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

December 13, 1977

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Attached is a memorandum from Mr. Volcker, dated December 12, 1977, and entitled "The Federal Reserve role in providing short-term investment facilities to foreign central banks and international institutions."

It is contemplated that this memorandum will be discussed at the forthcoming FOMC meeting, under agenda item 8.

Attachments

CONFIDENTIAL (FR)
CLASS II FOMC

December 12, 1977

TO: Federal Open Market Committee

FROM: Paul A. Volcker

SUBJECT: The Federal Reserve role in providing short-term investment facilities to foreign central banks and international institutions

Pursuant to the Committee's discussion at its June 21 meeting, the Federal Reserve Bank of New York submitted to the Internal Revenue Service on July 22, 1977 a request that income received by foreign central banks from repurchase transactions with the Federal Reserve Bank of New York or the System Open Market Account (SOMA) be ruled exempt from Federal income tax. On November 8, 1977, the IRS so ruled (see attachment A).1/ It thus becomes appropriate for the Committee to authorize a course of action to handle short-term foreign account investments in a manner that best meets Federal Reserve System objectives while also meeting the legitimate investment needs of the accounts of foreign central banks and international institutions (hereinafter called "foreign accounts").

1. The Options.

The Committee has the continuing responsibility for prescribing the manner in which market transactions are to be

1/The ruling is limited in its application to matched sale-purchase transactions (MSPs) effected with foreign central banks of issue that are entitled to exemption under Section 895 of the Code. Foreign account MSPs may also be effected tax free for certain international organizations and other foreign entities that are exempt from tax by virtue of Section 892 of the Code (dealing with foreign governments and international organizations).

conducted, irrespective of which course of action it chooses. Three possible approaches appear available to the Committee. (See attachment B, my memorandum of June 14, 1977 on "The Use of Repurchase Agreements for Foreign Central Banks and International Institutions"). Under all three options, the Desk would make matched sale-purchase transactions (MSPs) between the Federal Reserve and foreign accounts, offsetting the effect on reserves through repurchase agreements (RPs) with Government securities dealers to the extent deemed appropriate by the Manager of SOMA. The options involve choices on two issues: first, should MSPs be made solely for SOMA, or should the Manager be able to make them, at times, for the Federal Reserve Bank of New York (with offsetting RPs in the second case); second, should new language relating to the MSPs with foreign accounts be added to the domestic authorization.

Briefly, the options call for the following decisions on these two issues:

Option 1: All MSPs with foreign accounts would be for SOMA, and no change would be made in the authorization. This has been the practice in the interim period since May 1977.

Option 2: All MSPs with foreign accounts would be for SOMA, as in alternative 1. For the sake of clarity and completeness a new paragraph, specifically authorizing such transactions, would be added to the domestic authorization.

Option 3: Depending on over-all need to affect reserve availability, the Manager could choose to satisfy foreign account overnight investment needs with SOMA, or on occasion by making

MSPs for the account of the New York Bank--offsetting the reserve effect in the latter case by arranging New York Bank RPs with the dealers. (This would be equivalent to the practice prior to May 1977, except that then the New York Bank acted as agent for foreign accounts in placing their RPs in the market, rather than as the principal in two separate transactions.) A new paragraph authorizing such transactions for the New York Bank's account (which are not presently authorized) would need to be added to the authorization.

Open market operations to manage reserves can be carried out effectively under any of the three options. (See tabular array on page 4.) Each of the options permits efficient communication of the System's short-run Federal funds rate objective to financial market participants. The first two options impose an automatic reserve drain, which the Manager can offset by making System RPs in the market to the extent that is appropriate in the light of bank reserve or money market conditions. The third option permits the Manager to absorb reserves by MSPs with foreign accounts for any amount ranging from zero up to the foreign investment interest without a SOMA market entry--much as the sale of Treasury bills to foreign accounts affects reserves without a market entry. Such flexibility has often proved useful in the past as a means of managing reserves without requiring a market entry.1/

1/To keep the public generally informed, it would probably be useful to publish weekly the average amount of MSPs concluded by SOMA with foreign accounts.

System open market operations in relation to actual and proposed practices for handling foreign account RPs[1/]

System operation:	Market entry to absorb or supply[2/] reserves (through MSPs or RPs)	No market entry to absorb or supply reserves temporarily
Practice before May 1977	SOMA MSPs made with foreign accounts, under present paragraph 1(a) of authorization.	Desk can absorb reserves, using SOMA MSPs with foreign accounts to extent desired; New York Bank acts as agent to arrange remainder of foreign account RPs in market. (Not under FOMC direction.)
Practice since May 1977	SOMA MSPs made with foreign accounts, under present paragraph 1(a) of authorization.	SOMA MSPs made with foreign accounts, under present paragraph 1(a) of authorization[3/]; results in reserve drain, and can lead to offsetting System action in market.
Option 1	SOMA MSPs made with foreign accounts, under present paragraph 1(a) of authorization	SOMA MSPs made with foreign accounts, under present paragraph 1(a) of authorization[3/]; results in reserve drain, and can lead to offsetting System action in market.
Option 2	SOMA MSPs made with foreign accounts, under first form of new paragraph 4	SOMA MSPs made with foreign accounts, under first form of new paragraph 4; results in reserve drain, and can lead to offsetting System action in market.
Option 3	SOMA MSPs made with foreign accounts, under present paragraph 1(a) of authorization.	Desk can absorb reserves using SOMA MSPs with foreign accounts to extent desired; New York Bank acts as principal to arrange remainder of foreign account RPs in market under second form of new paragraph 4.

1/Transactions are RPs from point of view of foreign account, MSPs--matched sale-purchase transactions from the point of view of Federal Reserve.

2/At times when Desk's objective is to supply reserves, SOMA MSPs with foreign accounts are offset by an equivalent volume of New York Bank RPs with market.

3/This treatment was authorized by FOMC as an interim measure in telephone conference on May 27, 1977, and at FOMC meeting of June 17, 1977.

Whichever option is chosen, the New York Reserve Bank plans to continue to maintain restraints on foreign account use of the RP facility. Experience suggests, however, that it is quite difficult to turn the use of the facility on or off as an aid to open market operations. Accordingly, restraint will consist mainly of limiting the amounts that individual accounts can maintain routinely in the RP facility, as opposed to the sizable amounts that may be placed there temporarily because of short-lived international flows.

