SOMA SECURITIES LENDING PROGRAM
ANALYSIS OF PUBLIC COMMENTS
Attachment II

Proposed revisions to the SOMA securities lending program were distributed to each of the primary dealers on June 16, 1998. Subsequently, Peter Fisher, Executive Vice President of the FRBNY and Manager of the System Open Market Account, hosted a luncheon with dealers to discuss informally their views on the proposal and invited them to submit formal comments in writing.

Most of the responses received, both in the form of letters addressed to the FRBNY and views aired in industry publications, lauded efforts to update the securities lending program. Many respondents also offered specific recommendations for modifications to the terms that they felt would help the program meet the dealer community's needs. A review of these suggestions resulted in two modest revisions to the terms and conditions.

The following describes the modifications made to the original proposal--a revision of the fail policy and a new provision for release of auction results--and evaluates the comments that prompted those changes. Other comments are also addressed by clarifying the intention of the SOMA lending program or explaining the operational constraints that shaped the proposed policy.

I. Revisions to Proposed Terms and Conditions

Fails Policy

In the original proposal, the penalty imposed on failure to re-deliver loaned securities was 6 percent plus the basic lending rate. For the new program, the fee was amended to the prevailing general collateral rate and the provision for loan extensions was eliminated.

Several respondents expressed concern about the stringent fees imposed under the original terms and conditions for failure to re-deliver loaned securities, suggesting that the high penalty rates created the equivalent of a "no-fail" policy. They asserted that such a policy is not consistent with market practice and could result in disruptions in specials market trading because dealers would be willing to receive negative interest rates on cash in order to obtain securities for re-delivery to the FRBNY. Although the policy for non-delivery of collateral was equally as stringent, dealers did not similarly object to those penalty rates because qualified collateral is more easily obtained.

The original penalty imposed for failure to return loaned securities was intentionally stringent in order to ensure that fails did not impede the program's ability to auction similar amounts of securities each day. However, as dealers asserted, on rare occasions the policy might have unintentionally resulted in negative specials rates.

The potential for disruption stems from the fact that the proposed fails fee exceeded the maximum cost of borrowing securities in a normally operating market. The highest cost imposed for borrowing in specials markets is a zero percent specials rate, which indicates that the borrower will receive zero percent interest on cash invested in order to obtain the desired security. The

implied cost of such borrowing is the general collateral rate that would have otherwise been earned on the cash. Because penalty fees stipulated in the previous terms exceeded the prevailing general collateral rates by a wide margin, dealers would have found it cheaper to receive less than zero percent interest on cash than to fail to the FRBNY. While instances of negative rates would have been rare, any such occurrence would undermine the goals of the program.

An appropriate fails fee structure strongly motivates dealers to re-deliver securities when they are available in the market, but allows them to fail when securities are unavailable. Industry-standard fail policies meet these goals by imposing penalties that encourage dealers to return securities up to the point at which they are trading at zero percent specials rates. Standard market practice is for the failing party to leave cash collateral with the securities lender and forego interest income on those funds, which is an implicit penalty equal to the general collateral rate.

This type of policy is not applicable to the SOMA lending program because the FRBNY requires re-collateralization of non-returned loans in order to avoid holding cash collateral. However, a comparable practice for the FRBNY would be to hold Treasury collateral against non-returned loans and also impose an explicit fee equal to the prevailing general collateral rate. Similar to industry-standard fail policies, this market-based fee structure encourages dealers to return securities if the specials rates are above zero percent, but allows them to fail if rates are at zero percent.

To incorporate a market-based fee structure, the fails policy was amended to reflect an explicit fee equal to the general collateral rate for failure to re-deliver loaned securities, which will be assessed in lieu of the contracted lending rate. A reliable and accessible reference rate for overnight general collateral will be chosen to maintain transparency and accuracy of the fee structure.

The penalty for failure to deliver collateral against a loan on the loan date was also modified in order to simplify the two-pronged fails policy. If acceptable collateral is not received on the loan date, cash will be held as collateral without interest, a penalty fee equal to the general collateral rate will be imposed, and the basic lending fees will be assessed.

Publication of Auction Results

A provision for release of the weighted average award rate and the amount lent for each security was added to the terms and conditions in response to dealer requests for information on auction results.

Several dealers expressed their desire to have the auction results publicly announced in order to increase the transparency of the securities lending program. These firms suggested that summary information about the amount lent and the award rates for each security would facilitate price discovery after the auction, particularly given the noon auction time, when liquidity is low. Furthermore, some stated that the lack of such information could cause volatility in specials market rates after auction as market participants attempted to adjust for an unknown quantity of securities.

Although numerous dealers requested auction results, some did not share this view. A few dealers expressed concern about releasing information to the market that would specify the amount of each issue that needs be returned to the FRBNY the following day, suggesting that this could put borrowers at somewhat of a disadvantage when they attempted to obtain securities for re-delivery.

The structure of the securities lending program should mitigate the potential for borrowers to be burdened by release of auction results. The revised fail policy makes fail penalties from the FRBNY roughly equivalent to most other overnight borrowing arrangements. In addition, securities need only be returned before the close of the securities wire, not prior to the auction time, so there is no temporal bottleneck to re-delivery. As such, traders should find it difficult to differentiate borrowing for re-delivery to the FRBNY from other borrowing activity. Therefore, borrowing for re-delivery should not have an untoward impact on specials rates.

