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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

June 5, 1984

TO: Federal Open Market Committee

FROM: Normand Bernard NB.

Attached is a note from Mr. Sternlight transmitting a Congressional statement by Mr. Geng on the New York Bank's proposed standard of capital adequacy for government securities dealers. The final Committee print of the hearing, including statements by other participants at the hearing, may not be available until mid-summer.

Attachment

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June 1, 1984

TO Members of the Federal Open
Market Committee and
Other Federal Reserve Bank
Presidents

FROM Peter D. Sternlight

You may be interested in the attached statement by Ed Geng discussing the Federal Reserve Bank of New York's proposed standard of capital adequacy for Government securities dealers. This statement was presented at a hearing held at the New York Fed on May 31, 1984.

Att.

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Statement of Edward J. Geng
Senior Vice President
Federal Reserve Bank of New York
before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
May 31, 1984

I am pleased to have this opportunity to discuss the capital adequacy guidelines for Government securities dealers that have been proposed by the Federal Reserve Bank of New York. The guidelines are a cornerstone of the program of surveillance of Government securities dealers that has been established by the Federal Reserve. The proposed guidelines, a copy of which is attached to this statement, were sent to the primary reporting dealers on December 20, 1983, for their comment.

The need for capital guidelines and standards is quite clear in our view. The well publicized defaults of recent years have shown that some participants have been able to exceed the bounds of prudence, often because of inadequate attention to credit concerns by investors. While the ability of many participants to take large market risks has been constrained by self-policing within the market, we believe that the development of capital guidelines for traders in Government securities can provide investors a starting point for analyzing the credit worthiness of counterparties. Those who deal only in U.S. Government securities are not subject to statutory requirements which address their financial capacity for risk. That is <u>not</u> to

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say that market participants are uninhibited in their ability to take risks. In fact, it has become increasingly difficult for participants to trade beyond their means. More participants than ever before have established procedures and standards for reviewing the financial capacity of their counterparties. It has become more difficult for under capitalized participants to find trading partners; in general such participants are shunned by major dealers. Moreover, for almost two years the Federal Reserve has stepped up its own surveillance of primary reporting dealers, subjecting them to an explicit program of monitoring the degree of risk in their securities holdings and comparing that risk to their capital. We know therefore that the primary dealers that report daily to the Federal Reserve do conform to what I consider a prudent capital adequacy test. Additionally, about two thirds of the primary dealers are formally regulated through Federal statutes.

The capital adequacy guidelines that are the subject of this hearing build on the Federal Reserve's present system for monitoring primary Government securities dealers. However, the main purpose of the proposed guidelines is not to have a standard to apply to the primary dealers, who are already closely monitored in this regard; rather the aim is to set a standard for other market participants who are not now subject to any capital adequacy standards. Primary dealers would be expected to apply these standards to their counterparties as well as to adhere to them in their own dealings. The goal of the guidelines is to

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establish in the market acceptable standards of prudence that can be used by all market participants to assure that their counterparties are reasonably capitalized.

At present, market participants evaluate their counterparties mainly by reference to certified financial statements. Such statements do provide a glimpse of the financial health of a firm on the date of an audit, but they do not provide adequate information regarding risk exposure on that date, much less any guidance with respect to a firm's overall risk experience. Dealer positions often change by sizable amounts each day. Moreover, financial statements provide little information about the composition of assets. While the risk exposure of a portfolio of long-term assets is substantially different from that of short-term assets, the maturity of securities is not usually identified on financial statements.

The Federal Reserve believes that there should be a relatively simple, uniform measure of the capital adequacy of Government securities dealers. We think it should have three components. The first is a quantitative evaluation of the risk to which a dealer is exposed. The second is a reliable way of determining how much capital is readily available to support that risk. The third is a standard for the relationship between that risk and the firm's available capital.

To be effective, a voluntary system of this type must be accepted by both dealers and customer participants as reasonable and fair. It must measure the need for capital in relation to

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risk, without stifling market performance and incentive. We believe that the proposed guidelines accomplish these objectives, although some additional work remains to refine some of the technical features in line with comments and suggestions received from a wide range of dealers and other market participants.