We plan to impose a service charge of 1 or 2 basis points for the use of the RP facility, in view of the Federal Reserve's participation as a principal. This activity charge would supplement the implicit charge imposed by the uninvested deposit balances foreign accounts maintain. In the aggregate, the balances have raised SOMA earnings by more than the cost of providing services to such accounts. However, a number of accounts have not adequately compensated in this manner for the investment services used. Through the RP charge and selective counselling on balance levels, the Bank plans to achieve more equitable treatment of the various accounts.

2. Discussion.

In choosing among the options, the Committee needs to weigh, among other factors, the public posture it presents by its choice among the three alternatives.

(a) Committee directive that SOMA routinely enter into MSPs with foreign and international accounts without formal change of authorization. The Committee could merely indicate in the

policy record that the Committee after discussion had concluded that SOMA would make MSPs with foreign accounts as a means of ensuring the effective conduct of open market operations while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York.

Such a course could be chosen on the basis that the System's domestic policy directive is sufficiently broad in its statement of objectives that the contemplated action does not represent a significant change in Desk activities that would call for new authorization. This approach would acknowledge that the Federal Reserve System plays an active role in carrying out the international financial policies of the United States as well as allowing in its policy deliberations and operations for the interplay of international forces on the domestic financial system and the economy. Indeed, a broad concern of this kind is typically reflected in the domestic policy directive. A recent one (11/15/77) stated the Committee's policy was:

> "to foster bank reserve and other financial conditions that will encourage continued economic expansion and help resist inflationary pressures, while contributing to a sustainable pattern of international transactions." (underscoring added)

Both the written and oral reports of the Manager of the System Account over the years have presented the domestic, and at times international, considerations that have impacted on daily decisions made on the timing of, and avenues chosen for, domestic open market operations. Committee members have often discussed at their meetings the international aspects of domestic

operations undertaken or contemplated by the Committee. The current authorizations already provide authority for the Federal Reserve Bank of New York to arrange purchases and sales for SOMA (paragraph 1(a)) and the RPs for the FRBNY (paragraph 1(c)) in furtherance of the FOMC's policy directives. Matched sale-purchase transactions have been considered since a special meeting of the FOMC in July 1966, to be covered under paragraph 1(a). No amendment was deemed necessary to give effect to a modification of procedures at that time.

Mr. O'Connell in his memorandum to the Committee on June 14, 1977 (attachment C), found that such a view could be legally supported on the basis that the total of actions under paragraph 1 for a given day must be consistent with the committee directive.

(b) Amend the authorization for domestic operations to provide explicit authority to engage in MSP transactions with foreign and international accounts. The Committee may prefer for the sake of completeness and to clarify its intent to add a new paragraph 4 to its domestic policy authorization. This might read as follows:

> In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market, allowing for a service fee when appropriate.

This alternative would result in the same operational procedure as (a), but provide a full public announcement of, and rationale for, the new procedure. It would perhaps imply greater significance to the change than was warranted, and lead some observers to misconstrue the motivation of the change. But the Committee would protect itself against any allegation that it was moving without full disclosure on an issue that might be interpreted as substantive. Mr. O'Connell expressed some concern that this alternative might raise possible legal questions about past practices. He believes these could be resolved by a combination of the (b) and (c) authorizations shown as attachment D.

(c) Amend the authorization for domestic operations to authorize the Federal Reserve Bank of New York to undertake the appropriate operations as principal. A new paragraph 4 might be added as follows:

> In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(c), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. These transactions, and transactions undertaken with such accounts under the provisions of paragraph 1(a), may provide for a service fee when appropriate.

This approach would be quite similar operationally to the procedure employed before the potential tax problem appeared. The Account Manager could decide daily to what extent, if any,

SOMA would be involved with foreign accounts to facilitate domestic open market operations. When the Account Manager saw no need for the System to add reserves or to withdraw reserves to the full extent allowed by foreign account investment needs, the Reserve Bank would enter into MSPs with the pool in which foreign accounts held an undivided share and offset the reserve effect by making RPs with Government securities dealers. Changes in the contractual arrangement would provide that the Reserve Bank would act as principal rather than as agent for foreign accounts. In those cases when the Federal Reserve sought to absorb, or supply, reserves through MSPs or RPs, respectively, SOMA would routinely make MSPs with foreign accounts.

Mr. O'Connell stated in his memorandum of June 14, 1977, that he preferred this third alternative because it raised the least possible questions about past practices. It leaves undisturbed the authority to engage in SOMA transactions under paragraph 1(a) and provides an alternative to the smaller class of transactions most directly affected by the IRS ruling--Reserve Bank transactions with dealers. Mr. O'Connell has indicated more recently that he would prefer a combination of the authorizations of (b) and (c) above (see attachment D).

3. Recommendation.

The Federal Reserve Bank of New York believes that operations could be conducted effectively under any of the three courses outlined. The Bank prefers the third alternative, which appears more straightforward in the sense that it forestalls any question that System open market operations are directed at a

purpose other than one of domestic monetary policy. It also provides maximum flexibility to the System Account Manager in the conduct of open market operations. Mr. O'Connell's suggested formulation of the authorization would also be acceptable.

ATTACHMENT A

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

0895.00-00

Federal Reserve Bank of
New York
New York, N.Y. 10045

Person to Contact: Leonard A. Lipson

Telephone Number: (202) 566-3501

Refer Reply to: T:C:C:3:1

Date: NOV 8 1977

Corp. A = Federal Reserve Bank
of New York
EIN 13-5562116

Group B = Other Regional Federal Reserve
Banks

Group C = Government Securities Dealers

Group D = Foreign Central Banks of Issue

Gentlemen:

This is in reply to a letter dated July 22, 1977, in which a ruling is requested as to the Federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated September 7 and September 30, 1977. The facts submitted for consideration and upon which this ruling is premised are substantially as set forth below.

Corp. A is an instrumentality of the United States which together with Group B performs statutory functions with respect to domestic monetary policy in addition to serving as the central bank of the United States in dealings with foreign governments, foreign central banks and other foreign governmental or international institutions on international economic matters.

In this capacity, Corp. A maintains accounts for Group D through which portions of the monetary reserves controlled by Group D are invested. Such investments by members of Group D are considered governmental activities by U.S. standards.

