ECONOMIC COMMENTARY

Seeking Safety by E.J. Stevens

Investors seeking safety frequently purchase U.S. government securities. Nonetheless, some investors lost over $750 million operating in the government securities market within the past five years. These losses were not incurred because of losses of the market itself or its debit, of course, or even because of falling prices of outstanding government securities (in fact, prices were rising much of this time). Rather, losses arose from failures of securities firms with whom the investors were dealing. And out of the ensuing debate and calls for reform has come the Government Securities Act of 1986.

What is notable about the Government Securities Act of 1986 is that it imposes federal regulation on institutions because they do business in the government securities market, rather than on only some institutions that happen to do business in that market. Until now, it was possible to go into business freely of any federal securities market or financial institution regulation as long as the business was restricted to bringing a broker or dealer in exempt securities, principally U.S. government securities.1

The Government Securities Act of 1983 fathomed Securities and Exchange Commission (SEC) regulation of participants in non-exempt securities markets, and the banking acts of the 1930’s fathomed modern deposit institution regulation. Together, these regulation acts in three aspects, a protective (some would say overprotective) layer of regulatory insulation. But the government securities market remained a unique area of unregulated financial instruments. That exception is gone, and that is probably a good thing. It remains to be seen whether regulations can be effective in curbing abuses without being unduly cumbersome and damaging to market liquidity. Before the passage of the Government Securities Act of 1986, many were regarded and prudently operated government securities brokers and dealers had been unregulated. Some are among the more than three dozen “primary” dealers who report their trading and financing activity and securities positions daily to the Federal Reserve Bank of New York as a precondition for engaging in transactions brokers and dealers. Repricing the repurchase agreements and not necessarily those of the Federal Reserve and not necessarily those of the Federal Reserve. Nonetheless, an investor would like to thank Andrea Kalodner for her helpful comments.

The major thrust of these regulations is to standardize capital arrangements in repurchase agreements involving government securities and to bring previously unregulated brokers and dealers within a capital adequacy, financial recordkeeping, and customer protection standard similar to that which already applies to brokers and dealers in other securities.

Regulations don’t necessarily solve problems. The Act itself recognizes the uncertain balance of regulatory costs and benefits by including a mechanism for evaluating its results. (See the Comptroller General and, in a joint study, the SEC, Treasury, and Federal Reserve are required to present studies in 1990, evaluating the effectiveness of these arrangements and making recommendations to Congress about continuing or modifying them. If for no other reason than this, seeking safety will remain a concern of both investors and regulators in the government securities market.

Conclusion

Safe securities do not make safe transactions—as can be told by former customers of Capital Corporation (1975), Winters (1977), Hibbard and O’Connor (1982), Drysdale (1982), Comar (1982), Lombard-Wall (1982), Lion Capital Group (1984), E.S.M. (1985), and Brevik, Bressler, and Schulman (1985) (year of failure in parentheses), whose combined losses apparently totaled well over three quarters of a billion dollars. Flaws in the practices of both investors and dealers apparently contributed to these failures. The major flaws are thought to have been Open market practice: pricing the repurchase agreement contract, custody arrangements, and customer unawareness of the integrity (or lack thereof) of the government securities brokers and dealers.

By guaranteeing and assuring that one actually comes to hold such a security, however, regulators prudently behave, particularly when transactions are arranged by telephone and, as likely as not, sold out again before any documentation is exchanged. Moreover, in the case of derivative instruments such as repurchase agreements, as well as futures and options, safety may not depend so much on the correctness of the federal government as on the integrity and creditworthiness of the counterpart with whom a transaction takes place.1

An investor subscribing to a new issue or redeeming a maturing Treasury security can always deal directly with the Treasury via its fiscal agent, the Federal Reserve Banks. Other than that, however, the government securities “market” is an over-the-counter market created by a large number of brokers and dealers who operate independently, rather than within the rules of an organized exchange such as the New York Stock Exchange.

Perhaps the best way to characterize the government securities market is its analogy. Government securities dealers are like used-car dealers, handling inventories and standing ready to buy for and sell from that inventory. Similarly, government securities brokers might be likened to mortgage brokers seeking to buy carrier and seller together.