As described in the proposal, the first step following completion of the final form of the guidelines would involve applying this method of analysis to the primary reporting dealers and having assurance of their compliance with the standards on a continuing basis. As I noted earlier this step has already been largely accomplished since we have been monitoring each primary dealer's capital positions for almost two years using a similar system based upon the regular reports submitted daily by these firms.

The next step would involve the public advocacy of the system of analysis as a "generally accepted" standard for all firms dealing in Government securities. We would urge all such firms to announce their voluntary compliance with the standard and urge customers to check whether the firms that they deal with have agreed to comply. Accounting firms would then make such tests during the course of their annual audits of dealers as necessary to certify compliance with these standards.

Basically, such a system would have participating firms make appropriate and prompt adjustments to changes in their capital position. If losses occur and the ratio of capital to

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risk slips below minimum standards, dealers would immediately reduce exposure or add to their capital. Unless there is fraud, against which neither voluntary nor formal regulatory standards can ensure, the proposal would provide some assurance to customers that their dealer counterparties will not take irresponsible risks in relation to their capital. Clearly, firms that have failed and inflicted losses upon their counterparties have submitted themselves to risks which exceeded their available capital.

Now let me turn again to some of the factors that we have considered in developing our approach and comment briefly on the components of the guidelines. While the concept of capital adequacy is simple, the techniques for evaluating it are highly complex. Nevertheless, I believe the Federal Reserve has proceeded to develop and implement standards in a careful, deliberate manner, and we plan to continue that kind of approach. We are well aware of the damage that can be done through advocacy of unduly restrictive or ill-conceived standards. The U.S. Government securities market's lifeblood is the dealer that is willing to risk its capital in creating a market, even in periods of great volatility. The U.S. Treasury can not wait for favorable markets to sell its debt. The investor in need of liquidity can not delay a sale if market conditions are fragile. Consequently the market requires dealers who are willing to take risks to support the Treasury and investors, even under difficult and uncertain circumstances. If a capital adequacy standard is

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excessively stringent the market will not be able to serve the needs of the Treasury or the public at large. The standard must strike a balance that preserves the freedom of risk takers while restraining those who would cross the line between acceptable risk and irresponsibility. Our aim is not to protect the risk taker; the aim is to protect the market as a whole from the effects of irresponsible risk taking by a few participants.

The Subcommittee has asked whether the guidelines would be adequate to protect persons investing with a covered firm. I believe adherence to the guidelines would greatly improve the level of such protection. However, they would not eliminate the need for prudent practices beyond initial credit evaluations, including concern over the appropriateness of one's own investments and careful attention to procedures such as securing control of securities in repurchase agreements and marking-to-market the value of those securities.

The possibility that guidelines could be potentially misleading to investors in determining the safety and soundness of a firm is also an important issue to be considered. It is our belief that the use of a voluntary guideline or standard should aid in raising the attention and concern of market participants to matters of financial protection. However, it will also be vital in publicizing and promulgating this system that customers be urged to remain vigilant in their independent evaluation of dealers and observe prudence in their own activities.

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Generally accepted accounting principles do not address the issue of potential risk directly, but the concepts on which the guidelines are based are consistent with those principles and we have discussed our methodology with several leading accounting firms. Moreover, the methodology is based in large part upon the SEC's financial responsibility rules which have been in use for many years for registered broker dealers.

Similarly, in regard to the Subcommittee's question about the ability of investors to avoid doing business with firms such as Drysdale and Lion, the focus must be on the importance of due diligence in conducting one's investment activities. In virtually all cases of loss, investors could have avoided problems by using the protective devices which are now available. Even so, the existence of, and compliance with capital guidelines, could have prevented the deterioration of capital from imposing losses upon customers.