In this regard Corp. A, on behalf of itself and Group B, proposes to sell an undivided interest in a pool consisting of U.S. Government or Federally sponsored agency securities to individual members of Group D. A Federally sponsored agency security is defined as a

security issued by an agency or instrumentality of the United States, which is by law either an obligation of the United States or an obligation of the agency or instrumentality issuing the security, or both. Corp. A simultaneously agrees to repurchase this interest, usually on the next business day, at a higher price determined by the market rate for such transactions. Neither party may terminate the agreement prior to maturity.

These transactions will be effected on the books of Corp. A, usually pursuant to standing investment instructions. There is no written agreement between the parties for individual transactions. Members of Group D will be initially apprised of the terms under which the securities are offered and will be informed after the fact of each transaction. Corp. A and Group B are under a legal obligation to repurchase the undivided interest from Group D members.

A second type of transaction is also proposed whereby Corp. A, acting for its own account rather than for itself and Group B, would enter into repurchase agreements with one or more members of Group C. Under these agreements, Corp. A buys a U.S. Government or Federally sponsored agency security from a member of Group C who agrees to repurchase the obligation at a specified future date up to fifteen days later (usually one to seven days later) at the original price plus an agreed upon return. Delivery of the securities purchased from a member of Group C is effected on the same day by the Group C member's instruction to its bank to transfer the securities to Corp. A. Payment for the securities is made by Corp. A the same day upon delivery of the securities. An executed contract covering the repurchase transaction is delivered by the Group C member to Corp. A. The Group C member has a legal obligation to Corp. A to repurchase the securities.

The securities received by Corp. A from its repurchase agreements with Group C are pooled in a specific account on its books. Under standing or specific instructions from Group D members permitting investments, Corp. A will sell an undivided proportionate interest in this pool of

securities to individual Group D members. Corp. A simultaneously agrees to repurchase the undivided interest, usually on the next business day, at the same price plus an agreed upon return. Corp. A may impose a service charge.

These transactions are effected without written agreement but each Group D member is notified of the amount of its funds placed that day in the purchase of the undivided interest in Corp. A's security pool.

Corp. A is under a legal obligation to the individual Group D members to repurchase the undivided interest which it sold.

You have requested a ruling that income derived by individual Group D members from the aforementioned short-term matched sale-purchase agreements in U.S. Government and Federally sponsored agency securities effected with Corp. A both on its own account and on behalf of Group B is exempt from Federal income tax and withholding pursuant to sections 895 and 1442 of the Internal Revenue Code of 1954.

Section 895 of the Code provides, in pertinent part, that income derived by a foreign central bank of issue from obligations of the United States or of any agency or instrumentality thereof which are owned by such foreign central bank of issue shall not be included in gross income and shall be exempt from taxation under this subtitle unless such obligations are held for, or used in connection with, the conduct of commercial banking functions or other commercial activities.

Rev. Rul. 77-59, 1977-11 I.R.B. 9 holds that repurchase agreements whereby a trust "purchases" from a bank a stated face amount of United States Treasury obligations and simultaneously agrees to "resell" the obligations to the bank on a fixeddate (not more than several days later) at the "purchase price" plus an agreed amount of interest shall be treated for Federal tax purposes as loans to the bank secured by the obligations.

Federal Reserve Bank of
New York

In the instant case, the transactions between Corp. A and the individual members of Group D are conducted under general standing instructions without written agreements between the parties and are subsequently confirmed by telex. The securities comprising the pools (an undivided interest in the pool is "sold" to individual Group D members) remain in the custody of Corp. A. No specific security is credited to the Group D member's account on Corp. A's books. No Group D member has a claim against individual securities held by Corp. A. The Group D member neither benefits nor suffers from any change in either the market value of the United States Government or Federally sponsored agency securities or the rate of return received upon "resale" of such obligations.

Consequently, the Service views such short-term matched sale-purchase agreements as loans by individual members of Group D to Corp. A and Group B under the first transaction and to Corp. A under the second transaction.

Furthermore, under the structure of the first proposed transaction, Corp. A on behalf of itself and Group B is obligated to the individual members of Group D for repayment of the loan and any interest thereon. Additionally, under the second transaction, Corp. A is under a legal obligation to Group D members for repayment of the loans and interest. The obligation of Corp. A to Group D is not contingent upon the repurchase by Group C of its obligation to Corp. A. Group C's obligation to Corp. A is separate and distinct from Corp. A's obligation to the individual members of Group D.

Therefore the obligations of Corp. A (acting for itself and on behalf of Group B) constitute obligations of an instrumentality of the United States. Such obligations are owned by the individual members of Group D within the meaning of section 895 of the Code and are not held for, or used in connection with, the conduct of commercial banking functions or other commercial activities.

Federal Reserve Bank of
New York

Accordingly, the income received by the individual Group D members which is derived from the aforementioned obligations of Corp. A is exempt from Federal income tax and withholding pursuant to sections 895 and 1442 of the Internal Revenue Code of 1954.

In accordance with section 6.14 of Rev. Proc. 72-3 1972-1 C.B. 698, a copy of this letter is to be attached to any return to which it is relevant with respect to a completed transaction.

Sincerely yours,

John L. Crawford

Chief, Corporation Tax
Branch

ATTACHMENT B

CONFIDENTIAL (FR)
CLASS II FOMC

June 14, 1977

TO: Federal Open Market Committee

FROM: Paul A. Volcker

SUBJECT: The Use of Repurchase Agreements for Foreign Central Banks and International Institutions

The Federal Reserve System has provided deposit, investment, and custodial services to foreign central banks through the Federal Reserve Bank of New York since the early days of the System. As an outgrowth of these services and in the aftermath of the large flow of funds internationally following the oil crisis, in August 1974 the Reserve Bank as agent, at the request of the Central Bank of Venezuela, began making repurchase agreements (RPs) involving U.S. Government and Federally sponsored agency securities on the model of System RPs. Use of the RP facility has expanded to include at one time or another 71 of more than 130 foreign and international accounts, reflecting an active interest in this new service. About 70 percent of such RPs have involved the System Open Market Account (SOMA) as principal; the remainder were executed with dealers by the Federal Reserve Bank of New York as agent.

