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Alternatives to the Primary-Dealer System

A main goal of open-market operations is to maintain system-wide liquidity so that private financial firms can provide financing to other private companies as needed.

Traditionally, the Fed has conducted open-market operations via a limited number of financial firms known as primary dealers, a system created in the 1960s when there were clearer advantages to having a centralized open-market system in New York.

In practice, when the Fed wants to expand the monetary base so that banks can make more loans, it directs its traders to buy Treasuries from the primary dealers. The Fed then electronically credits the reserve accounts of the dealers' banks, thus leaving it to the primary dealers to distribute credit through the federal funds market.

The primary-dealer system's reliance on a small number of firms hampered the Fed's ability to maintain system-wide liquidity during the 2008 crisis and worsened the too-big-to-fail problem.

Replacing the primary-dealer system with a broader liquidity facility so that nearly all financial firms can directly participate in open-market operations could fix this problem. Other central banks do use broader liquidity facilities. For instance, the European Central Bank (ECB) conducts its open-market operations with more than 500 bank counterparties in the eurozone, and the Bank of England uses a "product-mix auction" to provide broad-based liquidity in both normal and crisis conditions.

In 2002, the Fed published a report that discussed an auction-based lending facility as one alternative method for providing liquidity to the banking system. Although the Fed decided to maintain its traditional blend of policy tools, it introduced the Term Auction Facility (TAF)—similar to an option discussed in the 2002 report—in December 2007 when the primary-dealer system broke down.

Experience from the crisis (and the Bank of England and the ECB) suggests a modified TAF program—a standing, system-wide auction facility—could improve the Fed's ability to maintain system-wide liquidity. Properly structured, it could replace the primary-dealer system, the discount window, and Section 13(3) emergency lending. Rather than rely on a small number of primary dealers, the Fed could open auctions of regular short-term advances to, for example, all banks that have the safest two CAMELS ratings.

In the near term, Congress should require the Fed to update its 2002 study to reflect the experience of the TAF and the Bank of England's standing auction facility.

Even absent new legislation, the Federal Reserve Board and the Federal Open Market Committee could replace the primary dealer system with a standing, system-wide auction facility. Section 12A of the Federal Reserve Act, 12 USC 263(b), stipulates that:

> No Federal Reserve bank shall engage or decline to engage in open-market operations under section 14 of this Act except in accordance with the direction of and regulations adopted by the [Federal Open Market] Committee. The Committee shall consider, adopt, and transmit to the several Federal Reserve banks, regulations relating to the open-market transactions of such banks.

The regulations for open market operations, at C.F.R. §§ 270.1 - 270.4, explain, among other items, the governing principles for the Fed's open market operations. In particular, C.F.R. § 270.3 states that:

> As required by section 12A of the Federal Reserve Act, the time, character, and volume of all purchases and sales of obligations in the open market by Federal Reserve banks are governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country.

Congress should work with the Federal Reserve to determine the best way to improve open market operations.