I hope to be able to assure this Subcommittee of the sufficiency of the capital adequacy guidelines by describing their basic elements and origins and the modifications of the published proposal that we are prepared to adopt. The guidelines are based on tried and accepted concepts. The first step in our process of determining capital adequacy is to define net liquid capital, i.e., the amount of its own funds a firm has readily available to meet the losses it could suffer through position risk. The definition of "net capital" is the same as that used

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for the SEC's Financial and Operational Combined Uniform Single Report (FOCUS). This definition was chosen because it is widely used, well established and has been refined through experience. Questions regarding the definition and its application can be easily answered through reference to the SEC's Uniform Net Capital Rule 15c 3-1. Many participants in the U.S. Government securities market are now subject to this rule or are at least familiar with it.

The second step of the capital adequacy procedure, measuring position risk, is the more complex and controversial. Risk is, of course, a matter of probabilities that cannot be quantified with perfect precision. The market is frequently unpredictable and consequently there may be differences of opinion over how much risk a position in securities presents. Again, our approach to measuring risk is based on the widely accepted and tested approach used for the FOCUS report. In this approach holdings of securities are subject to "haircuts" according to probable exposure to losses. In other words, each type of security or maturity category is multiplied by a factor which represents its vulnerability to loss. The sum of each of these "haircuts" represents the amount of money that could be lost in a short time in a significantly adverse market. The haircut factors are based on statistical analysis of historical price volatility that indicates the degree of price change to which such securities or maturities may be subject.

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The Federal Reserve, in its proposal, used the position haircut schedule devised by the SEC, but also applied haircuts to several position categories that the FOCUS procedure does not address. These include: (1) a dealer's exposure to customers through repurchase agreements or reverse repurchase agreements, (2) lack of customer diversity for those agreements, and (3) unmargined forward commitments. Each of the additional haircuts is directed at the credit risk of dealing with other traders and customers, a risk that has risen in recent years. Traditional haircutting is largely directed at the market risk of holding securities and to some extent default of the security's issuer. The element of credit risk in dealer transactions is not easy to quantify particularly since statistics are not available. Nevertheless we believe that the vulnerability of the market to customer and dealer default is significant enough to warrant requiring dealers to have capital in reserve for this possibility. The actual haircuts applied to the credit exposure constitute a reasonable approximation of the magnitude of loss that could be incurred in a brief time span. While we believe that good credit analysis on the part of dealers substantially reduces potential for credit losses, credit analysis will never be perfect, and consequently a capital cushion should be available if a miscalculation occurs. Protection of the customer is also enhanced by this requirement; if a dealer's capital is adequate for the level of risk, insolvency with possible subsequent losses to customers is less likely.

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The haircut schedule applied to market risk indicated in our proposal is essentially the same as that used for the FOCUS report. Some dealers have criticized the haircut factors, questioning whether they give appropriate recognition to price volatility, hedging and other factors. We are now working with the primary dealer group through the Public Securities Association with a view to developing acceptable modifications to our proposal.

The final component of the Federal Reserve's guidelines is the ratio of capital to total haircuts. That is to say, how much capital should a dealer have relative to the position and credit risk that has been assumed. It is part of our proposal that a dealer should have a capital cushion which would allow for major losses without seriously impairing the dealer's ability to continue functioning. In the discussion accompanying our proposal, it was noted that in applying the standard to primary dealers the Federal Reserve would scrutinize the risk more closely the lower the ratio of capital to risk. A ratio of 1 to 1 was specified in the proposal as the floor below which capital would be considered clearly inadequate, although it was expected that actions would be taken by the dealer to address a problem before that level was reached. In the final proposal we expect to specify a slightly stricter ratio of capital to risk as a reasonable minimum capital adequacy standard. The final determination will depend upon the outcome of our discussions with dealers and others.

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I expect that within a few months the primary dealers and the Federal Reserve will agree on a set of guidelines that adequately assesses the risks of a securities dealer relative to its capital. At that point we will begin the process of promulgating the guidelines so that they will be useful to the public. I want to reemphasize that our objective is to increase the public's ability to choose reliable trading partners. The primary dealers, while meeting the guideline standards, as I have pointed out, are already subject to our capital adequacy standard. Our major goal is to have non-primary dealers also subscribe to the guidelines and provide assurance to their customers that they meet the standard on a continuing basis. Independent auditors should test and certify their client's compliance with the guidelines.