Recently, the Internal Revenue Service (IRS) ruled explicitly for the first time on the tax treatment of RPs on U.S. Government and Agency securities, essentially holding such RPs were loans and not purchases and sales of securities. The ruling raised serious doubts whether the income, earned by foreign and international accounts on RPs concluded with Government securities dealers by the Reserve Bank as agent, qualifies as tax exempt under the IRS code section relating

to such accounts. Accordingly, the Reserve Bank has halted RPs with dealers for such accounts. Informal discussion involving the Treasury and IRS subsequent to the ruling strongly points toward RP income to foreign central banks qualifying for tax exemption provided that such RPs involve as principal the Federal Reserve--either the Federal Reserve Bank of New York or the System Open Market Account (SOMA). Plans are now under way to request a formal ruling from IRS on this point, if preliminary FOMC discussion indicates the desirability of continuing a Federal Reserve role in the arrangement of foreign account RPs. In the meantime all RP operations for foreign accounts in recent weeks have involved SOMA as principal.

Depending on the alternative chosen, FOMC approval and authorization may be necessary under the second paragraph of Section 12A, Federal Reserve Act, to authorize the Federal Reserve Bank of New York to act as principal, or to authorize System Open Market Account transactions which might be regarded as not covered by present authorizations. (Section 12A of the Act provides that no Federal Reserve Bank may engage, or decline to engage, in open market operations except with the permission of the FOMC.)

The first decision to be made is whether to continue making the RP facility available to foreign accounts. In the view of the System Account Manager, the availability of the facility has, on balance, been helpful in the conduct of System open market operations. It is especially

useful when the Account Management must accomplish sizable reserve absorptions on a temporary basis, as the direct arrangement of matched sales-purchase (MSP) transactions between SOMA and foreign accounts achieves that reserve absorption efficiently and unobtrusively. When there has been a need to add reserves through RPs, the Account Management has typically executed MSPs betwen SOMA and the foreign accounts, which absorbs reserves, and then arranged sufficient Federal Reserve RPs in the market to offset that absorption and provide the desired net addition to reserves. This technique avoided the need to execute the Federal Reserve's own RPs at the same time foreign account RPs were being placed in the market--which would have been a cumbersome and confusing procedure. About 30 percent of the time--when the Account Manager found no need to add or absorb reserves--the Federal Reserve Bank, as agent, arranged RPs in the market for foreign accounts. Thus, when the Account Management has sought to add reserves or leave them unaffected, the foreign account RP facility has not proven to be a hindrance to the conduct of System open market operations. The inconvenience experienced on a few occasions was more than outweighted by the usefulness to the Manager at other times. In addition, the availability of the facility has provided a means for the Federal Reserve to be better informed about flows of funds in and out of foreign accounts. Moreover, the frequent contact with foreign accounts in the course of managing these funds has helped build an environment of mutual confidence and understanding that is useful when problems arise of international financial policy.

If it is the Federal Reserve's desire to continue making the RP facility available to foreign accounts--and this is the recommendation of the Federal Reserve Bank of New York--there is a choice among various approaches to assure that the foreign account RPs are made only with SOMA or the Federal Reserve Bank of New York as princpals.[1/]

Under the first approach, there would be no change in the FOMC's authorization for domestic operations, but the Trading Desk would routinely execute matched sale-purchase transactions between SOMA and foreign accounts wishing to make RPs. Since this would absorb reserves, it would be understood that there would have to be offsetting action by the Desk to replenish reserve availability, probably through Federal Reserve repurchase agreements, at times when the System did not wish to achieve that reserve absorption.

The second approach would be identical to the first except that there would be a change in the formal authorization for domestic operations to authorize explicitly the routine arrangement of foreign account RPs with SOMA.

The third approach would modify the authorization for domestic operations to authorize explicitly the Federal Reserve Bank of New York to arrange RPs with dealers and corresponding back-to-back RPs with

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1/ While many accounts appear eligible for tax exemptions as foreign government entities, the uncertainties associated with obtaining individual rulings from the IRS suggest that abandonment of the RP facility would be the more likely result.

foreign accounts; this technique would be used in those circumstances where, in the past, the Reserve Bank had acted as agent in arranging foreign account RPs with dealers. Under a variant of this third approach, the Federal Reserve Bank of New York would always be the principal with foreign accounts, whether the other side were done with dealers or with SOMA.

The Federal Reserve Bank of New York would find acceptable any of the above options that would permit continuation of the RP facility for foreign accounts. The Bank has some preference for the third approach, which would correspond most closely to past practice and would minimize questions as to whether SOMA was being used to accommodate foreign account investments rather than facilitate domestic open market operations.

Depending on the outcome of the discussion at the June FOMC meeting, members may wish to agree in principle on the appropriate course to be followed. If the understanding is that the Committee is prepared to take action along the lines of one of the above options consistent with continuation of foreign account RPs (and presuming that any language in an IRS ruling does not require further substantive Committee discussion), then receipt of a favorable ruling from the IRS could be followed promptly by appropriate Committee consideration, perhaps by telegram.

The appended memorandum sets forth the background of operations for foreign accounts (including the relationship to Federal Reserve open market operations), the technical aspects of the IRS ruling on RPs and its implications, and alternative courses of action for discussion at the Committee's June 21 meeting.

Attachment

USE OF REPURCHASE AGREEMENTS FOR FOREIGN CENTRAL BANKS AND INTERNATIONAL INSTITUTIONS AT THE FEDERAL RESERVE BANK OF NEW YORK

1. The Background of the RP Facility. The Federal Reserve Bank of New York has long provided banking services in the United States, to foreign official and international institutions, and the Federal Reserve has itself occasionally used similar services provided by a number of these institutions. The mutual provision of service of this kind has been a tradition of central banks. Unlike some other central banks, however, the Bank has not sought to constrain foreign accounts from freely availing themselves of the full range of services provided by the private sector. The Reserve Bank's holdings for foreign official accounts have declined from over half of their total foreign exchange reserves at a 1971 peak to about 40 percent at the end of 1976. The counterpart was an increased share for U.S. banks and their branches. The bulk of foreign holdings at the Reserve Bank has been U.S. Treasury securities, $66 billion at the end of 1976. (See table.)

