borne in mind when considering these legislative proposals. These concerns, which are also relevant to other proposals that Congress might wish to consider, are as follows:

--First, a clear purpose needs to be identified for legislation with particular attention paid to the issues of market instability and fraud.

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<sup>1</sup>The scope of our work, which we have undertaken at the request of this Subcommittee, has concentrated on the market for U.S. Treasury securities, the major component of the larger U.S. government securities market.

--Next, there should be appropriate recognition of Treasury securities' unique role in debt management and monetary policy and of administrative relationships that already exist in the regulatory structure of the market.

--Last, we should not accept as a given the present system of primary dealers and other aspects of market operations. These, too, deserve examination.

#### PURPOSE OF REGULATION

The Treasury securities market is highly complex. There is no centralized marketplace for Treasury securities. Rather, there are dealers and brokers who have established a complex set of trading relationships in an electronically integrated market. This market is characterized by innovative responses to changing conditions. This is evidenced by the development and extensive use of repurchase agreements and of derivative markets in forwards, futures, options, and other instruments.

Over the years, a rather complex network of federal regulation has evolved. Currently, nine federal regulatory agencies are involved in supervising participants or instruments in the market. I am appending to my statement a table which portrays the scope of this regulatory structure.

Despite this regulatory coverage, many Treasury securities dealers operate outside of federal regulatory, supervisory, or oversight mechanisms. It is estimated that there could be as many as 200 to 300 unregulated firms. It is from the ranks of these unregulated dealers that failures have occurred.

The question of regulating this market to reduce the problems of market instability and fraud should be approached with great care, weighing costs and benefits of alternative regulatory approaches. Costs resulting from regulatory changes that reduce market liquidity, stifle innovation, or increase participant expenses would be reflected in higher interest payments and in turn increase federal outlays. In addition, higher interest rates in this market influence interest rates in other markets.

#### Preservation of market stability

Regulatory policy toward the Treasury securities market should be designed to preserve market stability. The various legislative proposals being considered by the Congress have resulted from concerns over the recent failures of unregulated government securities dealers.

The prospect of multiple dealer failures is clearly cause for concern because of the potential effects such an occurrence could have on the stability of financial markets.<sup>2</sup> If the

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<sup>2</sup>The effects on market stability that could result from the failure of one or more dealers come in several forms. The most common form is that the Treasury securities market could become less liquid if dealers were to become reluctant to buy and sell or to borrow and lend securities. This instability may be a result of a loss of confidence in the dealer system leading to a higher risk premium or flight from particular markets (such as the repo market) or a flight from transactions. (This happened, although to only a minor and temporary degree, following the failure of Drysdale Securities in 1982.) This would decrease the price and raise the interest rate of Treasury securities, thus temporarily increasing the Treasury's borrowing costs. Higher interest rates on Treasury securities would also have

market becomes disturbed to any significant degree, the Treasury would no doubt have to pay a higher interest rate on the debt, and any loss of confidence in this market can quickly spread to others. In the extreme, multiple failures could lead to disruption throughout the economy and have grave effects on the Treasury's ability to meet the government's financing requirements.

The failure of a single dealer may or may not be cause for concern. Exit of poorly managed firms from an industry is an essential element of achieving economic efficiency, and in general we need not be concerned about these events. However, as the recent ESM debacle demonstrated, it is possible that a single dealer failure can have serious repercussions on other financial institutions because of the growing interrelationships among participants in the financial services industry.

Certain types of federal regulation, like the type proposed in the legislation, may lessen the probability of failure. Nevertheless, it is unrealistic to attempt to prevent all failures. Failures occur even among those financial firms (banks and securities firms) that are most heavily regulated by the federal government. Therefore, it seems appropriate for the

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repercussions on other financial markets. The Treasury securities market is not only the principal means of financing the Nation's debt but is also the core of the domestic and even the global fixed income securities market because it is the biggest and most liquid of essentially default-risk-free markets. Interest rates and contracts in almost all other fixed income markets are linked, directly or indirectly, to Treasury rates and many risks (i.e., interest rate risks, credit risks, and liquidity risks) are hedged in this market or in derivative markets.

Congress to be sure that the existing regulatory structure can (1) implement adequate damage control strategies to reduce market instability when problems occur and (2) anticipate the factors that are most likely to generate destabilizing conditions.

As a result of its oversight and business relationships with the market, there is evidence that the Federal Reserve and the Treasury have been able to influence market behavior (or engage in damage control strategies) when problems have arisen or were thought to be likely. Examples include changing the accounting for accrued interest on repurchase agreements after Drysdale's collapse and shortening the time between announcements and auctions because of concerns about the when-issued market.

