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

March 19, 1984

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

FROM: Normand Bernard N.B.

Attached is a recent memorandum from Mr. Sternlight on Desk operations in bankers' acceptances together with earlier memoranda on the same subject. This matter is on the agenda for next week's meeting of the Committee (Item 7).

Attachment

March 13, 1984

TO: Federal Open Market Committee

FROM: Peter D. Sternlight

SUBJECT: Desk Operations in Bankers' Acceptances

The Domestic Account Management has been asked to review once again the desirability of continuing to conduct repurchase agreement operations in bankers' acceptances (BAs). A review of this subject was presented to the Committee in March 1983.1/ The Committee decided to continue these operations temporarily, pending another review in several months.2/

Summary and Recommendations

Pros and cons of continuing these operations are presented below. In our view, the case is a very closely balanced one, with the decision largely dependent on how the Committee weighs the continued modest usefulness of these operations on the one side, and the limited risk of operating in BAs on the other side. If the Committee is prepared to accept what we believe to be a small risk, then it may be considered reasonable to continue these operations even though their value is modest. If the Committee considers the risk appreciable, relative to the value of the operations, repos in BAs can be discontinued without significant loss in ability to conduct open market operations; should this be the Committee's preference, the present time is probably as good as any to announce a withdrawal from this market.

1/ See memo to Federal Open Market Committee from Messrs. Axilrod, and Sternlight dated March 21, 1983, and its attached memo by Messrs. McCurdy and Struble.

2/ In consultation with the Chairman, the review period was extended to early 1984.

In the view of the Account Management, the pro and con arguments are very nearly balanced. A respectable rationale can be developed for either position or against it. By the narrowest of margins, our recommendation is to discontinue repurchase agreement operations in BAs. If the Committee adopts this approach, it is recommended that a public announcement provide several months' lead time before actual cessation, as there seems no need to act precipitately and a less hurried withdrawal would minimize the possibilities for adverse market consequences. Even after the cessation date is reached, it may well be desirable to retain the authorization to conduct repos in BAs, to deal with special circumstances that might arise--just as the Committee has chosen to retain the authorization for outright purchases of BAs even though such activity was discontinued in 1977.

If the Committee decides to continue repo operations in BAs, the Desk expects to give consideration to plans for limiting System holdings of any particular bank's BAs under normal conditions. This would make it more feasible, when special circumstances arise, to set even more stringent standards for selected banks.

Discussion

The March 21, 1983 memorandum to the Committee, attached, gave extensive background on the history of System open market operations involvement in BAs, and discussed various features weighing for and against continuing the limited participation in repurchase agreements in effect during recent years. Rather than repeat these points, this review merely highlights the pro and con arguments as seen at this time, noting particularly any different degrees of emphasis between the situation now and a year ago.

1. <u>The Case for Disengagement</u>

a. Repos against BAs have played an increasingly modest role in System open market operations. In 1983, the volume of BA repos was only 7 per cent of total System repos compared with roughly 15-20 per cent in the several preceding years. In part, the decline was because the Desk tended to use System repos less frequently last year, turning relatively more often to passing through foreign account repos (which are not done against BAs) to the market to meet temporary reserve needs. Because the Desk offered the BA repos less often, BA dealers probably tended to complete their daily financing arrangements earlier in the day, being less inclined to see if the Desk might be a provider of overnight financing.

b. Given the present Federal budget situation, it does not seem likely that there will be a shortage of Government securities for repo purposes any time soon.

c. The BA market is thriving and mature, and well able to take care of itself. It is long past needing the nurturing that may have seemed appropriate in past decades.