II. Other Comments

Market Impact

Two respondents expressed broad concern about the expansion of the securities lending program, of which one suggested that the program may significantly affect specials market rates and profits for securities lenders.

The goal of the program is to provide a temporary and secondary source of supply to the market and to facilitate smooth clearing of Treasury securities. The program was crafted to prevent direct competition with most securities lending activity. The auction will be held at noon, well after the most active hours for securities lending, which should ensure that the program will not be used as a primary source of securities for dealers. In addition, lending will be restricted to overnight borrowing only, which is not an attractive term for many dealers. Dealer limits will be imposed, so that award amounts facilitate clearance of trades but do not offer a substantial supply for trading. Finally, the minimum lending fee of 150 basis points will discourage borrowing of securities not trading significantly on special.

Although SOMA holds a large amount of securities, the percentage of those holdings lent at any one time is expected to be small. Only a few issues held trade special enough at any one time to be borrowed under the proposed program structure.

Lending Fees

Several dealers suggested that lending fees remain at their current, fixed rate of 150 basis points for all securities rather than being competitively determined. Some asserted that this approach would be simpler than awarding securities at auction.

Although fixed fees are simpler, they do not reflect market borrowing rates for securities. Fixed fees of 150 basis points could allow some dealers to reap profits by borrowing securities from the FRBNY at a lower-than-market cost. In addition, when demand for loans exceeded the available supply there would be no mechanism to distribute securities to dealers equitably.

Other dealers suggested that the FRBNY set rates for each security based on prevailing specials markets rates. However, determination of market rates by the FRBNY is not consistent with the intent of the securities lending program. Moreover, allocation of loans under any fixed-fee rate structure would be problematic.

Overnight Lending

A few respondents suggested that term or open borrowing arrangements would be more beneficial to dealers in need of securities. They asserted that dealers usually hold term short positions and would be reticent to borrow only on an overnight basis.

The overnight lending term was chosen for both conceptual and operational reasons. The securities lending program is structured to be used as a secondary and temporary source of securities. Overnight borrowing will assist borrowers in meeting immediate delivery obligations. The following day, they can attempt to cover their positions with loans of more attractive maturities in the active market.

Operational considerations also support overnight lending. In order to reduce uncertainty about supply, the securities lending program attempts to offer similar amounts of securities each day. Overnight borrowing, implemented in tandem with a ceiling on daily lending of SOMA holdings, allows the program to consistently offer a stable and significant supply of securities.

Publication of SOMA Holdings

Numerous dealers expressed interest in more frequent, issue-specific publication of SOMA holdings, which they believed would help them bid effectively for securities at auction. Some suggested that the absence of such information could generate volatility in specials rates around auction time because of uncertainty about the supply offered.

Although issue-specific SOMA holdings are currently published only once a year in the Open Market Operations report, other public sources of information on SOMA holdings should provide sufficient supply data on the majority of issues borrowed. Treasury auction results, which specify Federal Reserve awards, offer the most useful estimate of holdings. Because recently-issued coupon securities are most likely to trade with enough scarcity value to be borrowed, tracking auction results should provide useful information for borrowers of notes and bonds. While somewhat less accurate for bill issues, tracking auction awards in this sector should still provide a reasonable proxy of SOMA holdings.

Dealer Limits

A few dealers made suggestions with respect to the limits placed on dealer borrowings. Some suggested that the per-issue limit be lowered in order to more widely distribute securities, while others recommended that the limit be based on the percent of holdings lent. Some also proposed that the fixed total borrowing limit be raised for larger firms, stating that the flat limit penalized better-capitalized dealers.

Dealer limits have been raised from those in the existing lending program in order to improve dealers' ability to clear trades. However, the levels have been lowered from the proposal

distributed in July, commensurate with the smaller auction size limits. The dealer limits are intended to provide enough securities to facilitate clearing, without significantly augmenting individual dealers' positions.

Limits based on a percent of SOMA's holdings would be difficult to track, as they would be different for each issue auctioned. A $100 million per issue limit was constructed with a 25 percent offering of SOMA securities in mind. Should the 25 percent ceiling be changed, dealer limits may be adjusted accordingly.

The total borrowing limit of $500 million is uniform for all dealers to avoid discriminatory policies.

Auction Format

Some respondents questioned the use of multiple-price auctions given the recent shift of Treasury auctions to the single-price format.

The securities lending program was designed to be consistent with all other domestic operations conducted by the FRBNY, which utilize the multiple-price auction format. A multiple-price auction may also support the goal of providing a temporary supply of Treasury securities to dealers with delivery obligations. Dealers who need securities to meet existing obligations will be motivated to bid aggressively to avoid fail fees.

Option to Withdraw from Award

Some comments recommended that dealers be given the option to withdraw from their awards within a specified period of time after the auction and asserted that auctions do not provide the best price discovery mechanism.

The program is intended to provide only a secondary and temporary source of securities to dealers. If dealers are unable to meet their delivery obligations by borrowing in the active market, they are encouraged to seek securities through the program by bidding aggressively at auction. Dealers who choose to use the program for purposes of re-lending securities in the specials market may incur some risk in doing so. Allowing dealers to cancel awards in instances where the trade becomes unprofitable is not consistent with the goals of the program.