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

March 14, 1978

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Attached are memoranda relating to the annual review of System lending of securities, from the Deputy Account Manager dated March 6, and from the Committee's General Counsel dated March 14. These memoranda will be discussed at the forthcoming meeting of the Committee under agenda item 9.

Attachments

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March 6, 1978

TO: Federal Open Market Committee

FROM: Peter D. Sternlight
Deputy Manager
System Open Market Account

SUBJECT: Annual Review of System Lending of Securities

Attached is a statistical report on the lending to dealers of Treasury securities held in the System Open Market Account since the last annual meeting of the Federal Open Market Committee in March 1977. The report indicates a moderation in both the number and, to a much lesser extent, in the total dollar volume of loans processed by the Desk, while delivery failures increased slightly.

The moderation in the System's lending activity occurred against a background of record level trading activity in the dealer market. Trading turnover surpassed the previous year's record volume by 4 percent, to a daily average of about $10.9 billion. While the volume of new loans was down slightly, loans were not repaid as quickly as in the previous year, so that daily average loans outstanding rose by 10 percent to $158 million.

Although dealers sought to find new and less costly sources of lendable securities, this task was made more difficult as some major lenders of Treasury issues tended to reduce their holdings as interest rates rose. Dealers also were inclined to hold light inventories and occasionally set up large short positions in some areas of the market. Although the Desk does not lend against a short sale, the existence of short positions for the dealer community in general probably tends to increase the volume of delivery failures and hence the subsequent need to borrow securities. The Desk's ability to lend against normal delivery problems kept the situation from becoming worse. A further pervasive influence on the availability of lendable securities was the investment in Treasury issues by foreign central banks of their large takings of dollars; the diversion of these securities into portfolios where they were not available for lending contributed to the scarcity of lendable securities.

I believe the System's lending of Treasury securities contributes significantly to relieving the pressures of costly fails to deliver. Without this facility, dealers would be inhibited in their willingness to make trading commitments, and the Government securities market would not function as smoothly as it does. In turn, the termination of this facility would be likely to impact adversely on the ability of the Desk to achieve the objectives of the Committee, the Treasury and foreign central bank correspondents. Accordingly, I feel the lending of securities remains reasonably necessary for the effective conduct of open market operations and I recommend that the Committee renew the authorization to lend securities for another year.

The overall operation continues to be profitable. Earnings for the New York Bank in 1977 amounted to $2,397,340, an increase of about 21 percent from 1976. Estimated expenditures in running the lending operation amount to less than 10 percent of earnings.

Statistics on Federal Reserve Lending of Securities
(dollars in millions)

	March 1976 through February 1977	March 1977 through February 1978	Percentage Change
Number of Loans	9,653	8,048	-17%
Total Amount	$20,789	$20,297	- 2%
Daily Averages			
Number of Loans	38	32	-16%
Amount	$82.8	$81.8	- 1%
Balance Outstanding	$144.4	$158.3	+10%
Size of Each Loan	$2.2	$2.6	+18%

Dealer Fail Statistics

	1976	1977	
Daily Average Fails to Receive	$446	$453	+ 2%
Daily Average Fails to Delivery	$312	$342	+10%

March 14, 1978

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

SUBJECT: Review of System Lending of Securities

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FROM: Thomas J. O'Connell

In a memorandum dated March 6, 1978, the Deputy Manager of the System Open Market Account has recommended that the Committee renew for a period of one year the authorization contained in paragraph 3 of the Authorization for Domestic Open Market Operations for the lending of securities from the System Open Market Account. While the Deputy Manager's report notes a marked dimunition in the Desk's lending to dealers during 1977, it is clear that the Desk's ability to lend against normal delivery problems constituted a cost effective and reasonable support of open market operations. Absent the facility afforded by the System's lending of Treasury securities, the report concludes that the government securities market would not function as smoothly as it does and that such consequence would impact adversely on the ability of the Desk to achieve the objectives of the Committee, the Treasury, and foreign central bank correspondents. The Deputy Manager finds the continued lending of securities to be a reasonably necessary function for the effective conduct of open market operations and urges renewal of the authorization for another year.

It is my opinion that the Committee could find that the continued lending of securities from the System Account to dealers and clearing banks is reasonably necessary for the effective conduct of open market operations, and that the continued lending of System securities, as authorized by the Authorization for Domestic Open Market Operations, is within the "incidental powers" of the Reserve Banks.