d. While the actual credit experience with BAs is excellent, the instrument is nonetheless a private credit and as such bears some risk as compared with Treasury securities. Probably more significant than the actual risk of loss, which can fairly be regarded as very small indeed, there is the risk that the Federal Reserve could be placed in an awkward position if it sought to avoid taking in BAs drawn on a bank whose name was coming under question in the market. At the present time we are not being confronted with such situations but one need go back only a year or two to recall instances where the market was sensitive to some major U. S. bank names. Also, it is worth bearing in mind that a sizable portion of the repos in BAs--often about half--tend to be in paper drawn on branches and agencies of foreign banks. It is only prudent to anticipate that situations of heightened sensitivity can recur from time to time. The fact that we are now enjoying something of a respite from such sensitivity makes this, if anything, a good time to announce an orderly phased disengagement from the market, because this can be done without seeming to cast doubts on the state of the Federal Reserve's confidence in the banking system (as might have been the case a year ago). At this time a disengagement move could be a simple response to a finding that the activity is not sufficiently useful to be continued.

2. The Case for Continuing BA Repos

a. While of limited size, BA repos remain of some usefulness in effecting System open market operations. On occasion, even in the recent period of quite modest use of BA repos, the ability to take BAs made the difference between being able to meet a given day's reserve objective-and falling a little short--or made it possible to come a little closer to an objective even though there was some shortfall anyway. Even as a marginal addition to the supply of repo collateral, the presence of BAs adds to the overall competition for the System's repurchase agreement dollars, thus improving our rate of return somewhat.

b. The risk factor in holding BAs cannot be brushed aside altogether but it should be recognized as very small. As noted earlier, the actual credit experience with BAs has been excellent--unflawed in the System's experience. The paper is backed not only by original drawer and the goods, but more meaningfully by generally well-regarded bank names as acceptors. Moreover, in the case of repos we can look to the acceptance dealer, whose financial position we keep under general surveillance, to honor the contract to repurchase the paper in a few days.

Admittedly, there is the potential problem of preferring to avoid the paper of banks whose name might be coming under a cloud. Our greatest protection here is probably the vigilance of the dealer market itself in avoiding such paper. Also, since our repo contracts usually run for just a few days (the maximum allowable is 15 days), the window of vulnerability is limited. As a further protection from situations where one could encounter paper that it is considered preferable to avoid, it might be desirable to establish procedures for routinely limiting the volume of any particular bank's BAs held under repos; if it is seen as routine and normal to turn back some of the proferred "collateral" on occasion, then it can be done in more exigent circumstances without attracting as much attention.

c. While our judgment is that the BA market is no longer dependent on Federal Reserve participation, there is some possibility (small, we believe) that our withdrawal would diminish confidence in the market and impair its functioning to some degree. Moreover, our participation, even though modest and occasional, provides a window through which we can observe developments in the market more effectively than as a nonparticipant. Also, our withdrawal would tend to diminish our ability to exert an influence over developments in that market through interpretation of regulatory questions.

d. The System's presence in the BA market has facilitated market access by banks of various sizes--medium as well as large. A likely consequence of System withdrawal would be an appreciable increase in rate "tiering"--with BAs of smaller banks and foreign banks facing larger rate spreads over those of major U. S. banks than is now the case.

Atts.

March 21, 1983

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

FROM: Stephen Axilrod and Peter Sternlight

The attached memorandum has been prepared to provide background for the FOMC's review of authorization for the Trading Desk to arrange repurchase agreements based on bankers acceptances (RP-BAs). Such a review appears appropriate in light of the financial difficulties experienced recently by two dealer firms that previously had had a trading relationship in BAs with the Desk and of some possible recent deterioration in the financial strength of some accepting banks. The potential risks and difficulties of RP-BAs need to be weighed against the value of such transactions to the Desk as a supplementary means of making short-term adjustments in nonborrowed reserves. Given the potential risks of continuing the activity and the relatively modest usefulness of RP-BAs for open market operations, we would be tempted to recommend against renewal of the authorization. A further factor, however, is the risk that withdrawal from the market could add to general anxieties about the banking system, which while less acute than last summer, are still present to some appreciable degree. On balance--narrowly--we would recommend that the FOMC renew its authorization at this time.