In addition where the Federal Reserve and other regulators have not been able to respond to a problem because of lack of authority, the Congress has taken action. Repurchase agreements again serve as an example, as this Subcommittee is well aware, because of your role in redefining their status in a bankruptcy situation.

Despite these positive aspects of current arrangements, we think that questions need to be addressed relating to market instability that do not necessarily have to do with problems created by unregulated firms. These include the following:

--Does market stability depend upon the perception of market participants that the Federal Reserve System will not allow a primary dealer to fail? What should government policy be toward the failure of a primary dealer?

- For many firms operating in the Treasury securities market, no one regulatory agency has the ability to assess the total risk exposure of the firm. How big a problem is this?
- Does the continued increase in federal debt generate forces that may make it more likely that the Treasury market will experience a serious degree of instability?
- Are federal regulators set up to anticipate destabilizing situations that could develop?
- Are traditional measures of capital adequacy sufficient to deal with degrees of interdependence between firms that could contribute greatly to problems in one firm (or one industry) spreading to others?
- Does the Federal Reserve have all the tools it needs to stabilize markets while continuing to market the public debt?

We raise these questions not to be critical of existing legislative proposals. We are saying simply that adopting any of the proposals designed to deal with the destabilizing potential of unregulated firms may not deal totally with other factors that may lead to market instability in the future.

#### Fraud and investor protection

Another argument for bringing about tighter regulation of the Treasury securities market is based on the need for fraud deterrence and investor protection. Clearly, if a dealer is intent on engaging in fraudulent practices, such as pledging the same securities as collateral for two or more separate

transactions, investors unfamiliar with appropriate safeguards to protect their interests in transactions could lose a lot of money, as has happened recently in several well-known cases.

In considering various actions designed to deter fraudulent behavior we should not lose sight of the limitations of government responsibility which exist in a market economy, particularly in the investor protection area. In this regard, the decisions to invest funds in the firms that failed were made by paid managers employed by depository institutions or state and local governments. Federal and state regulators have already provided guidance to banks, savings and loan institutions, state and local governments, and others about safe and sound practices and more guidance will be forthcoming.<sup>3</sup> If managers disregard this guidance or decline to use safe options which are available, why shouldn't they also bear the losses associated with the more risky positions?

While we do have questions about the degree of investor protection that should be sought, it nevertheless remains true that many firms operate in the market completely outside of the

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<sup>3</sup>For example, Federal Home Loan Bank Board rules and regulations for federally chartered savings and loan institutions permit S&Ls to invest in repurchase agreements only with a financial institution insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation, or with a broker/dealer registered with the Securities and Exchange Commission. However, several federally chartered S&Ls lost money through uncollateralized repo transactions with nonregistered dealers. Thus, the existence of regulation in these cases did not prevent the occurrence of undesirable practices.



federal regulatory oversight and investigation processes. This lack of federal authority to investigate potentially fraudulent situations among unregulated dealers and brokers is probably the most glaring weakness of the present system. However, it is not clear that the entire range of regulatory controls is needed to deal appropriately with fraud.

In seeking to design a regulatory system that can provide the desired level of protection against fraud, it is essential that a mechanism be developed in which every firm operating in the market is subject to an effective fraud investigation and disciplinary procedure. This means that some form of revocable registration of all dealers would be required, that authority for federal officials to examine books would be clarified, and that coordination among federal regulatory and law enforcement officials regarding suspected problem cases would have to be improved. We note that, as presently drafted, H.R. 2521 would incorporate this approach, although the regulation would continue to be informal for primary dealers that are presently unregulated.

ADMINISTRATIVE CONCERNS AND THE  
UNIQUE ROLE PLAYED BY THE GOVERNMENT  
IN THE TREASURY SECURITIES MARKET

The importance of interest on the public debt to the federal budget and to the taxpayers places Treasury securities in a special status, even compared to federal agency securities that

are also exempt from regulation. Also, the operational presence of the Treasury and the Federal Reserve System in selling securities, conducting open market transactions, recording ownership, and transferring securities gives the federal government options in influencing the market that do not exist for regulating markets for other securities.<sup>4</sup>

The Congress needs to consider carefully administrative responsibilities and relations that would be involved in a new regulatory arrangement. There is a basic issue of how consistent regulation of this market needs to be and what kind of problems striving for consistency might create.