To summarize my reply to the question whether the capital adequacy guidelines are sufficient, I would like to point out that none of the comments on the proposal that we have received indicate that the original guidelines are too lenient. If we have erred in drafting a proposal, it has been on the side of conservatism. We are prepared to consider some modifications in the proposal to meet industry concerns. The Federal Reserve is keenly aware of the importance of the dealer market and will not move to reduce the market's effectiveness in underwriting Treasury debt or providing a secondary market for Treasury issues. However, the unavoidable truth is that events over the past several years prove that some market participants have

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risked and lost more than their own capital and such participants must be restrained in the future. In the long run, lax standards that permit weak and vulnerable dealer operations to become over-extended tend to restrict the breadth of underwriting and market-making in Treasury issues.

The restraint we are attempting to introduce will not affect the majority of dealers who maintain positions commensurate with their financial capacity. The restraints will not reduce freedom to take normal business risks. Dealers would thus be able to serve the legitimate needs of the market while also engaging in potentially profitable activity. While the proposed system provides for more public disclosure, we are not asking that dealers disclose specific information which might be useful to their competitors. We only ask that they satisfy their trading partners that they will maintain minimum capital to protect commitments.

Issuance of the final form of our proposed standard of capital adequacy has been delayed due to the inability to obtain an acceptable consensus with the Primary Dealer Committee of the Public Securities Association. Views within that group are quite diverse. Since we believe that their concurrence and support is essential to effective implementation of such a voluntary program, including their willingness to apply the standard to their counterparties, we plan to provide a further short period of time to resolve technical aspects with the primary dealer group. If they do agree, we will advise the Committee and move quickly to implement the proposal, hopefully by late summer.

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Absent substantial agreement with primary dealers, I think we and the Congress would have just two alternatives. One is to confine Federal Reserve surveillance of capital adequacy just to the primary reporting dealers, whom we monitor in any case since they are the group of dealers with whom we transact our open market operations. Of course, this leaves the attendant risk that capital adequacy needs would not be addressed by other participants. The other alternative would be to conclude that there is a case for regulation, either of non-primary or of all dealers. In this case the Federal Reserve System would proceed to work with this Subcommittee and the Congress toward formulating a legislative proposal.

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ATTACHMENT

FEDERAL RESERVE BANK OF NEW YORK

PROPOSED CAPITAL ADEQUACY GUIDELINES

FOR GOVERNMENT SECURITIES DEALERS

The Federal Reserve Bank of New York has developed capital adequacy guidelines to provide a framework for our assessment of the capital of reporting Government securities dealers. The guidelines will be reviewed from time to time for possible adjustments commensurate with changes in the economy, financial markets, and securities practices.

Objectives

The goals of our capital adequacy guidelines are to:

- Provide a framework for the Federal Reserve's evaluation of reporting dealers;
- Introduce greater uniformity, objectivity and consistency into analysis of the capital adequacy of Government securities dealers; and
- Provide a standard of capital evaluation for market participants that may ultimately have application to all dealers.

Principles

Our capital guidelines are based on the maintenance of sufficient liquid capital to cushion a reporting non-bank dealer against position losses resulting from unfavorable market movements as well as adverse credit related

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developments which could affect the valuation of financing transactions or unmargined forward commitments. Our definition of liquid capital parallels that of the SEC's in its net capital rule. The level of position risk is measured by applying the SEC's "haircuts", or percentage factors based on monthly price volatility, across the various maturity ranges of traded securities. To these position haircuts, we have added estimated capital costs for financing positions and unmargined forward commitments to reflect the potential losses resulting from customer failure or nonperformance, i.e., credit risk.