March 21, 1983

To: Messrs. Axilrod and Sternlight

From: Christopher McCurdy (New York)
Frederick Struble (Board)

Subject: Review of Federal Reserve Activities in the Bankers Acceptance Market

Background to FOMC's Current Directive

In March, 1977, the FOMC decided that the Trading Desk should cease its longstanding practice of acquiring bankers acceptances on an outright basis.[1] This decision was based on the judgment that the disadvantage of such transactions--the Desk had recently been placed in the position of having either to purchase the paper of a bank experiencing financial difficulties or to turn down offers of such paper and thus further damage the bank's reputation--outweighed benefits gained, since trading in acceptances on an outright basis could be conducted only on a relatively limited scale. The Committee also decided, however, to authorize the Desk to continue to arrange repurchase agreements based on bankers acceptances (RP-BAs). It did so on grounds that such transactions could be done in a volume sufficient to serve as a useful supplement to RPs in Treasury and federal agency securities, while the risk exposure of such transactions was minimal, given the fine credit history of acceptance paper, the relatively short maturity of the RP agreements and the obligation of a responsible dealer to repurchase. The FOMC has renewed its authorization in each following year.[2]

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1. See Appendix for a review of the Federal Reserve's involvement in the bankers acceptance market prior to 1977.

2. Under the authorization, the Desk purchases under repurchase agreement BAs that are considered "prime." In the Account Management's view, as expressed to the Committee, that quality is conferred by the market whose participants, individually and collectively, have a self-interest in avoiding risky paper. Prime BAs are those that have a reputation for trading freely in the market and are drawn on banks known to have competence in the field of acceptance financing. After a bank's acceptances meet these criteria, its name is placed on the list of banks whose acceptances the Desk is willing to acquire on a repurchase basis. At the present time, there are about 210 banks on this list, and with branches added on a total of about 275 names altogether.

Review of Desk Use of RP-BAs

As anticipated by the FOMC, the ability to arrange RP-BAs has provided the Desk with a useful additional means for achieving its nonborrowed reserve target. In general, when the needs to supply reserves on a temporary basis have been large, the Desk has arranged RPs based on BAs as well as on Government securities. When reserve needs have been moderate, on the other hand, the Desk has often injected reserves by passing through to the market a portion of the repurchase agreement orders it has on hand from foreign accounts--so called customer RPs. BAs have not been included in these cases, although the Desk has continued to buy and sell acceptances for foreign accounts in an agent capacity.

As can be seen in the table, over the last five years the amount of RP-BAs arranged annually has ranged from about $18 billion to $41 billion, accounting for about 13 to 22 percent of the total volume of RPs done by the Desk on behalf of the Federal Reserve. The share of RP-BAs in the total is usually a little bit higher when expressed as a percentage of the daily average amount of RPs outstanding, probably because BAs make up a slightly larger amount of over-the-weekend and other multi-day RPs, compared to overnight RPs. The proportion of RP-BAs to total RPs tends to fall off slightly as the size of a reserve injection increases. In 1982, BAs made up about 19 percent of reserve injections of $3 billion or less and about 15 percent of larger injections.

REPURCHASE AGREEMENTS ARRANGED BY THE TRADING DESK[1]

	1978	1979	1980	1981	1982
Total RPs Arranged ($ billions)	221.5	185.8	167.2	111.0	179.1
Treasury and Agency Securities	192.2	144.7	142.8	93.2	149.7
Bankers Acceptances	29.3	41.1	24.4	17.7	29.3
BAs as percent of Total	13.2%	22.1%	14.6%	16.0%	16.4%
Daily Average of all RPs[2] ($ millions)	2,496	2,658	2,542	2,525	3,115
Treasury and Agency Securities	2,081	2,005	2,143	2,089	2,611
Bankers Acceptances	415	652	399	435	504
BAs as percent of Total	16.6%	24.5%	15.7%	17.2%	16.2%

1. Does not include foreign customer account RPs passed through to the market. Components may not add to totals due to rounding.

