BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
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May 13, 1975

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Attached is the Second Report of the Staff Committee on Repurchase Agreements, dated today. The committee consists of Messrs. Scheld, Sternlight, and Axilrod (Chairman).

It is contemplated that this report will be scheduled for discussion by the FOMC in the near future, but not at the meeting to be held on May 20.

Attachment

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Second Report of Staff Committee on Repurchase Agreements

In April 1972 the Federal Open Market Committee amended the Authorization for Domestic Open Market Operations (then called the "continuing authority directive") to provide that interest rates on repurchase agreements arranged by the Federal Reserve's Trading Desk with nonbank dealers should be determined by competitive bidding unless otherwise authorized by the Committee. The Committee decision followed a report by a staff committee, which had recommended not only the change to an auction technique for setting rates on repurchase agreements (RP's), but also recommended that the Federal Open Market Committee authorize RP's with bank dealers. While the Committee favored introduction of an auction technique, a majority of the members preferred to exclude bank dealers, at least initially.

This report examines the experience with an auction technique in the past two and one-half years, reconsiders the question of making RP's with bank dealers in light of the intervening experience, and concludes with a renewal of the recommendation that the Federal Open Market Committee authorize RP's with bank as well as nonbank dealers.

Review of Experience with Competitive RP's

In general, the experience with competitive RP's has been quite satisfactory, bearing out the advantages anticipated in the March 1972 Report of the Staff Committee on Repurchase Agreements. The

Report had noted the following advantages of a competitive technique for RP's: (a) it would minimize the possibility that changes in an announced rate would be viewed as signaling forthcoming changes in System policy; (b) it would reduce the subsidy element in making RP's; and (c) it would facilitate the inclusion of bank dealers.

As to the first advantage--the avoidance of "signals" that might appear to emanate from changes in posted RP rates--the experience of the past two and a half years provides a sharp contrast with the immediately preceding period of late 1971-early 1972 when frequent changes in the Desk's RP rate generated undesirable announcement effects. While the RP rate has varied in the period of competitive bidding, the variation has reflected the vigor of market competition rather than deliberate System decisions to set different rates. The Desk does, of course, exercise some discretion with respect to the "stop-out rate" or lowest acceptable rate at which it will do RP's on any given occasion, but these rates are not officially announced and do not have nearly the same weight in the market as the old posted RP rates. While market participants are aware of the stop-out rates, and some modest market impact occasionally flows from changes in these rates from one day to the next, market participants tend to regard the stop-out rate as an incidental function of the market's eagerness in bidding for the System's RP money rather than a deliberate rate decision by the Desk. This point of view has been encouraged as Desk officers have pointed out to the dealers that the Desk's primary aim in making RP's is to inject a volume of reserves that the Manager has in mind, in rough magnitude, before the operation;

and the stop-out rate will be set at a point such that the desired volume will be executed.

The past two and a half years have also demonstrated the reduction of the subsidy element. With day-to-day money costs ranging well above the discount rate through most of the period since the switch to competitive bidding, dealers have bid for System RP money at rates related to going market levels. Typically, dealers have bid for the System's RP's at rates about ½ to 1¼ percentage points below the going Federal funds rate, although at times when collateral has been in particularly scarce supply the differential has ranged closer to 1½ or 2 percentage points. Even when the RP rate has been as much as 2 per cent below the funds rate, however, it usually exceeded the discount rate--which presumably would have been the charge under the previous method for setting RP rates.

As to the third advantage that had been mentioned earlier for competitive RP's--that this method would facilitate inclusion of bank dealers--the experience of the past two years also offers some evidence. First, since the subsidy element was reduced, as compared with a situation in which RP's would otherwise have been made at the discount rate, there is less reason to be concerned that dealer banks would receive funds on a favored basis relative to other banks. Second, since on most occasions in the past two years the Desk invited the nonbank dealers to bid for Desk RP's on the basis of customer collateral as well as their own securities holdings, bank dealers as well as other banks and other customers of the nonbank dealers, already have had indirect access to Desk RP's.

The attached tables summarize Desk RP activity since April 1972, when the change was made to competitive bidding. As indicated in Table 1, there has been an increasing tendency during this period to offer RP's against both dealer and customer collateral. In part, this has reflected the shortage of collateral in nonbank dealers' hands as monetary restraint persisted and intensified over much of the period. However, it has become fairly typical for the Desk to permit customer collateral to be shown even in the easier monetary climate of the past several months, as this broadens the competition for System RP money.