Under H.R. 1896, the Federal Reserve System would have the power to set rules that affect all participants in government securities, including all primary dealers, irrespective of how they may be presently regulated. This could create problems of overlapping federal regulations. H.R. 2521 avoids this potential problem by restricting the Federal Reserve's rule-making authority to presently unregulated non-primary dealers. However, H.R. 2521 would involve the Federal Reserve in regulating smaller, retail level securities firms, an activity not traditionally within its scope of operations. In the banking area,

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<sup>4</sup>For example, just as in the check clearing process, where Federal Reserve standards for presentment times and the physical dimensions of checks it will process tend to dominate market practices, in the securities area the Federal Reserve can set requirements that need to be satisfied before it will send securities over the wire or record ownership in its books.

the Vice President's Task Force on Financial Industry Regulation has determined that the Federal Reserve System should concentrate its efforts on only the largest firms that can have an impact on market stability. Furthermore, H.R. 2521 assumes that use of the Federal Financial Institutions Examination Council, other information coordinating mechanisms, and the power of the Federal Reserve and Treasury to set standards will be sufficient to achieve whatever degree of consistency may be needed.

In principle we do not feel that Congress necessarily needs to fix responsibility on a lead regulator for the whole market, but this is a matter which the Subcommittee cannot avoid considering in adopting a legislative position.

NATURE OF THE PRIMARY DEALER  
SYSTEM AND OTHER CONCERNS

Concentrating on the problems associated with unregulated dealers should not divert attention from possible improvements in operational aspects of the Federal Reserve System's relationship with the market. We note that H.R. 2521 instructs the Board of Governors of the Federal Reserve System to study ways of expanding business relationships of the Federal Reserve to non-primary dealers, giving all primary dealers access to the clearing system, and related matters.

With regard to this proposed study of expanded access alternatives, one thing that should be kept in mind is that existing arrangements may already be taxing the current

technology. There has been continuous growth in the volume of securities transactions and worldwide securities trading on a 24-hour basis has developed. The continuous and smooth operation of the Fedwire system, which handled about 260,000 transactions per day in 1984, is essential to the functioning of the government securities market; yet frequent late closings suggest that the current system may have problems handling increased volume in the future. What are the implications of increased access to the wire by dealers as it relates to this problem?

One of the matters that is not addressed in H.R. 2521 is the primary dealer system, an arrangement which has served well in the past but which may need to be modified in order to keep up with current and future market developments. For example, in view of the current increase in the debt and the volume of secondary market transactions, are the Federal Reserve's criteria for primary dealer status still appropriate, or do changes need to be made? This issue becomes particularly important because H.R. 2521 would create a situation in which primary dealers that are presently unregulated would remain the only unregulated firms operating in the market.

In sum, we believe it important and appropriate that the primary dealer system and its operational aspects also be examined when deciding on the shape of a new regulatory framework.

## CONCLUSIONS

To sum up, I would like to reiterate our view that great caution should be exercised in bringing about changes to the current regulatory structure within which the Treasury securities market operates. We believe the market has functioned quite well despite the recent failures of certain unregulated dealers. Let me close by highlighting the more important points covered in my testimony:

- There are regulations or guidance in place that if effectively enforced or followed might have prevented certain of the situations we are concerned about from developing.
- Because of the special nature of Treasury securities, the Federal Reserve, Treasury, and the Congress have successfully used nonregulatory means to address problems and to influence market practices.
- Market stability is affected not just by failures of firms due to lack of regulation but by other factors as well.
- It is questionable whether adoption of a full blown regulatory approach is necessary to address problems arising strictly from fraudulent behavior.
- The regulatory system within which this market operates is already complex. Regardless of which regulator is given responsibility for overseeing new regulations, an element of additional complexity can be anticipated.

--In addition to addressing the regulatory questions before the Congress, it is important not to lose sight of operational questions involved in expanding the business relationships that exist between the Federal Reserve and the dealer and broker community.

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This concludes my prepared statement. We will be happy to answer any questions you have at this time and continue to be available to assist the Congress in any way deemed appropriate.



Footnotes:

- <sup>1</sup>Includes bank dealers that are subsidiaries of bank holding companies.
- <sup>2</sup>Can be a specialist firm or an affiliate or subsidiary of a multipurpose financial entity.
- <sup>3</sup>Choice of regulation depends on how bank is chartered.
- <sup>4</sup>Clearing of transactions in derivative products.
- <sup>5</sup>Limited to products that can be classified as securities.
- <sup>6</sup>Applicable only if firm utilizes futures markets.

Acronyms used in heading:

- FRS - Federal Reserve System
- SEC - Securities and Exchange Commission
- SRO - Self-regulatory Organization
- OCC - Office of the Comptroller of the Currency
- FDIC - Federal Deposit Insurance Corporation
- FHLBB - Federal Home Loan Bank Board
- CFTC - Commodity Futures Trading Commission
- NCUA - National Credit Union Association
- DOL - Department of Labor