February 26, 1963

TO: Federal Open Market Committee

FROM: Robert W. Stone and John R. Farrell

SUBJECT: Suggested revisions in procedures with respect to allocations of the System Open Market Account

On January 29, 1963, the Federal Open Market Committee amended the procedures with respect to allocations of the System Open Market Account so that adjustments of a Bank's holdings because of a low reserve ratio would not be made until a Bank's reserve ratio fell below 28 per cent.

It was mentioned at that meeting that an informal group from the New York Bank and the Board of Governors would make a review of the procedures prior to the annual organization meeting of the Committee.

Attached for the consideration of the Committee is a draft of proposed procedures with respect to allocations of the System Account, incorporating changes recommended by this group, in which recommendations we concur. It is felt that adoption of the changes would help prevent the reserve ratios of the individual Reserve Banks from falling to undesirably low levels, would reduce further the frequency of interim adjustments in holdings of System Account securities, and would also reduce the need for frequent adjustments between pledged and unpledged gold certificates in order to maintain a 25 per cent reserve against notes and a 25 per cent reserve against deposits.

The principal proposed changes are as follows:

(1) Monthly reallocations in lieu of quarterly reallocations.

(2) Insertion of language that would make the raising of a Bank's reserve ratio all the way to the System average, in the course of a special adjustment, discretionary rather than mandatory.

(3) Elimination of the provision concerning reversal of any adjustments made in a Bank's holdings between reallocations.

(4) Insertion of a provision in the procedures which would give an additional participation to Banks having a relatively high proportion of note liabilities to total note and deposit liabilities.

(5) Insertion of a provision which would permit allocating a Bank's participation in purchases on any one day to other Banks if it were anticipated that the Bank could not assume its participation in such purchases without incurring a reserve deficiency.

The first change proposed will keep the allocations more in line with current movements in the reserve ratios.

The second change would provide for the kind of situation experienced by the Boston Bank on January 15, in which the Bank's reserve ratio was not raised to the System average in a special adjustment since the Bank did not have sufficient unpledged securities.

The reason for the third change is that if a Bank's reserve ratio should fall below 28 per cent, its reserve position is in all likelihood tending downward, and the adjustment made to raise its reserve ratio should hold at least until the next reallocation, which at most would be only one month ahead.

The fourth change would alleviate what is essentially a Federal Reserve note collateral problem at the Richmond Reserve Bank, which at present has a System Account participation percentage of 6.6990 but has 8.2 per cent of total Federal Reserve notes outstanding. In this situation, the Richmond Bank has had to pledge as collateral so large a portion of its gold certificate reserves that it has at times had a dangerously low reserve against deposits. (Gold certificates pledged as collateral can be counted only as reserve against notes.) An additional allocation of securities under the recommended provision would enable the Richmond Bank, or any Bank at which the same problem might develop, to pledge more Government securities and thereby make additional gold certificates available as reserve against deposits.

The purpose of the fifth change is to anticipate situations in which a Bank might not be in a position to assume its share of an unusually large purchase of securities for the System Account.

Robert W. Stone

John R. Farrell

Attachment

DRAFT
2-26-63

Procedures with Respect to Allocations of the System Open Market Account

1. Securities in the System Open Market Account shall be reallocated on the first business day of each month by means of adjustments proportionate to the adjustments that would have been required to equalize the average reserve ratios of the 12 Federal Reserve Banks over the first 23 days of the preceding month; provided, that the participation of each Bank, after such reallocation, shall not be less than 80 per cent of its outstanding Federal Reserve notes unless a smaller participation is necessary in order to prevent its reserve ratio from being less than 28 per cent. Any additional allocation required by the foregoing proviso shall be taken from the participations of the Banks having participations in excess of their outstanding notes, in proportion to such excesses.

2. If a Bank's reserve ratio should fall below 28 per cent on the next to the last business day (as observed by the Agent Bank) of a statement week or month, its holdings as of the close of business that day shall be adjusted by an amount sufficient to raise its reserve ratio to the average reserve ratio of the 12 Banks combined on the preceding day, or to such point as the Manager of the System Account and the Bank concerned consider feasible. Such securities shall be allocated to the Bank in a position to absorb the largest additional amount without reducing its reserve ratio below the ratio of the 12 Banks combined. If that Bank is unable to take the entire amount, the excess shall be allocated to the Bank which can absorb the next largest amount without reducing its reserve ratio below the average for the System.

3. If a Bank's reserve ratio should fall below 28 per cent on any other day, or if a Bank anticipates that its reserve ratio will fall below that figure, it may arrange with the Manager of the System Open Market Account for an adjustment similar to those provided for in paragraph 2 so as to increase the Bank's reserve ratio in any degree desired up to the average of the 12 Banks combined.

4. If purchases by the System Open Market Account on a particular day would, in the opinion of a Reserve Bank, be likely to reduce the ratio of that Bank's gold certificate reserves to its note and deposit liabilities, either combined or separately, below 25 per cent, the entire purchase shall be allocated to other Banks. Such allocation, having the effect of a special adjustment increasing the participations of the other Banks above normal proportions, shall be made to those Banks having the largest amounts of excess gold certificate reserves in relation to total note and deposit liabilities.

5. The Account shall be apportioned during the ensuing month on the basis of the ratios determined in paragraph 1, after allowing for any adjustments as provided for in paragraphs 2, 3, and 4.

6. Profits and losses on the sale of securities from the Account shall be allocated on the day of delivery of the securities sold on the basis of each Bank's current holdings at the opening of business on that day.