2. Covers only those days when RPs were outstanding.

The ability to arrange RP-BAs has proven particularly helpful when dealer positions in Government securities have been relatively low. Indeed, on a number of occasions, the Desk was not offered RP propositions based on Government securities in a volume sufficient to meet its intended reserve injection. At these times the use of BAs allowed the Desk to achieve, or at least come substantially closer to, its intended reserve provision.[1]

1. The volume of RP-BAs exceeded the rejected RP tenders on Government securities about one-third of the time for the 1981-1982 period; thus, on those occasions, if no RPs had been done based on BAs, the Desk would not have been able to supply the volume of reserves that was in fact accomplished--unless it can be assumed that in the absence of RP financing of BAs by the Desk, the dealers would have shown in a larger volume of propositions in Government securities. In the judgment of the Account Management this latter assumption is questionable, given the limited degree of short-term substitution between BAs and Governments in day-to-day financing arrangements.

Moreover, the inclusion of BAs has strengthened the dealer rate competition in System RP transactions. In these operations, Desk personnel assemble dealer propositions at each rate. Guided by the intended volume of reserve injection, the Account Management selects the amount of propositions it will accept (and thereby the lowest rate it will accept) and rejects the rest of the propositions (all at rates below the selected cutoff rate). The same procedure is followed for RP-BAs except that the rate cutoff is set about 25 basis points higher for BAs, in keeping with rate spreads customary in the market. Consequently, the use of BAs has allowed the Desk to fill reserve needs without reaching as far down in rate and provided a slightly higher rate of return on reserve injections.

Current Risk of Arranging RP-BAs

The System has incurred no loss in arranging RP-BAs; nor does it seem to have been in significant danger of suffering a loss. Indeed, there have been no defaults on "prime" acceptances over the post World War II period. It might be further noted that dealers with which the Desk had arranged RP-BAs in all cases fulfilled their commitments to repurchase the BAs in timely fashion. (As for the two BA dealers that encountered financial difficulties, the Desk had in fact ceased trading with them in 1981, well before their difficulties surfaced openly.) Despite the unblemished record of RP-BAs, it seems appropriate, in light of several recent developments, to reassess the risks involved in engaging in RP-BAs.

Inevitably, events of the past year have raised or renewed questions about the financial strength of a number of major banks with prime acceptances outstanding.[1] A recitation of events linked to the collapse of Drysdale Government Securities or Penn Square Bank, difficulties with other energy related loans, and needs for wholesale reschedulings of debt owed by developing countries is superfluous here. Suffice it to say that these developments are pointed reminders of the vulnerability of the U.S. (and world) banking and financial systems. While eligible acceptances finance "real transactions," for practical purposes the holder of an acceptance relies on the accepting bank for repayment.[2] Whether or not one concludes that the general credit quality of prime acceptances is as high today as in the past, recent history does demonstrate considerable variations in the market's evaluation of acceptances in relation, say, to Treasury bills. While a number of factors may have contributed to these variations, changing assessments of risk no doubt played a significant role.

As can be seen in the accompanying chart, the rate premium on prime bankers acceptances has been subject to sharp fluctuation since 1976. After posting a high for the period in the late summer of last year, however, the premium has dropped back to a level near that prevailing in 1977. There is no assurance that periods of stress will not recur from time to