The services provided by the Reserve Bank have included deposit and collection facilities, the execution of foreign exchange and securities transactions as agent, and the custody of gold and securities. They have been provided for the most part without explicit charge to such accounts. But the balances that foreign accounts have maintained at the Reserve Bank have resulted in raising System Open Market Account earnings by more than the cost of providing the services. The uninvested balances held do not always coincide with the size and activity of individual accounts. The Reserve Bank is developing cost measures for individual accounts that will provide

DISPOSITION OF OFFICIAL FOREIGN EXCHANGE RESERVES
(in billions of dollars, and percent)

	1961	1971	1974	1975	1976
In Custody at the New York Reserve Bank:					
Cash	0.3	0.3	0.4	0.4	0.4
RPs			0.3	0.5	1.1
U.S. Treasury Securities	6.0	42.9	55.2	60.0	66.5
Other[1/]	0.7	1.7	4.1	5.1	6.1
Total	7.0	44.9	60.1	65.9	74.0
Percentage Share of Total	*36.5*	*55.3*	*39.2*	*41.4*	*40.2*
With U.S. Commercial Banks:					
U.S. Offices	5.4	7.0	18.0	16.7	20.1
Branches Abroad	—	5.5	20.2	22.8	25.8
Total	5.4	12.5	38.2	39.5	45.9
Percentage Share of Total	*28.3*	*15.4*	*24.9*	*24.8*	*24.9*
Elsewhere	6.7	23.8	55.1	53.9	64.3
Percentage Share of Total	*35.2*	*29.3*	*35.9*	*33.8*	*34.9*
Total Foreign Exchange Reserves[2/]	19.0	81.3	153.4	159.3	184.3
Memorandum item: Volume of RPs (daily average)			0.3	0.5	0.8

1/ Excludes: (a) certain foreign-currency denominated securities understood not to be reported as part of official reserves, and (b) U.S. corporate bonds held on behalf of Japan and not an integral part of reported Japanese reserves.

2/ IMF data from which have been deducted: (a) U.S. foreign exchange reserves, and (b) proceeds of gold swap between Germany and Italy ($2.0 billion, $1.5 billion and $1.7 billion in 1974, 1975 and 1976 respectively).

NOTE: Numbers may not add exactly to totals shown due to rounding.

a foundation for requesting additional balances where this seems appropriate. In addition, the Reserve Bank is studying the possibility of instituting a user charge on RPs in the form of a few basis points on the RP rate given correspondents. The Reserve Bank's charges and balance policy would be made known to correspondents.

The working relationships maintained in the course of the Federal Reserve's daily operations for foreign accounts have contributed to the System's ability to play a useful role in the evolution of the international monetary system. The daily contacts involved in maintaining these accounts have helped develop an environment of personal relations, confidence and awareness of mutual problems that is useful when problems of international financial policy arise. More explicitly, knowledge of individual account activity offers an insight into events and policies of individual countries, and adds significantly to the System's knowledge of the international flows affecting domestic financial markets and the Eurocurrency and foreign exchange markets.

The Reserve Bank in its role as agent for foreign accounts conducted short-term matched transactions or RPs on a number of occasions beginning as early as 1968. Such transactions proved useful to the System Open Market Account (SOMA) in managing large, and short-lived flows of funds into foreign accounts. Similar transactions were carried out in 1969, 1971, and 1973 in response to particular situations.

The routine use of RPs as an investment outlet developed in response to a direct request by the Venezuelan central bank,

made during a visit by senior officials in the summer of 1974. Venezuela, like other OPEC countries at the time, was undertaking to diversify its rapidly growing dollar assets geographically rather than to continue relying predominantly on the Eurodollar deposit market. Consistent with official United States policy of facilitating the orderly placement of OPEC dollars in this country, and as part of Venezuela's investment program, the New York Reserve Bank began making RPs as agent for the central bank in August 1974 on an experimental basis. In doing so, it used the model of traditional Federal Reserve RP transactions, which provide for the simultaneous purchase and commitment to resell the securities involved.

Use of RPs spread gradually over the next year or so as OPEC and other countries learned of the facility. Several accounts kept sizable amounts regularly in RPs as interest earning balances held against cash drains. Other accounts--with Iran the most notable example--used RPs to invest large regular receipts temporarily, pending disbursement or investment in Treasury securities, CDs, Eurodollar deposits, or other outlets. Still others--for example, the United Kingdom--used RPs to employ temporarily large, but irregular, cash receipts, often reflecting borrowing from the IMF or other credit sources.

In March 1976 the introduction of a pooled RP investment facility simplified Reserve Bank operations and permitted a larger number of accounts to use it on a daily basis. In the first four months of 1977, about 25 to 40 accounts used the RP facility daily, and the average daily amount was about $1.5 billion. (The amount

outstanding typically ranged between $1 billion and $2 billion.) Large OPEC users in the past year have been Indonesia, Iran, Iraq, Saudi Arabia, Trinidad-Tobago, and Venezuela. Other regular substantial users have been Egypt, Germany, India, Italy, Mexico, and the United Kingdom. The facility has been of special interest to developing countries, which have used it in increasing numbers without adding greatly to the total dollar amount outstanding.

The Account Management integrated the execution of foreign account RPs into the daily work flow of the Trading Desk with a view to assisting System open market operations. The Manager has traditionally valued the outright investment activity of foreign accounts for the options it has given him in managing bank reserves unobtrusively and in moderating the impact of international flows on the U.S. banking system and financial markets. The initiation of RP activity for foreign accounts happened to take place during the period when swings in Treasury cash balances at the Federal Reserve Banks began to impact heavily on member bank reserves.

SOMA has been involved on the other side of foreign account RPs about 70 percent of the time. When the System Account Management faced a need to absorb reserves, the inflow of foreign account deposits helped the System accomplish the desired reserve absorption. Accordingly, SOMA arranged matched sale-purchase transactions (MSPs) with the foreign accounts. It did so whenever it needed to absorb reserves but did not wish to intervene overtly in the market, and also when it was making MSPs in the market.

In the case when the Federal Reserve faced a need to add reserves to the banking system, the inflow of foreign funds would absorb reserves and augment that need. Although the Bank had the option of executing RPs directly in the market for foreign accounts, the Account Manager nevertheless preferred to arrange MSPs between SOMA and foreign accounts (thus absorbing reserves). He then arranged enough RPs in the market to meet the original reserve need plus the further need occasioned by the inflow of foreign funds. This practice avoided tying up the market and System personnel with two operations that were technically different in form, and potentially confusing.[1]

In the case where there was no need to absorb or add reserves before the inflow of foreign funds, that inflow in itself absorbed reserves. This is the case in which the Reserve Bank arranged RPs as agent for foreign accounts in the market. Such agency transactions in the market occurred about 30 percent of the time.

