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JUL 27 1964

July 24, 1964.

Board of Governors

Mr. Hackley

Subject: Legality of allocations of Government securities in System Account to avoid Reserve Bank reserve deficiencies

NATURE OF THE QUESTION

On several recent occasions, question has been raised whether the procedure for allocation among the Reserve Banks of participations in securities in the System Open Market Account, as adopted by the Federal Open Market Committee on December 3, 1963, is consistent with the letter and spirit of provisions of the Federal Reserve Act regarding the maintenance by the Reserve Banks of gold certificate reserves against Federal Reserve notes and deposits.

The present allocation procedure provides that securities in the Account shall be reallocated on the last business day of each statement week and of each month. It further provides that, if calculations in the morning of any business day should disclose a deficiency (below 25 per cent) in the reserve ratio of any Reserve Bank for the preceding day, the Manager shall make a special adjustment "as of" such previous day to restore the combined reserve ratio of that Bank to the average of all Banks or to such higher level as may be necessary to eliminate the deficiency. This procedure differs from that in effect prior to December 3, 1963, in that the earlier procedure (adopted on September 10, 1963) provided for special adjustments on the day following each statement date "as of" the previous day to eliminate deficiencies on the statement dates, except that, if a Bank anticipated a deficiency on any other day (between statement dates), the Bank might arrange with the Manager to make the necessary special adjustment to raise the Bank's ratio for that day. In net effect, the difference is simply that the Manager now is required to make special adjustments on a day between statement dates "as of" the previous day if necessary to avoid deficiencies on such previous day, whereas previously adjustments were made between statement dates only if a Reserve Bank anticipated a possible deficiency and made arrangements with the Manager to make an adjustment on a particular day.

Whether a special adjustment between statement dates is made at the initiative of a Reserve Bank through advance arrangements with the Manager or is made by the Manager on an "as of" basis, without such prior arrangement, would seem to make no difference in principle; in both instances the objective of the special adjustment is to avoid a deficiency at a particular Reserve Bank. The practical difference, of course, is that the earlier procedure did not guarantee avoidance of a deficiency.

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Actually, the principle underlying adjustments between statement dates in both the present procedure and that of September 10, 1963, is essentially the same as the principle inherent in earlier allocation procedures. For many years, with changes in details, the procedures have provided for special adjustments (in addition to periodic allocations) to prevent the reserve ratio of any Bank from falling below a specified percentage above the statutory minimum. At one time (May 1936) the specified "floor" was set at 50 per cent; it was gradually lowered to 40, 35, 30, and eventually 28 per cent. The purpose was to avoid unusually low reserve ratios at individual Banks. Under the present procedure, the purpose is to avoid an actual deficiency, since the present "floor" is the statutory minimum. However, in both cases, the general objective was to equalize reserve ratios of the various Banks.

Going further, it is difficult to see any distinction in principle between special "as of" adjustments between statement dates and "as of" allocations on statement dates or at other specified periodic intervals as provided in earlier procedures. The objective of "allocations", like that of "special adjustments", has always been to equalize the reserve positions of the Reserve Banks. Stated differently, if special adjustments between statement dates in order to avoid reserve deficiencies are vulnerable to legal objection, the same is true in principle of periodic allocations based on equalization of the average combined reserve ratios of the twelve Reserve Banks.

Accordingly, it is assumed that the broad question presented is whether "allocations" and "adjustments" of Reserve Bank participations in Government securities held in the System Account, as determined by the Open Market Committee, for the purpose of avoiding a reserve deficiency on the part of any Reserve Bank is inconsistent with statutory requirements.

It is understood that the principal argument that has been advanced against the legality of the allocation procedure is that it constitutes a device to conceal reserve deficiencies through bookkeeping adjustments and, in effect, amounts to consideration of Reserve Bank reserve requirements on a System basis rather than an individual Bank basis as contemplated by the Federal Reserve Act.

It should be emphasized that this memorandum deals only with the legal question just stated. It is not concerned with the policy question whether deficiencies in reserves at individual Reserve Banks should be allowed to occur between statement dates (with payment of the statutory tax), without any effort to avoid such deficiencies through special adjustments in the System Account, or whether a more fundamental change should be made to discontinue periodic allocations based on equalization of the reserve ratios of the twelve Reserve Banks.