We propose to evaluate reporting non-bank dealers by comparing the size of the total position and credit risk haircuts to the amount of liquid capital available to absorb such losses. We expect that non-bank dealers' liquid capital will amount to more than double their total haircuts. The application of this system of haircuts for bank dealers will provide their management and supervisory authorities with additional insight into the level of risk involved in the dealer operation. We intend to discuss positions, hedges and other factors limiting risk in detail with all dealers whose ratio of capital to haircuts falls below 2:1. But in no event should a dealer's capital fall below its total haircut. Depending upon circumstances, intermediate steps, such as the imposition of trading limits, could be employed before more drastic steps were undertaken. However, a failure of a dealer

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to take decisive action to restore the firms' capital position to acceptable levels would lead to removal of the dealer from reporting status.

We recognize that no single ratio can be expected to reflect an institution's financial condition with complete accuracy. However, for comparative purposes and as a means of identifing situations requiring further review, we have found this approach to be very useful. The guidelines will be applied in a flexible manner with the assessment of capital adequacy made on a case-by-case basis considering various other quantitative and qualitative factors that affect an institution's overall financial condition. In the process other ratios, such as total assets to capital, will be monitored. A ratio in excess of 100:1 would be considered cause for concern in an organization where market making is a primary function.

In assessing capital adequacy, we also plan to use a measure of a firm's earnings volatility to evaluate the probability of losses implied by the reported position haircuts. Such a measure, based on actual income performance, would permit a review of a firm's financial condition in light of its demonstrated risk management abilities.

Capital Adequacy Calculation

Net Liquid Capital

Net liquid capital is defined as the net worth of a broker/dealer adjusted by: (1) adding liabilities which are

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subordinated to the claims of creditors, and (2) subtracting fixed assets and assets which cannot be readily converted into cash including, among other things: real estate, investments in subsidiaries, memberships, prepaid expenses, goodwill, organization expenses, unsecured or partly secured receivables, and all assets doubtful of collection.

Position Haircuts

Securities haircuts will be calculated in accordance with Section 15c3-1 of the Securities and Exchange Commission's rules. This method applies fixed percentages to securities in defined maturity categories. It provides for netting of long and short positions and certain forward and futures commitments within these categories as well as some limited hedging across maturity categories.

Financing Positions

In evaluating financing positions capital charges are applied to both market and credit risks. For market risk a haircut will be applied to the net open financing position by maturity category, treating open unmatched transactions as positions, RPs as a short and reverse RPs as a long.

The haircut for credit risk on repurchase agreements is 10% of the total amount of excess collateral given up by the dealer on these transactions. The difference between the market value of securities sold and the cash received for

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these securities is the amount that is nominally "at risk" in these transactions, and is established largely on the basis of the maturity of the transaction and the underlying collateral. We view 10% of this amount as representing the potential loss to the dealer as a result of the failure of one or two large customers. It should be noted that excess collateral averages about 1% of the transaction value, so that this capital charge represents approximately 1/10th of one percent of such transactions.

For reverse repurchase agreements, the capital charge is 100% of the shortfall, if any, between the market value of securities purchased and cash paid out. The premise here is that the transaction is analogous to secured lending which should always be fully collateralized.

Forward Commitments

Unmargined forward commitments are treated in a manner similar to that for financings. Our approach is to take a 5% credit haircut on the market risk associated with the gross long plus gross short commitments. In the absence of margin requirements on such trades, we are using position haircuts as a means to estimate potential losses that are subject to a credit exposure. Without knowing in advance on which position the loss might occur, we believe that taking 5% of gross commitments will approximate 10% of either side.

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Implementation

After a relatively short comment period we expect to apply such standards in evaluating the primary reporting dealers. Following some initial experience with the data received, we would hope that the concept could develop beyond the primary dealer community and encompass smaller, unregulated Government securities dealers and trading concerns. We expect to promulgate such standards publicly, urging lending and clearing banks, as well as other customers, to monitor and review dealers' capital in light of such "generally accepted standards". We will urge voluntary compliance of non-reporting firms and suggest that outside auditors test and attest to such compliance. General acceptance of such standards as necessary and desirable would virtually assure compliance, since customers would presumably refrain from dealing with firms poorly capitalized or unwilling to declare that they met such standards.