Shown in Table II are the sources of collateral for Desk RP's during the past two and a half years. While in the earlier part of the interval--1972--the bulk of the collateral represented the nonbank dealers' own securities, customer securities comprised around half the total in the first half of 1973 and more than half the total since mid-1973. Dealer bank securities have comprised a varying proportion of customer collateral--occasionally running well over half the total but more often in the area of about one-third. A major factor affecting this proportion is whether or not a large West Coast bank participates in the Desk's RP's. Dealer bank collateral as a proportion of total customer collateral declined fairly sharply in 1974. Data available to the Desk do not permit a determination of whether the dealer bank collateral presented to the Desk constitutes <u>dealer</u> collateral from those banks or portfolio securities. Most likely the figures include some of each, but probably weighted toward the portfolio side--reflecting the substantial participation of a large West Coast bank.

In Table III, a comparison is made of rates on RP's with Federal funds and the discount rate. Except for the early months of the competitive RP period, when money was easy and it was difficult to attract collateral, RP rates generally fell between the Federal funds and discount rates. Rates are shown for total RP's, RP's on dealer collateral, and RP's on customer collateral--with customers further divided between dealer banks and others. While relationships among RP rates for these three groups varied somewhat over the period, there has been a tendency on average for rates on dealers' own collateral to exceed those on customer securities, reflecting the willingness of dealers to bid more aggressively for the System's RP money. In 1972, dealer banks were less aggressive than other customers of the nonbank dealers, but in 1973 and 1974 there seemed to be little difference on average between these two groups of customers.

Pros and Cons of Making RP's with Bank Dealers

The case in favor. The main argument for making RP's directly with bank dealers is that such action would tend to broaden the scope of System RP's. Through their participation in System RP's as customers of nonbank dealers, the bank dealers have shown that they are a potentially significant source of collateral when the Desk wishes to inject reserves through RP's. It may be asked why, if bank dealer collateral can be presented to the Desk through nonbank dealers whenever the latter are asked to round up collateral from customers, there should be any advantage to approaching the bank dealers directly. However, the Desk probably does not see as broad a response from the bank dealers via this roundabout route as might follow from a direct approach. There have been some indications that bank dealers are reluctant to go through another dealer, particularly when the bank is presenting dealer department collateral rather than portfolio securities. Moreover, there is reason to believe that if the Desk asked all dealers, bank and nonbank, to show customer collateral as well as their own, the bank dealers might be able to offer collateral from a broader range of customers than has been seen from the nonbank dealers alone. Bank dealers are likely to know where additional pools of securities are owned and held, and as major money market institutions they would inspire particular confidence with their customers in the smooth execution of these transactions.

Further, as a matter of equity amongst the dealers trading with the Desk, it seems unfair to discriminate against the eleven bank dealers among the 27 dealers trading with the Desk as of this writing. While it had been argued in the past, when RP's were made at the discount rate, that making RP's directly with banks was akin to extending discount window funds without the accompanying discount window discipline, this comment does not appear to be applicable to a competitive bidding system. The bank dealers, like the nonbank dealers, would get what they were willing to bid for. Based on their behavior as customers of the nonbank dealers, the bank dealers would probably bid less aggressively than the nonbank dealers if given direct access to Desk RP's--in which case they would get a lesser share of the System's funds.

Another equity problem in the present arrangement is that the nonbank dealer has the advantage of seeing what rates and amounts his customers are submitting, which can be helpful to him in developing his own bid. Whichever nonbank dealer puts in the bid for certain large banks has a distinct advantage over other dealers and customers.

It might be asked, as a logical extension of the points made above, if it is preferable to take bank dealer bids directly, rather than as customers of the nonbank dealers, then why not take other bank or other customers' bids directly too? Such an open-ended approach is simply not feasible, however, within the time limits that the Desk must work in controlling day-to-day reserve availability. It is feasible to handle bids from 27 or so dealers, as the Desk now does in its outright operations or in its matched-sale purchase transactions. But it would not be feasible to handle bids from the potentially numerous other bidders who might seek direct access to the Desk if that route were open to them.

The case opposed. It might be argued against making RP's directly with bank dealers that participation of the latter group may be obtained when it is needed by inviting the nonbank dealers to round up customer collateral, while ordinarily Desk RP's should be reserved to the nonbank dealer so as to help "even up" the over-all financing environment in which the nonbanks are at a disadvantage to banks. The recent history of the Government securities market has seen bank dealers gain at the expense of nonbank dealers, at least in shares of market business, although not necessarily in profitability. While it would be difficult to justify an overt subsidy to the nonbank dealers in order to help preserve their financial health and stability, restriction of Desk RP's to this group might be regarded as helpful in order to even the score a bit.

Also, it might be argued that even though RP's are frequently made with bank dealers as customers of the nonbanks, direct arrangements with the bank dealers would be sufficiently close to discount window borrowing as to undermine discount window discipline. Moreover, related to this point, direct RP's with bank dealers might be considered discriminatory against banks that are not dealers and would have to use the discount window, or arrange RP's with the System indirectly through a nonbank dealer, to obtain Federal Reserve credit.