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OPINION

For the reasons hereafter stated, it is my opinion that:

(1) The law does not expressly prohibit transfers of particular assets between Federal Reserve Banks, as provided by the present allocation procedure, in order to avoid reserve deficiencies; on the contrary, such transfers of assets may be regarded as a legitimate means of achieving compliance with Reserve Bank reserve requirements;

(2) The Federal Open Market Committee has statutory authority to determine the basis upon which securities in the System Account shall be allocated, and the basis provided in the present allocation procedure is therefore to be regarded as valid unless clearly contrary to some provision of law; and

(3) Transfers of assets among the Reserve Banks, including allocations of Government securities in the System Account, have been regarded since the earliest years of the System as an appropriate means of equalizing the reserve positions of the Reserve Banks and avoiding reserve deficiencies; and Congress has been aware of, and has not objected to, the System's long-established practice in this respect.

I conclude, therefore, that the present allocation procedure does not violate either the letter or the spirit of the relevant provisions of law.

DISCUSSION

1. Statutory Provisions

Paragraph 3 of section 16 of the Federal Reserve Act (12 U.S.C. 413) requires every Reserve Bank to maintain "reserves in gold certificates of not less than 25 per centum against its deposits and reserves in gold certificates of not less than 25 per centum against its Federal Reserve notes in actual circulation". These are separate requirements; the fact that a Reserve Bank has gold certificates equal to 25 per cent of its combined notes and deposits is not sufficient.

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In computing its reserves against Federal Reserve notes, a Reserve Bank (1) must include gold certificates pledged as collateral for such notes under paragraph 2 of section 16 (12 U.S.C. 412), which requires such notes to be secured 100 per cent by eligible paper, direct obligations of the United States, or gold certificates; (2) must include gold certificates held with the Treasury Department in the "redemption fund" pursuant to paragraph 4 of section 16 (12 U.S.C. 414); and (3) may include all or any part of gold certificates to its credit in the "Interdistrict Settlement Fund" provided for by paragraph 16 of section 16 (12 U.S.C. 467).

In computing its reserves against deposits, a Reserve Bank may include gold certificates in the Interdistrict Settlement Fund, but not gold certificates pledged as collateral for Federal Reserve notes or gold certificates in the redemption fund.

Under section 11(c) of the Federal Reserve Act (12 U.S.C. 248(c)), the Board is authorized to suspend any reserve requirements prescribed by the Act for a period of not more than 30 days and to renew such suspension for periods not exceeding 15 days, provided that the Board must prescribe a graduated tax on reserve deficiencies. In the case of reserves against Federal Reserve notes, the Board must establish a graduated tax on deficiencies in accordance with the formula set forth in that section. Any tax required to be paid on a reserve deficiency against notes must be added to the discount rate charged by the deficient Reserve Bank.

Clearly, these provisions of the law require reserves against both notes and deposits to be computed separately for each Reserve Bank. In other words, it is not enough that the aggregate amount of gold certificates held by all Reserve Banks and "allocated" to note backing equals 25 per cent of all Federal Reserve notes in circulation. However, the question at issue appears to be whether, assuming the necessity for computations on an individual Bank basis, it is permissible to make allocations and adjustments in the System Account in order to avoid deficiencies at individual Banks.

2. Mechanics of Adjustments

Banking transactions throughout the country result in debits and credits among Federal Reserve Banks, resulting from the collection of checks, transfers of funds, and so on. In the very early days of the System, such transactions were settled through reciprocal balances between the Reserve Banks. In 1915, the Board established a "gold settlement fund" to provide for weekly settlements of interdistrict

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debits and credits. In 1917, in order to simplify such settlements, Congress amended the Federal Reserve Act (paragraph 16 of section 16) to provide for deposits of gold or gold certificates with the Treasury, subject to orders of the Board - the "Gold Settlement Fund". Since the Gold Reserve Act of 1934, this Fund has been known as the "Interdistrict Settlement Fund".