On balance, in the view of the System Account Manager, the foreign account RPs have been of benefit to the conduct of System open market operations. The chief advantage from a reserve management standpoint has been that the Desk has been able to absorb reserves unobtrusively in size when it would prefer not making an overt market entry. The availability of the RP facility has also helped in the broader task of keeping track of, and

1. Trading Desk procedures for doing RPs for Federal Reserve account focus on the par value of the securities purchased while procedures for doing customer account RPs were designed to invest a specific dollar amount.

moderating, the impact of international flows on domestic financial markets. It has been possible to arrange a cutback in the scale of RP operations on occasion when that was helpful to System operations. At the same time, the availability of the RP facility has enabled the Federal Reserve to develop a better, though still incomplete, picture of international flows of funds. The continuity of working relationships has made it easier to obtain supplemental information from foreign accounts.

2. Tax Issues Affecting Use of the RP Facility by Foreign Central Banks. When the Federal Reserve Bank of New York, on behalf of the System, began the foreign RP facility, it was assumed that foreign central banks which participated would be exempt from tax on income derived from RPs under Section 895 of the Internal Revenue Code of 1954 (the "Code"), which provides as follows:

> "Income derived by a foreign central bank of issue from obligations of the United States or of any agency or instrumentality thereof (including beneficial interests, participations, and other instruments issued under section 302 (c) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1717) which are owned by such foreign central bank of issue, or derived from interest on deposits with persons carrying on the banking business, shall not be included in gross income and shall be exempt from taxation under this subtitle unless such obligations or deposits are held for, or used in connection with, the conduct of commercial banking functions or other commercial activities. For purposes of the preceding sentence the Bank for International Settlements shall be treated as a foreign central bank of issue." [Emphasis supplied.]

Foreign correspondents which are recognized by the IRS as foreign governments and foreign central banks acting as fiscal agents of their governments are exempt from U.S. tax on all income

from U.S. sources under Section 892 of the Code, and are unaffected by this discussion.

In March 1977, the IRS held in Revenue Ruling 77-59, I.R.B. 1977-11, p. 9, that REIT investments in U.S. Government security repurchase agreements would be deemed secured loans for tax purposes and that a REIT could not claim "ownership" of Government securities held subject to RP. In view of the similarity of the repurchase agreements affected by this ruling to the System's RPs (the ruling was distinguishable for this reason from prior related IRS rulings), it was concluded that the IRS would be very likely to apply the same principle in both instances. (It is to be emphasized, however, that IRS's characterization of repurchase agreements for tax purposes need in no way alter the System's characterization of repurchase agreements under the Federal Reserve Act). Since Section 895 of the Code and the regulations thereunder require a foreign central bank of issue to "own" U.S. government securities on which income is claimed to be tax exempt, the result of the application of this principle would be to deny exemption to RP investments by foreign central banks under Section 895 of the Code.*/ On the basis of this analysis, transactions by the Federal Reserve Bank of New York in RPs as agent for foreign accounts were terminated. At this point discussions were commenced with the Treasury Department to explore the implications of the IRS rulings. The alternatives suggested by these discussions are outlined below.

*/ In the absence of a reduced tax treaty rate or other exemption, 30 percent of a foreign central bank's income from RPs would be subject to tax withholding.

(a) RPs as obligations of SOMA, or of the Federal Reserve Bank of New York as principal. As previously noted, until recently, foreign RPs were effected in one of two ways: either by SOMA directly or by the Federal Reserve Bank of New York in the market as agent for a foreign correspondent. As noted above, Section 895 of the Code provides that a foreign central bank of issue shall be exempt from tax on income derived from "obligations of the United States or of any agency or instrumentality thereof...which are owned by such foreign central bank of issue..." [Emphasis supplied.] Since SOMA is legally no more than an account maintained collectively for all twelve Federal Reserve Banks, each of which is an instrumentality of the United States, an obligation of SOMA would presumably constitute an obligation of "the United States or of any...instrumentality thereof..." under Section 895. If IRS were to determine that the foreign RPs conducted directly with SOMA were secured loans by a foreign central bank to SOMA, the foreign central bank would then "own" SOMA's obligation to repay the loan. Thus, so long as foreign account RPs are effected with SOMA, they would appear to be tax exempt under Section 895.

In the case of RPs effected by the Federal Reserve Bank of New York in the market as agent for a foreign correspondent, IRS would presumably deem the transaction to be a loan by a foreign central bank to a Government securities dealer, the only obligation involved being that of the dealer to repay the loan. For this reason, it has been suggested that if the System wishes to preserve the ability to effect foreign RPs with Government securities dealers,

these RPs should be restructured so that the Federal Reserve Bank of New York would be the principal in each transaction. In effect, the New York Reserve Bank would enter into RPs with Government securities dealers in its own name, pool the RPs as it presently does, and enter into offsetting MSPs with its foreign correspondents collateralized by undivided interests in the pool. If IRS determined that the MSPs constituted a secured loan by foreign correspondents to the New York Bank, it would follow that they held the obligation of the New York Reserve Bank--a U.S. instrumentality--to repay the loan.

This position has been discussed informally with the Internal Revenue Service, which has indicated its preliminary concurrence, provided that the System can show that the funds involved are used by foreign central banks for "governmental" and not for "commercial" purposes. The IRS has suggested that a formal ruling should be obtained, and it is planned to do this. The Treasury has indicated that it will give us its active support in any such application.

(b) Limit RPs to foreign correspondents that qualify for exemption under Section 892 of the Code. Section 892 of the Code provides a complete exemption to foreign governments for all income they may earn from U.S. sources, other than, perhaps, income derived from the conduct of a U.S. trade or business. Many of the System's foreign accounts are in the name of foreign governments or foreign central banks acting as fiscal agents of their government which certify that the funds held in such account are

the property of their government. This type of account, as previously noted, would be unaffected by an adverse IRS determination under Section 895. Accordingly, one possible approach to this problem would be to request foreign correspondents wishing to invest in RPs to do so through fiscal agency accounts of this type.

The IRS in Revenue Ruling 75-298, I.R.B. 975-30, p. 16, has construed the exemption provided by Section 892 to apply only to foreign central banks and other organizations that are wholly owned by their governments and meet four other criteria designed to exclude entities engaged in commercial activity in the United States or having any significant connection with the private sector.

Many, but not all, of the foreign central banks which have used the RP facility appear to qualify for exemption under Section 892 as construed by this ruling. Thus, if IRS is willing to approve a procedure that would allow a withholding agent (the Federal Reserve Bank of New York) to rely on its customer's (a foreign central bank's) certification that it fulfills the requirements of the ruling, it may be possible to substantially broaden the use of this exemption for foreign central banks which cannot shift their funds into fiscal agency accounts. However, it would take some time before such a procedure could be established and the ruling would not assist those foreign central banks, including the Central Bank of Venezuela, which have some private ownership.