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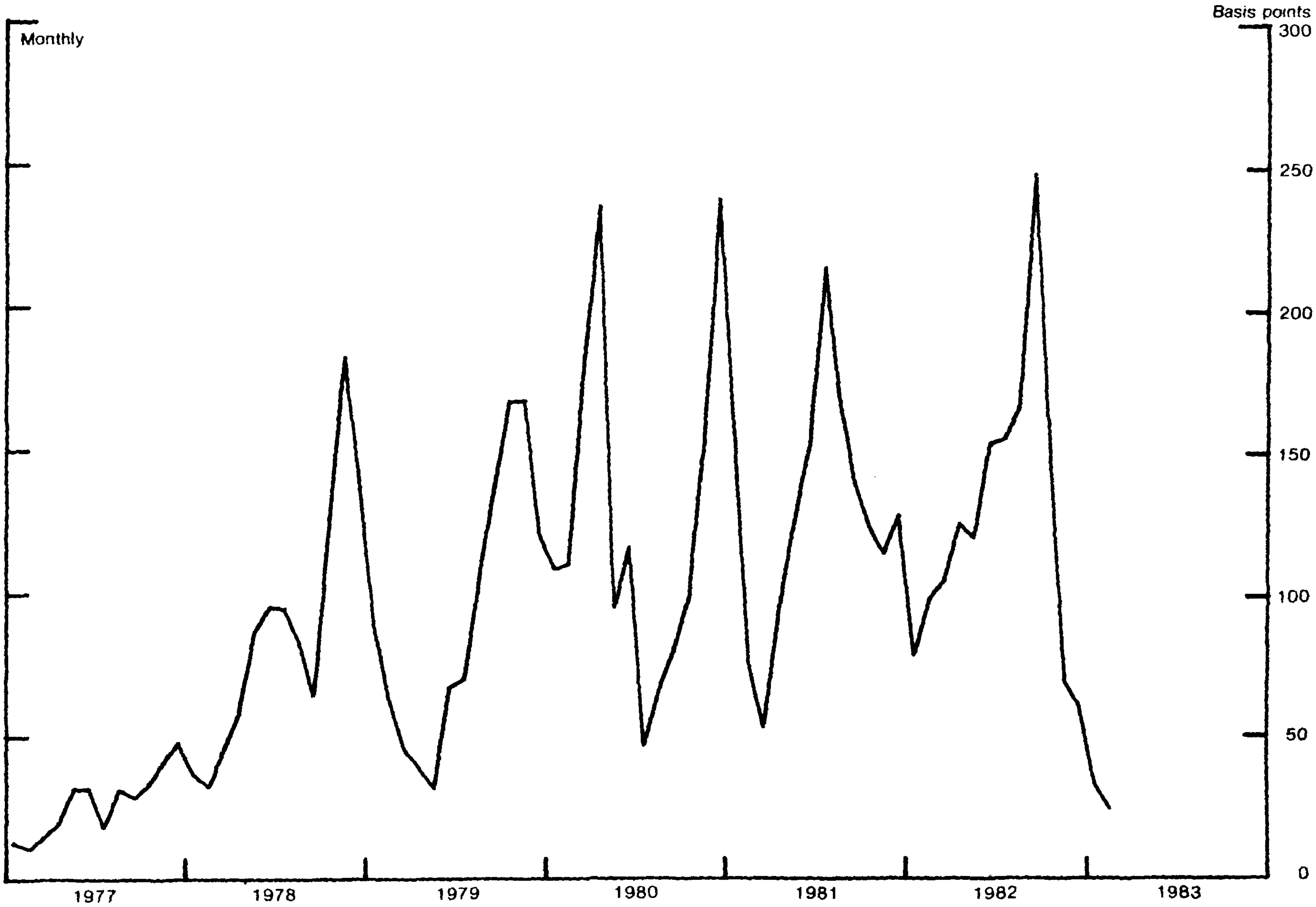
1. Acceptances of Continental Illinois National Bank have continued to trade in the market in recent months, although not as freely as in the past and at a discount relative to the paper of other "prime" accepting banks. This bank and Seattle-First National Bank remain on the Desk's list, and the Desk has been offered and has acquired a relatively small amount of the acceptances of these banks in recent RP operations.

2. In theory, the account party on an acceptance is obligated to pay the holder in the event the accepting bank fails to make payment. However, in practice, the holder may not be able to enforce this obligation of the account party because (1) the account party might be insolvent or a poor credit risk requiring the holder to stand in line with the other general creditors and (2) the account party may be located outside of the jurisdiction of United States courts, making it expensive and difficult to obtain or enforce a judgment.

Differential Between Interest Rates (3-month maturity) on Bankers Acceptances and Treasury Bills



time, when BAs in general, or particular bank names, could come under a cloud. At such times, situations could arise where the Desk would be confronted with the difficult dilemma of either acquiring paper that was coming under some question as to its creditworthiness or rejecting such paper and thereby adding to the difficulties of the bank or banks in question.