To the extent that gold certificate credits in the Interdistrict Settlement Fund are used to settle balances owing by one Reserve Bank to another, the result is obviously a reduction of the debtor Bank's reserves. That Bank, however, has a participation in the System Account's holdings of Government securities; and it is able to restore its reserves by "selling" a part of such participation to another Reserve Bank in exchange for gold certificates.

In a memorandum from the Division of Bank Operations, dated April 10, 1964, it was suggested that balances might be settled by transfers of holdings of Government securities rather than by transfers of gold certificates in the Interdistrict Settlement Fund. The adoption of such a proposal clearly would not give rise to the legal question discussed in this memorandum, since it would not involve any adjustments in Reserve Bank holdings of gold certificates in the Interdistrict Settlement Fund. Nor would such a plan give rise to any legal question as to the non-use of the Interdistrict Settlement Fund for "settlement" purposes, since, as pointed out in the memorandum above mentioned, there is no legal requirement that clearings be settled through that Fund. However, these considerations are irrelevant to the present question, which relates only to transfers of participations in Government securities in the System Account in exchange for gold certificates in order to avoid individual Reserve Bank reserve deficiencies.

3. <u>Compliance with the "Letter of the Law"</u>

Clearly, allocations of Government securities in the System Account do not violate the letter of the provisions of law heretofore mentioned. Those provisions require only that each Reserve Bank shall maintain specified reserves in gold certificates and that, in the event of a deficiency, the Bank shall pay a graduated tax at a rate fixed (within statutory limits) by the Board of Governors. The use of legitimate means to <u>avoid</u> a deficiency would not violate the statute.

Actually, the transactions in question may reasonably be regarded as an appropriate method of complying with the statutory reserve requirements. A member bank is required by law to carry reserves in the form of particular types of assets - a balance with

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its Reserve Bank or cash in vault; but it is recognized that a member bank may properly augment its reserves by rediscounting customers' paper with its Reserve Bank or by borrowing Federal funds from other member banks. Similarly, it may be argued, a Reserve Bank may properly sell Government securities in exchange for gold certificates in order to augment the type of assets in which _its_ reserves are required to be carried.

The difference, one might argue, is that a member bank must deal at arm's length with other banking institutions in seeking to avoid reserve deficiencies, whereas a Reserve Bank is able to avoid deficiencies by more or less automatic transactions in the System Account in a manner that in effect ignores the responsibility of each Reserve Bank to maintain its own reserves and that results, to some degree, in treating all the Reserve Banks as a single institution.

The answer to such an argument is to be found in (1) statutory provisions in effect authorizing the Federal Open Market Committee to treat Reserve Bank holdings of Government securities on a System basis, and (2) long-established sanction of the practice of transferring assets among the Reserve Banks in order to avoid reserve deficiencies.

4. _Federal Open Market Committee's Authority to Determine Basis for Allocating Securities_

Section 12A(b) of the Federal Reserve Act (12 U.S.C. 263) provides that no Reserve Bank shall engage or decline to engage in open market operations except in accordance with the direction and regulations of the Federal Open Market Committee. The Committee's regulation (sec. 4(b)) provides that the Committee shall from time to time "determine the principles which shall govern the allocation among the several Federal Reserve Banks of Government securities and other obligations held in the System Open Market Account, with a view to meeting the changing needs of the Federal Reserve Banks". This is the legal basis for the present allocation procedure.

The propriety of allocating participations in a common investment account to meet the "changing needs" of individual Reserve Banks has been recognized since 1923 when a "System account" was first established by the nonstatutory "Open Market Investment Committee" of the "Governors' Conference".

It is interesting to note that the first allocation formula adopted by that Committee was based on the reserve ratios of the Reserve Banks. For a number of years thereafter the formula was

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designed principally as a means of distributing earnings in a manner that would meet the estimated expense and dividend requirements of the respective Banks. At the same time, equalization of the reserve positions of the Banks continued to be an important consideration; and the formula adopted by the Executive Committee of the Open Market Policy Conference in May 1933 was based solely on reserve positions.