More likely the use of this method would require a separate IRS ruling for each central bank, and thus it would probably result in nearly complete abandonment of the facility by foreign central banks, many of which might prefer not to apply for a ruling.

3. Alternative Courses of Action.

In view of the approach of the IRS in its recent ruling, two main courses of action appear open at this time. The Reserve Bank can refuse to act as principal on a regular basis in providing an RP facility to foreign accounts, thereby effectively cutting off the facility. Alternatively, a choice can be made of one of three ways, in which SOMA or the Federal Reserve Bank of New York could act as principal in all RP transactions with such accounts.

(a) Decide not to act as principal on a regular basis. Such a decision would cut off the RP facility except to those accounts that qualified as tax-exempt under Section 892.[1] This course would be clearly indicated if the IRS were to react negatively to the proposition that the Federal Reserve Bank of New York or SOMA act as principal in the RP transactions of foreign accounts. However, the preliminary discussions reported above suggest that the IRS is likely to react affirmatively to this proposition if a formal request for a ruling is made.

Assuming a favorable IRS ruling, a decision not to act as principal regularly could also be based on a finding that continuation of the RP facility is not sufficiently important to warrant the risk of criticism. Such criticism might allege (1) the Federal Reserve was providing special tax treatment to foreign

1. At present, only the Saudi Arabian Monetary Agency has applied for and obtained a favorable ruling from IRS for exemption under Section 892.

central banks, (2) it was competing with U.S. commercial banks, or (3) such operations might hinder the conduct of domestic open market operations. On the first point, it may be noted that the broad intent of the relevant legislation is to exempt this type of account from tax liability, and a favorable IRS ruling would confirm this. On the competitive issue, U.S. banks are able to offer competitive overnight investment facilities either directly or through their overseas branches. Indeed, the great bulk of very short-term investment funds are held with such banks, mainly in the Eurocurrency market. Nevertheless the RP facility has enabled the Federal Reserve to stay in touch with a portion of the large flows involved and it appears to be important in retaining regular investment activities with this Bank. Finally, as noted earlier, the Account Management considers the investment operations of foreign accounts helpful on balance to the implementation of the Committee's policy objectives.

A number of adverse effects would follow a cutoff of the RP facility. The System Open Market Desk would lose a facility that has proved useful at times in moderating the market and reserve impacts of international financial flows in the past two years and might prove important in the future. To be sure, the Federal Reserve in cooperation with the Treasury was able to cope reasonably well with the massive flows of 1966 to 1973 with only occasional help from RP operations for foreign accounts. But the Treasury's willingness to issue securities to foreign governments on short notice and redeposit the proceeds with commercial banks has been significantly reduced in the past three years because

of the greater attention given to cash management. It would seem desirable to preserve as much flexibility as possible for the System to moderate the impact of international reserve flows by its coordination of domestic and foreign account operations.

Another distinct loss from cutting off the RP facility would be the quality of the System's knowledge of the international flows affecting domestic and international financial markets. The Federal Reserve's knowledge of, and ability to act on, foreign account orders in Government securities has provided a continuing window on the functioning of the Treasury securities market as well as on international flows. The RP facility has provided similar routine contact with the rapidly developing RP market and a new look at the short-term flows through OPEC and other accounts, many of which made relatively little use of their Federal Reserve accounts until the last few years.

The cutoff of the RP would deprive users of Federal Reserve accounts of an overnight investment facility, and could accelerate the decline in the share of foreign exchange reserves held at the Federal Reserve. In re-evaluating their short-term alternatives, central banks might be expected to reassess the currency composition of their reserves, possibly shifting a portion to foreign currency balances abroad. Another small fraction might

shift to sales of Federal funds to domestic banks or other short-term employment in the New York market. Perhaps the bulk would go into the overnight Eurodollar market, where no tax problems arise. It is not clear that this would be in the U.S. interest since it would add to the burden of commercial banks in intermediating between the OPEC countries and the non-oil developing countries. Such diversion is also likely to reduce the extent to which foreign accounts rely on the Federal Reserve and U.S. Treasury securities in the management of their exchange reserves.

b. Interposing the Federal Reserve as principal. Since this course involves Federal Reserve transactions in the open market, it is appropriate for the Committee to consider whether it should authorize one of the three lines of approach that appear open for having the Federal Reserve act as principal in all cases with foreign accounts. The Committee could: (1) agree it is appropriate that the System Open Market Account (SOMA) routinely enter into matched sale-purchase transactions (MSPs) with such accounts in giving effect to the existing current policy without amendment of the authorization for domestic operations, (2) amend the authorization for domestic operations explicitly to provide such authority, or (3) amend that authorization to provide the Federal Reserve Bank of New York with authority to act as principal in arranging RPs with Government securities dealers and corresponding "back to back" transactions between FRBNY and foreign and international accounts.

As noted in section 1, SOMA has been acting as principal with foreign accounts whenever it is either absorbing reserves or

providing reserves in the market--about 70 percent of the time. Only in the case when there is no need to absorb or add reserves before the inflow of foreign funds did the Federal Reserve Bank of New York act as agent--an operation no longer feasible because of the tax question. Under options (1) and (2), SOMA would act routinely as principal in accommodating foreign demand for RPs, while in option (3) the Federal Reserve Bank of New York would serve as principal. Under options (1) and (2), reserve absorption could be offset by arranging a corresponding amount of Federal Reserve RPs in the market. Under option (3) the Federal Reserve Bank would act as principal in the same way it has acted as agent. In (1), (2) or (3) while the Federal Reserve would act as principal, the Desk could indicate to the market that the RPs were being made in connection with customer account activity, providing essentially the same information as at present.