For the most part, acceptances traded as "prime" in the U.S. market are obligations of U.S. banks--even though the underlying transaction may have begun with a foreign bank and then been refinanced in the U.S. market. There is also an appreciable volume of acceptances of U.S. branches and agencies of foreign banks trading "on their own" in the U.S. market, that may be routinely offered to the Desk. The head offices of most of these banks are located in Japan and Europe.[1] Many of them may well have financial positions as strong as major U.S. banks. Nonetheless, they are not subject to the same examination process as U.S. banks, and, moreover, in the event they were to encounter difficulties, might not have available the same degree of assistance as provided by U.S. banking authorities.

While operations in acceptances thus have some element of risk, the limitation of System participation to short-term RPs in prime BAs tends

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1. In recent months, for example, acceptances of Japanese banks accounted for roughly 80 percent of the total volume of foreign bank acceptances purchased by the Desk under repurchase agreement. In addition to Japanese and European banks, a number of Canadian and Australian banks are on the Desk's list of prime accepting banks. All told, the list of prime accepting banks includes 65 banks from 14 foreign countries. Some of these bank names, including three Latin American bank names (Banamex and Bancomer from Mexico and Banco de Bogota from Colombia) have been seen only infrequently in the market lately. Since Mexico's problems became well known last August, the Desk has received BAs of the Mexican banks on a few occasions in very small amounts; prior to August these BAs were received with some regularity.

to limit the risk. First of all, there is the fact that reputable dealers are obligated to repurchase the acceptances. The value of this safeguard depends, of course, on the dealers with whom such trades are made having the financial strength (and will) to fulfill their obligations. Assessment of the dealer's ability to perform is a main objective of the Desk's market surveillance efforts. (To be sure, even a strong dealer, if invested too heavily in the acceptances of a specific bank, might be unable to perform his obligation to repurchase the BAs of a failing bank, but this can be regarded as a low-probability event given the sensitivity of dealers to the marketability of their stock-in-trade.)

Second, there is the short-term nature of the arrangement. In some cases, acceptances of a distressed bank may be dropped from dealers' portfolios well before its problems reach a critical stage. The probability would seem low that a critical stage in the accepting bank's creditworthiness would be reached during the brief interval--typically one day to one week--that the System held the paper on a repurchase agreement. However, there is currently less reassurance on this point, because of the possibility that in a dealer bankruptcy proceeding the courts may issue a stay on outstanding RP contracts, thus prolonging the period over which the System would hold acceptances and be exposed to the possible default of an accepting bank.

In light of the importance of assuring that dealers with whom the Desk trades are in sound condition, it is appropriate to review the Desk's experience recently with two dealers that got into financial stress.[1] The

1. One firm, Lombard Wall, Inc., filed for bankruptcy and the other, B.D. Discount Corporation of America, is reportedly operating on a much reduced scale.

Desk had a trading relationship, in BAs only, with both these dealers. The relationships were terminated, at the Desk's initiative, in late 1981 because the firms were not providing satisfactory financial information. This was well before their difficulties became widely known. Moreover, even had the Desk had RP-BAs with these firms at the time their troubles became acute, the System would not have been in great danger of incurring a loss. The quality of the prime BAs trading at that time was not under serious question. Also, following standard Desk practice, the Federal Reserve takes margins on its RPs that normally assure an ability to liquidate the holdings under RP without loss.

Even though the System was not exposed to a serious risk of loss in the case of these two firms, the experience nonetheless underscores the need for the Desk to be confident of the financial health of the dealers with whom it trades. To maintain such assurance, the financial condition of a firm with which the Desk arranges RP-BAs should be monitored closely, as are financial conditions of the "full line" dealers in Government securities.