Both objectives - distribution of earnings and equalization of reserve positions - were recognized in the open market regulation (Regulation M) issued by the Board on August 10, 1933, pursuant to the Banking Act of 1933, which gave statutory status to the Open Market Committee but placed regulatory authority in the Board. The Board's regulation gave first place, however, to equalization of reserve positions. It provided that allocations of Government securities and other obligations should be made

> ". . . with the view primarily of (a) enabling each Federal Reserve Bank to maintain a suitable reserve position, and (b) equalizing as far as practicable the net earning position of the Federal Reserve Banks."

The Banking Act of 1935 transferred regulation of open market operations from the Board to the Open Market Committee. In regulations adopted effective March 19, 1936, the Committee provided merely that allocations should be made with a view to meeting the "changing needs" of the Reserve Banks; but the specific procedure prescribed by the Committee followed generally the procedures that had been in effect for many years. Until 1953 the formula was based mainly on anticipated expense and dividend requirements; from 1953 until 1962 it was based on total assets; but at all times the procedure included provisions designed to maintain a specified level of reserves at all Reserve Banks. On March 6, 1962, the formula was changed to a basis that required periodic reallocations to maintain the reserve positions of the individual Banks; and, with changes in January, September, and December 1963, the procedure has continued on this basis.

The legal authority of the Federal Open Market Committee to determine the basis for allocations among the Reserve Banks was strengthened by the Banking Act of 1935, which prohibited the Reserve Banks not only from engaging, but from "declining" to engage, in open market operations except pursuant to directions and regulations of the Committee. Because of this change in the law, the Committee ordered the consolidation of all Reserve Bank holdings of Government securities in the System Account effective June 30, 1936. As a reasonable incident to the Committee's plenary authority to determine when and in what amounts Government securities should be purchased and sold in the System Account, the Committee clearly was vested with authority to prescribe

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the basis on which participations should be allocated among the Reserve Banks. It was on this ground that the Board's General Counsel, Mr. Wyatt, in an opinion of November 26, 1937, concluded that the Committee had legal authority to continue to require allocations of securities on the basis of book value instead of current market price.

For similar reasons, the Committee must be regarded as having authority to prescribe a procedure designed to avoid reserve deficiencies at individual Reserve Banks, unless such a procedure would be inconsistent with other provisions of law. As has been noted, such a procedure does not violate the letter of provisions of law regarding the maintenance of reserves by the Reserve Banks. It remains to be considered whether the procedure in any way contravenes the spirit or intent of the reserve requirement provisions.

5. Distribution of Assets to Avoid Reserve Deficiencies as Consistent with Spirit of the Law

Since the very beginning of the Federal Reserve System, it has been recognized - expressly and frequently - that distribution of assets among the Reserve Banks to avoid reserve deficiencies is a legitimate and appropriate practice.

One provision of the original Federal Reserve Act, which remains unchanged in the law today, was expressly designed - and has been used - for the purpose of shifting available resources among the Federal Reserve Banks in order to avoid reserve deficiencies at particular banks. This is the provision contained in section 11(b) of the Act which authorizes the Board

> "To permit, or, on the affirmative vote of at least five members of the Board of Governors of the Federal Reserve System to require Federal Reserve Banks to rediscount the discounted paper of other Federal reserve banks at rates to be fixed by the Board of Governors of the Federal Reserve System."

In describing this authority for "interdistrict rediscounting" during the debates on the original Act, Representative Phelan said:

> ". . . Herein is provided a means whereby funds in one part of the country for which there is no demand may be applied to that part of our country which is in need. . . ."

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During 1915, it appeared that such interdistrict rediscounting might become necessary; and, in its Annual Report for that year, the Board expressly stated that it had been prepared, if necessary, to set this provision of law in operation "in order to make available for Federal Reserve Banks requiring larger resources the available funds of other reserve banks, the collective strength of the reserve system as a whole being far in excess of any demands that might reasonably be expected to be brought to bear upon it at that time." (1915 Annual Report, page 8)

The first inter-Reserve Bank rediscounting occurred late in 1917, and from that time until the end of 1921 such transactions took place in considerable volume. At one time or another all of the Reserve Banks were both borrowers and lenders, depending upon the credit needs of member banks in the respective districts and the resulting reserve ratios of the individual Reserve Banks.