Finally, it might be argued that RP's with bank dealers still include some element of subsidy since the RP rate is generally below the Federal funds rate. However, any such subsidy is distinctly less than was the case earlier, when RP's were done at the discount rate. Also, in seeking to measure the extent of any subsidy it should be noted that the RP is a secured transaction, collateralized by Treasury and agency securities, while the typical Federal funds trade is not collateralized and could be expected to carry a somewhat higher rate.

Concluding Discussion and Recommendation

After reviewing the experience of the past two and a half years, and weighing the pro and con arguments above, the staff committee concluded that the Desk should be authorized to make RP's directly with bank dealers. A further question remains as to whether the Desk should sometimes confine the offer of RP's to dealer collateral only--in which case the bank dealers could offer only the securities in their dealer account and not those in the bank's investment portfolio. In the view of the staff committee this distinction should not be made; in order to achieve the broadest access to collateral in the most expeditious manner, the Desk should permit dealers to present customer collateral (including portfolio securities of bank dealers) at any time that it offers RP's. This would parallel the approach now pursued when the Desk asks the dealers for outright bids or offerings of securities, or invites propositions for matched-sale purchase transactions. To argue that RP's should be confined to dealers' own securities would seem to carry an implication that dealer financing somehow needs to be subsidized via Desk RP's. Under a competitive approach, however, the System's RP's are not a "goodie" to be rationed to the deserving dealers, but rather a convenient and efficient technique to inject reserves for short periods.

Recommendation: It is herewith recommended that the Desk be authorized to make repurchase agreements with bank dealers as well as nonbank dealers. This can be accomplished by amending paragraph 1(c) of the Authorization for Domestic Open Market Operations to delete the word "nonbank" in designating the dealers with which the Federal Reserve is authorized to undertake repurchase agreements for its own account. Paragraph 1(c) would then read:

"1(c) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers' acceptances of the types authorized for purchase under 1(b) above, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market."

Karl A. Scheld
Peter D. Sternlight
Stephen H. Axilrod, Chairman

Table I

Quarterly RP Activity

Date	Number of Rounds	Number of Rounds Using only Dealer Collateral	Proportion Confined to Dealer Collateral
1972			
2nd	11	5	45%
3rd	19	9	45
4th	25	10	40
1973			
1st	42	13	35
2nd	39	6	15
3rd	32	1	3
4th	33	1	3
1974			
1st	22	0	0
2nd	45	0	0
3rd	24	1	4
4th	32	1	3

Table II

Repurchase Agreement Collateral, 1972-74
(Quarterly Volume - Millions of Dollars)

1972	Total	Nonbank Dealer	Dealer Bank	Other Customer	Dealer Bank as Per Cent of Customer
IIQ	$ 4,134	$ 2,407	$1,180	$ 547	68%
IIIQ	6,599	5,330	400	870	31
IVQ	12,654	8,046	2,045	2,563	44
AVG.	7,796	5,261	1,208	1,327	48
1973					
IQ	$19,570	$10,117	$5,387	$4,066	57%
IIQ	21,682	10,000	3,982	7,700	34
IIIQ	15,879	6,984	3,742	5,153	42
IVQ	27,543	11,538	9,131	6,874	57
AVG.	21,169	9,660	5,561	5,948	48
1974					
IQ	$16,599	$ 5,355	$4,448	$ 6,796	40%
IIQ	29,646	8,016	7,456	14,174	34
IIIQ	15,202	6,401	1,750	7,051	20
IVQ	32,728	15,769	4,797	12,162	28
AVG.	23,544	8,885	4,613	10,046	31

Table III

Rates on Desk RP's and Related Data

Rate on:

Date	All RP's	Nonbank Dealer Collateral	Dealer Bank	Other Customer	Fed Funds*	Discount Rate: FRBNY*
1972						
2nd	3.93	4.01	3.71	4.05	4.30	4.5
3rd	4.48	4.55	3.94	4.30	4.90	4.5
4th	4.97	5.01	4.84	4.95	5.42	4.5
Avg.	4.46	4.52	4.16	4.43	4.87	4.5
1973						
1st	5.80	5.89	5.66	5.76	6.48	5.1
2nd	6.87	6.95	7.09	6.61	7.96	5.9
3rd	9.23	9.45	9.20	8.95	10.50	7.2
4th	9.48	9.48	9.33	9.68	10.50	7.5
Avg.	7.85	7.94	7.82	7.75	8.86	6.4
1974						
1st	8.90	8.86	8.84	8.97	9.67	7.5
2nd	9.90	9.95	9.96	9.87	11.38	7.5
3rd	11.10	11.12	11.05	11.07	12.76	8
4th	8.80	8.87	8.76	8.76	9.45	7.9
Avg.	9.68	9.70	9.65	9.67	10.82	7.7

*Based on average of days on which RP's were made.