



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

June 3, 1975

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann *M. A.*

Attached is a copy of a memorandum from Mr. Sternlight, dated June 2, 1975, and entitled "Lending of Securities from System Account Portfolio." In the memorandum, Mr. Sternlight describes the procedures for lending securities against cash that the Account Management plans to implement in about a week if there are no objections from Committee members.

Please let me know by Monday, June 9, if you have any objections to the new procedures.

Attachment

CONFIDENTIAL (FR)
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June 2, 1975

TO: Federal Open Market Committee Subject: Lending of Securities from System Account Portfolio

FROM: Peter D. Sternlight

At the April 15, 1975 meeting of the Committee, the Manager of the System Open Market Account recommended a procedural change in the System's lending facility to make the facility more effective in minimizing delivery failures in the Government securities market. Under existing arrangements, loaned securities are not delivered to the borrower until the collateral (in the form of other Government securities of at least equal market value) is actually received by the Reserve Bank. To expedite delivery of the loaned securities, it was proposed that upon the Desk's agreement to grant the loan request the borrower be sent the securities against a charge to the reserve account of the borrower or the borrower's clearing bank. Later that day, when the Reserve Bank receives the collateral, the charge to the reserve account would be reversed.

Initially, we were planning in connection with the modified lending procedure to charge the reserve account a sum equal to twice the par value of the borrowed securities. The effect of this approach was to provide a significant penalty to the dealer in the event (which we would expect to be quite rare) that there was a failure to deliver collateral in the

form of securities that same day. Discussion with dealers and their clearing banks have revealed some difficulties with this approach because of the "double debiting" of reserve accounts during the day. Not only did the dealers express concern about this procedure, but also the clearing banks felt that such an arrangement would result in their extending sizable unsecured loans to non-bank dealers, a practice not permitted by prevailing lending policies of these banks. In view of these considerations, the Account Management now proposes to lend securities against a charge to the reserve account of the borrower (or the borrower's clearing bank) equal to the market value of the loaned securities, plus a moderate margin, but levy a 6 percent per annum penalty should a dealer fail to deliver the promised collateral. The penalty would be in addition to the basic lending charge of 1 1/2 percent, and would retain the strong incentive for dealers to make timely delivery of collateral that was implicit in the initial form of our proposal. Beyond the rate penalty, repeated instances of not delivering collateral would result in the suspension of a dealer's borrowing privilege for a period of time.

If there is no objection from the Committee, the Desk plans to implement the new procedure within about one week.