(1) Committee agreement that SOMA routinely enter into MSPs with foreign and international accounts without formal change of authorization. This option would be chosen on the basis that the System's domestic policy directive is sufficiently broad in its statement of objectives that the contemplated action is a change in the modus operandi rather than a substantive modification, calling for new authorization . This approach would acknowledge that the Federal Reserve System plays an active role in carrying out the international financial policies of the United States as well as allowing in its policy deliberations and operations for the interplay of international forces on the domestic financial system and the economy. Indeed, a broad concern of this kind is

typically reflected in the domestic policy directive. A recent one (5/17/77) stated the Committee's policy was:

> "to foster bank reserve and other financial conditions that will encourage continued economic expansion, while resisting inflationary pressures and contributing to a sustainable pattern of international transactions." (underscoring added)

Both the written and oral reports of the Manager of the System Account over the years have sought to present the domestic, and at times international, considerations that have impacted on daily decisions made on the timing of, and avenues chosen for, domestic open market operations. Committee members have often discussed at their meetings the international aspects of operations undertaken or contemplated by the Committee. The current authorizations already provide authority for the Federal Reserve Bank of New York to arrange purchases and sales for SOMA (paragraph 1 (a)) and RPs for the FRBNY (paragraph 1 (c)) in furtherance of the FOMC's policy directives. Matched sale-purchase transactions have been considered since a special meeting of the FOMC in July 1966, to be covered under paragraph 1 (a). No amendment was deemed necessary to give effect to a modification of procedures at that time.

(2) Amend the authorization for domestic operations to provide explicit authority to engage in MSP transactions with foreign and international accounts. If the Committee prefers to handle the issue as a substantive one, requiring explicit authorization, then it could do so under a new paragraph 4 which might read as follows:

> In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to sell U. S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market, allowing for a service fee when appropriate.

This alternative would result in the same operational procedure as (1), but provide a public announcement of, and rationale for, the new procedure. It would perhaps imply greater significance to the change than was warranted, and lead some observers to misconstrue the motivation of the change. But the Committee would protect itself against any allegation that it was moving without full disclosure on an issue that might be interpreted as substantive.

(3) Amend the authorization for domestic operations to authorize the Federal Reserve Bank of New York to undertake the appropriate operations as principal. A new paragraph 4 might be added as follows:

> In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, when appropriate, to undertake with dealers repurchase agreements in U.S. Government and agency securities under the conditions prescribed in paragraph 1(c), and simultaneously to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank, allowing for a service fee when appropriate.

This approach would in a sense be the most straight-

forward, essentially corresponding operationally to previous practice and eliminating any question as to whether SOMA itself were being used to accommodate foreign central bank investments rather than facilitate domestic open market operations. The Reserve Bank would make "back to back" transactions with Government securities dealers and foreign accounts in cases when the System did not choose to affect reserves. These would, ir effect, substitute for the RPs the Desk previously arranged as agent for foreign accounts in the market. Changes in the contractual form would make clear the Reserve Bank's shift from agent to principal. In those cases when the Federal Reserve was making either RPs or MSPs in the market, in order to add, or absorb reserves, the System Open Market Account would routinely make MSPs with foreign accounts. The chief operational advantage of this alternative is that it would leave to the Trading Desk the daily choice of the channel for affecting bank reserves. A possible variant of this approach would be to have the Federal Reserve Bank of New York always be the principal with foreign central banks, whether the other side were done in the market or with SOMA. This would require additional modification of the authorization for domestic operations.

ATTACHMENT C

CONFIDENTIAL (FR)
CLASS II FOMC

Date June 14, 1977

To Federal Open Market Committee

From Mr. O'Connell

Subject: The Use of Repurchase Agreements for Foreign Central Banks and International Institutions.

RECOMMENDATION: If the Committee determines that it would be desirable to continue to provide an RP facility for foreign and international accounts, it is recommended that the Committee's Authorization For Domestic Open Market Operations (the "Authorization") be amended to reflect certain changes in such operations necessitated by a recent Internal Revenue Service ruling. Specifically, it is recommended that the Committee authorize the Federal Reserve Bank of New York ("FRBNY") to arrange RPs with dealers and corresponding back-to-back RPs with foreign accounts--the third alternative presented in the memorandum from the FRBNY.

DISCUSSION: Under the second paragraph of § 12A of the Federal Reserve Act and § 270.4(a) of the Committee's Regulations, a Federal Reserve Bank shall engage in open market operations under section 14 of the Act only in accordance with the Committee's Regulations and with the authorizations and directives issued by the Committee from time to time. As discussed more fully in the separate memorandum from the FRBNY, the FRBNY has for the past several years been providing an RP facility in U.S. Government and Federally-sponsored agency securities to its foreign accounts. Specifically, as an accommodation to its foreign accounts, the FRBNY has been investing idle account balances in RPs with the System Open Market Account ("SOMA") and with dealers. As a result of a recent IRS ruling discussed in the FRBNY memorandum, it now appears that such RP arrangements with dealers may have certain untoward tax effects for such foreign accounts and that all transactions may have to be arranged either with SOMA or with the FRBNY as principal to retain their tax exempt status.

Under ¶ 1(a) of the existing Authorization, the FRBNY may buy or sell U.S. Government securities from or to foreign and international accounts maintained at the FRBNY for the account of SOMA only "to the extent necessary to carry out the most recent policy directive adopted at a meeting of the Committee". The problem presented by arranging all foreign account RP transactions with SOMA is that on certain days such transactions may be inconsistent with the latest directive and thus deemed unauthorized by ¶1(a). It is possible to say that any such transactions would nevertheless be authorized so long as proper offsetting

actions were otherwise taken in the market. While such view can be legally supported on the basis that the total of actions under ¶ 1 for a given day must be consistent with the latest Committee directive, a separate authorization would be preferred from a purely legal viewpoint in order to make clear the lawfulness of the FRBNY's actions under the Act and FOMC Regulations. Counsel is influenced in this regard by the careful specificity with which the Committee has authorized other open market operations. Thus, it is recommended that either the second or third alternative in the FRBNY memorandum be adopted if the Committee decides to maintain the RP facility.

Of these latter two alternatives, we would prefer the third alternative because it raises the least possible legal questions about past practices. By specifically referring to foreign account RPs with SOMA, the second alternative raises the question of whether similar specific authority should not also have been included in ¶ 1(a) to cover such transactions and may cause confusion as to whether SOMA RP transactions with foreign accounts are authorized only under such new paragraph or may also be conducted under ¶ 1(a) when consistent with the latest directive. The third alternative avoids such problems by leaving undisturbed the authority to engage in SOMA transactions with foreign accounts under ¶ 1(a) and by proposing an alternative to the smaller class of transactions most directly affected by the IRS ruling--FRBNY transactions with dealers.

ATTACHMENT D

Mr. O'Connell suggests that he prefers the following new paragraph 4:

> In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank Account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(c), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.