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

March 11, 1975

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Attached is a copy of a memorandum from the System Account Manager, dated March 7, 1975, and entitled "Recommendations on System Lending of Securities." A related memorandum from the Committee's General Counsel is expected to be available for distribution soon.

It is contemplated that these memoranda will be discussed by the Committee at its meeting on March 18, 1975.

Attachment

CONFIDENTIAL (FR)
CLASS II - FOMC

March 7, 1975

TO: Federal Open Market Committee

FROM: Alan R. Holmes

SUBJECT: Recommendations on System Lending of Securities

Attached is a statistical report on the lending to dealers of securities held in the System Open Market Account since the last annual meeting of the Federal Open Market Committee in March 1974. The report indicates another sharp rise in the number of these loans although the average daily amount outstanding has not risen commmensurately, due to the smaller size of individual loans and to the daily balance between new loans and the return of securities previously loaned. The intensive use of this dependable source of borrowed securities has enabled dealers to keep delivery failures at a tolerable level and thus to continue servicing market participants, including the accounts handled by the Federal Reserve Trading Desk. On the basis of this report, I have concluded that the lending of securities remains reasonably necessary for the effective conduct of System open market operations and I recommend that the Federal Open Market Committee extend the lending authorization for another year.

I also recommend that the guidelines for the lending of securities be revised to provide for an increase from 3/4 per cent to 1-1/2 per cent per annum in the daily rate charged dealers on the face amount of securities borrowed. The higher charge would appear to be more equitable in the light of the consistently heavy use of this facility by the dealers and the increased expense incurred by the Reserve Bank in handling the transactions due to higher operating costs. The over-all operation continues to be profitable despite the increase in costs, which are estimated to be about 15 per cent of earnings. Earnings for the New York Bank in 1974 amounted to $1,054,433, compared with $774,863 in 1973, an increase of 36 per cent. More importantly, the higher charge might encourage the dealers to search more actively for other sources of lendable securities before coming to the System, which was intended by the Committee to be a lender of last resort. The original charge of 3/4 of one per cent, compared with the 1/2 of one per cent charge by other lenders, was initially expected to provide a sufficient penalty to discourage recourse to the System until other sources of lendable securities had been exhausted. However, given the effects of inflation psychology on all cost considerations and the expense and time required to search for other lenders (when the System has an available supply of practically every issue of Government securities), the 1/4 per cent penalty has apparently become less effective than when it was first imposed. A spread of 1 per cent over the charge of other lenders, instead of only 25 basis points, should provide somewhat more incentive to the dealers to seek other potential lenders first, without imposing an excessive fee for the accommodation provided.

If the Committee agrees to this increase in the lending charge, paragraph 5 of the Terms and Conditions for Lending Securities from System Open Market Account should be amended as follows:

5. The borrower will be charged interest on the principal amount (par value) of the securities borrowed at the following per annum rates:

Initial charge for five-day loan	1-1/2 per cent
First renewal of one day	3 per cent
Second renewal of one day	4-1/2 per cent
Subsequent renewals	6 per cent

The Federal Reserve will have the option of waiving or reducing penalty rates if the circumstances appear to warrant it.

I also propose to make a procedural change in the lending operations of the Desk. The guidelines require that the borrower be required "to pledge collateral consisting of United States Government securities of greater current market value than the securities borrowed..." In practice, the loaned securities are not released to the dealers until the collateral securities have been received by the Reserve Bank. The collateral securities are usually not delivered by the dealers' clearing banks until late in the day. This results in a corresponding delay in the receipt of the loaned securities by the dealers. As a result, the loaned securities are sometimes received too late to be redelivered before deadlines are reached and cannot be used by the dealers to avoid the delivery failures for which they were borrowed.

Such problems have reportedly been occurring more frequently since March 1974, when the automated securities clearing arrangement operated by the New York Reserve Bank was placed on a "real time" basis. This prevents any of the participating banks from sending any security from a book-entry account unless, or until, there is a sufficient amount of that issue already held to that bank's credit in the Sigma-5 computer. Before the "real time" restraint was adopted, the clearing banks had been able to wire out securities for a dealer as soon as the Desk agreed to lend them, since commitments of the Desk were regarded as a "guaranteed delivery." Collateral was delivered later in the day and the loaned securities were then released to the dealer by the Reserve Bank, usually by crediting the clearing bank's account in Sigma-5. This practice of anticipating securities loaned by the Desk is no longer possible under "real time" management of the computer.

It has been proposed that the delay in the receipt of loaned securities by the dealers could be eliminated if the System would lend them against "cash" early in the day, and return the cash later when the collateral in the prescribed form is delivered to the Reserve Bank.

This would enable the dealers to obtain borrowed securities immediately and to derive the maximum benefit from the borrowing. The later delivery of the security collateral would still fulfill the requirements of the Committee's guidelines for System lending of securities.

In order to expedite the operation of the securities clearing arrangement and to assure that all loans of securities by the dealers accomplish the purpose of the Committee in enabling the dealers to avoid delivery failures, the Manager proposes to adopt the procedure of temporarily holding cash against the securities loaned during the day, returning the cash when the securities collateral is received. If there is no objection from the Committee, the new procedure will become effective as soon as operating details can be worked out among the Reserve Bank, the dealers, and the clearing banks.

Briefly, the procedure will be as follows:

1. The Desk will agree to lend a dealer a specified amount of a particular security against other specified issues of Government securities having a greater market value than the loaned securities.
2. As soon as the loan is processed, the loaned securities will be delivered or credited to the dealer's clearing bank against a charge to that bank's reserve account amounting to twice the par value of the loaned securities.

3. Later in the day, upon receipt of the specified collateral securities, the charge to the clearing bank's reserve account will be reversed.

It should be noted that occasionally a dealer, for reasons beyond his control, might fail to deliver the security collateral before the usual delivery deadline set by the Reserve Bank. In such a case, the double charge to the member bank's account will remain in effect overnight, thereby penalizing the bank and, ultimately, the dealer for the failure. Given the usual cost of Federal funds, this penalty should provide a strong incentive for the dealers to avoid any such failure to deliver the collateral. In the event of such a failure, the loaned securities would be collateralized overnight by twice the amount of cash rather than by securities collateral with a much smaller excess of value over the loaned securities, thereby affording more than adequate protection to the System. Collateral securities would, of course, be obtained the next day unless the loaned securities were returned. It is not expected that such a failure to make timely delivery of security collateral would occur with any frequency. If it did, an offending dealer might be penalized further by the suspension of his borrowing privileges for a period of time.

The failure of a dealer to deliver securities in a timely fashion and the debit to a bank's reserve account would result in an unintended absorption of reserves. The amount, however, should be infinitesimal when compared with our typical daily miss in the projections. In the unlikely event that this becomes a problem, I would be prepared to recommend abandonment of the procedure.

Attachment

STATISTICS ON FEDERAL RESERVE LENDING OF SECURITIES
(dollars in millions)

	March 1973 through February 1974	March 1974 through February 1975	Percentage Change
Number of Loans	7,516	11,107	+48%
Total Amount	$14,319	$19,378	+35

Daily Averages

Number of Loans	30	45	+50%
Amount	$57.7	$77.8	+35
Balance Outstanding	$117.1	$150.5	+29
Size of Each Loan	$ 1.9	$ 1.7	-11

Dealer Fail Statistics

	1973	1974	Percentage Change
Daily Average Fails to Receive	$346	$293	-15%
Daily Average Fails to Deliver	$293	$220	-25

March 7, 1975