Although section 11(b) gave the Board authority to <u>compel</u> interdistrict rediscounting, this never became necessary because of "a spontaneous spirit of cooperation between the Federal Reserve Banks" as a result of which all transactions suggested by the Board were made voluntarily. (1919 Annual Report, page 5)

It was clearly recognized that such interdistrict rediscounts were directly related to the reserve ratios of individual Reserve Banks. Thus, in its 1918 Annual Report (page 3), the Board stated:

> "The Board's policy has been to utilize, in an appropriate degree, the reserves of the 12 Federal Reserve Banks with the purpose of avoiding undue variations in their reserve position. Discount transactions between the banks have not, as a rule, been negotiated between banks themselves, but through the medium of the Federal Reserve Board, instructions being given by telegraph and transfers incident to the operations were effected in the same way."

Again, in its 1921 Annual Report (page 42), the Board stated:

> "Reserve ratios of Federal Reserve Banks, considered separately, are closely related to the rediscount transactions between Federal Reserve Banks. A Federal Reserve Bank will seek rediscount accommodations from other reserve banks at times when its own reserve is insufficient, without declining to a point below the legal minimum, to supply the credit demands of its member banks. . . ."

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After 1921, the only interdistrict rediscounting transaction occurred in March 1933 when, because of an unusual flow of bank reserves away from New York, the New York Federal Reserve Bank was required to borrow from other Reserve Banks in order to avoid a reserve deficiency. (1933 Federal Reserve Bulletin 211)

During the early years of the System, the rediscounting of eligible paper among the Reserve Banks was the most logical method of distributing resources in order to avoid reserve deficiencies. Sales of Government securities between the Reserve Banks for this purpose did not occur, it is presumed, for the reason that the volume of Government securities held by the Reserve Banks was minimal during those years.

After the enactment of the Banking Act of 1933, which gave statutory status to the Federal Open Market Committee, and the great increase in holdings of Government securities by the Reserve Banks, the shifting of resources to avoid reserve deficiencies gradually came to be accomplished through allocations of participations in the System Open Market Account. This development was brought to the attention of Congress on a number of occasions.

For example, when Governor Eccles testified before the Banking and Currency Committees of Congress in 1945, in support of legislation to reduce the gold reserve requirements, he stated:

> ". . . I do not know what the ratios would be if we did not shift back and forth between the Reserve Banks to keep the reserves balanced out. . . ." (Hearings before House Banking and Currency Committee on H. R. 2124, February 27, 1945, p. 9)

> ". . . As a matter of fact today we are adjusting the holdings of Government securities between the various Reserve Banks almost daily to try to keep their reserve ratios as nearly equal as possible. . . ." (Hearings before Senate Banking and Currency Committee on S. 510, February 20, 1945, p. 31)

In 1949, in a statement submitted by the Board to the Joint Committee on the Economic Report, the Board stated:

> ". . . Adjustments may be made in the allocations of securities in the System Open Market Account from time to time if the reserve position of a particular Federal Reserve Bank indicates that an adjustment is desirable." (Hearings before the Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report, November 16, 1949, p. 38)

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From the foregoing, it is clear that the practice of distributing assets among the Reserve Banks, whether by interdistrict rediscounting or by the allocation or adjustment of Government securities in the Open Market Account in order to avoid reserve deficiencies at individual Reserve Banks, has been considered legitimate and appropriate throughout the existence of the Federal Reserve System and that this practice has been made known to Congress on numerous occasions. Despite amendments to provisions of the Act regarding reserve requirements and open market operations, neither Congress nor its Committees have ever questioned the legality of the practice. Under traditional rules of statutory construction, such long-established administrative practice, known to, and not disapproved by, the legislature, provides additional strong support, if it were needed, for the conclusion that such allocations of participations in the Open Market Account to avoid reserve deficiencies in individual Reserve Banks is consistent not only with the letter but with the spirit of the relevant provisions of law.