The universe of all government securities market participants included three types: 1) brokers or dealers registered with the SEC to do business in exempt securities, and also

1. The Government Securities Act of 1986, enacted last October, is in the process of being implemented. Treasury Department proposed regulations under the Act (Federal Register Vol. 52) were found to be fallacious. The proposed regulations were then referred to Federal Reserve and Federal Reserve Systems. As a result, the Federal Reserve proposed similar changes by March 27, and final regulations to be effective on July 15 this year. These new rules address the NYSE and SEC regulation concerns, “... the financial responsibility, protection of investors securities and futures, ... recording and reporting and audit of brokers and dealers in government securities ...” as well as “... the custody of government securities held by financial institutions that are not government securities brokers and dealers.”

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8. See Repurchase Agreements, Cleveland, Public Information Department, Federal Reserve Bank of Cleveland (1985) and “It’s 8:00 AM. Do you know where your collateral is?,” Federal Reserve Bank of New York, 1985.
9. Another area of ambiguity is whether a repurchase agreement or Notice of Sale is a sale and purchase transaction, or just a transaction in which, for purposes of the 1979 and 1986 Acts, the proceeds of a sale and purchase transaction are used to purchase a security.
10. SEC rules for nonexempt brokers and dealers in exempt securities specify a lower $1 million cutoff.
Box 1
Repurchase Agreements

Repurchase agreements are temporary transactions consisting of the sale of a security and a promise to "repurchase" it. The timing on the pur-
chase promise varies. A repurchase agreement is a method of investing
money overnight, or for a specified number of days. The "purchased
securities" are used as "collateral" to guarantee the safety of the invested
funds. The party offering to sell securities and then buy them back later
calling a repurchase agreement, also referred to as repo or RP.
The other party, which is offering to provide money to purchase those securi-
ties and receive them back (the repo), is making a reverse
repurchase agreement, sometimes shortened to reverse repo or RR.

Extracted from: "Repurchase Agreements," Public Information Depart-
ment, Federal Reserve Bank of Cleveland [1985].

Box 2
Book Entry

The Treasury computerized "book" of ownership entries is maintained by
Federal Reserve Banks. Depository institutions hold two kinds of
accounts, one for their own securities and another for those in custody
for customers. Repurchase agreements transfer entries between or within
accounts. Private clearing banks maintain records of transactions among
active market participants during the day. The clearing bank's custody
account at a Federal Reserve Bank, which in this instance does not have the name of the ultimate owner of the securities.
The legal rights concerning the cash and/or other documents held by both the depository institution and the customer.
A nondepository institution or individual always has the right to take
ownership in its own name in a separate direct account at a Federal Reserve
Bank.

This practice is expected to continue because the regulations provide for a single customer aggregating
more than $5 million, the purchaser (lender) will have the option of agreeing to comingling and clearing liens.2
The presumption is that large, active institu-
tional investors will remain capable of making the sophisticated credit
judgements required to support current custody arrangements without substan-
tial risk, in return for lower cost.
The proposed regulation also comes at the same time from another source. It
requires segregation of customer repo collateral from the proprietary securi-
ties holdings of all depository institu-
tions that are not government securi-
ties brokers and dealers, notably those
affiliated with the definition of brokers and dealers.

In all, these proposed regulations man-
dated changes which, in themselves, they were in place, might have saved many small municipalities and thrift institu-
tions from significant losses over the past five years. On the other hand, the
presumption is that very large partici-
pants in the market are sophisticated
enough to recognize the potential benefits of comingling.

2. Financial Responsibility: The
second area of reform would provide

2. The class of securities is that defined as
"investments in which ownership in its own name in a separate direct account at a Federal Reserve Bank is granted to the custodial institution with no lien or claim.

4. Purchase or sale of futures and options may carry no counterparty risk when traded on an
organized exchange that guarantees completion of the transaction. Entitlement to the proceeds
of the contract, however, still carries the risk that the counterparty might not perform.

5. The meaning of "incidental" is to be defined by the SEC regulation.

6. A third problem — nonrecognition of accrued interest in pricing repos and book entry Treasury
securities — was corrected by a change in the standard market practice even before enactment of the