While monitoring of BA-only firms has in fact been taking place--indeed it was because of such monitoring that the Desk decided to discontinue trading with the two firms--the increased sensitivity to possible problems of dealer firms would seem to call for intensified surveillance activities over such firms, as has been taking place with the primary Government securities dealers. This raises the question of whether the costs incurred in closer surveillance of firms whose transactions with the Desk are limited to RP-BAs are warranted by the benefits received. Firms that fall into this category are generally small, and the volume of RP-BAs that can be done with them is likely to be only a small proportion of the total that would be done at any one time. For example, at the present time 19 dealers have a trading relationship in BAs with the Desk and all but two of these also trade Treasury and agency issues with the Desk. In 1982, the two BA-only firms accounted for about 2-1/2 percent of the RP-BAs arranged by the Desk.

In light of this, the Account Management is now considering the possibility of engaging in RP-BAs only with dealers that meet the qualifications for a "full-line" trading relationship with the Desk--in Government securities as well as BAs. At the very least, this approach would mean not commencing a trading relationship in BAs only, and it could mean dropping the relationship with the two firms that now trade only in BAs with the Desk, although it may be preferable to "grandfather" the relationships with the remaining BA-only firms, at least for a time. In reaching a decision, the Desk intends to give some weight to the question of competitive equity--whether it is fair to exclude a dealer that accounts for a significant share of the trading activity in the acceptance market from a trading relationship with the Desk because the dealer does not account for a similar share of the trading activity in Treasury securities.

Staff Recommendations

While operations in "prime" bankers acceptances cannot be regarded as totally without risk, and recent events have tended to heighten an awareness of vulnerabilities, the risks incurred by the System in engaging in RP-BAs would appear to remain low. As a general proposition, prime bankers acceptances continue to be in the top quality echelon of private debt instruments. Moreover, as the FOMC noted in 1977 in authorizing the continued arrangement of RP-BAs, the short-term nature of the instrument and the obligation of a responsible dealer to repurchase the paper tend to reinforce the System's safety. While these safeguards do not provide absolute assurance, the possibility of the System incurring a loss in arranging RP-BAs appears to be small.

Aside from the possibility of financial loss, the System could be placed in an awkward position, if it declines to purchase an acceptance of a bank whose creditworthiness it had reason to question, lest that very refusal add to the bank's problems. As noted earlier, the Desk relies mainly on the market's judgment that a particular bank's acceptances are regarded as prime, but the Desk could receive additional adverse information not generally available in the market, or the generally available information may be such as to cause a borderline situation in the market's own evaluation process. It may well be expedient in such situations for the Desk not to "rock the boat" by declining to take an acceptance of a bank whose name was beginning to be questioned.

If this level of risk is acceptable, then the balance would appear to lie on the side of continuing the authorization for RP-BAs, since as reviewed earlier, this activity seems helpful in meeting System reserve management objectives. RP-BAs are expected to remain modestly useful, even though the prospect of large Treasury deficits in the years ahead is likely to assure a substantial availability of Treasury issues for RP purposes. In the face of 1982's large deficit, for example, RP-BAs still accounted for more than 16 percent of all System RPs.

Another reason to continue the authorization for RP-BAs is that System withdrawal from the market at this time could add to general anxieties about fragility of the international and domestic financial system. Some participants might interpret a withdrawal as evidence of System concern about the underlying creditworthiness of domestic and foreign accepting banks or acceptance dealers, and might also conclude that the System was concerned about the economic health of many foreign countries and perhaps also of the firms writing acceptance drafts. (The Federal Reserve's phased withdrawal from outright purchases of BAs, which had no noticeable effect, was undertaken in calmer times.) A further reason to continue the authorization for RP-BAs is that this activity facilitates Federal Reserve surveillance over the $80 billion BA market. Actual market participation makes it possible for the Federal Reserve Bank of New York to observe first hand the character of BAs in the market and to receive information about market practices in a more forthcoming fashion from BA dealers and accepting banks.

If the Committee chose, on the other hand, to discontinue the RP-BA authorization, it should be done in a way that minimizes adverse reactions, including an ample notice period. Stress could be placed on the further maturing of the BA market, removing any remaining vestige of need for special support, while recent System employment of RP-BAs could be fairly characterized as useful but not absolutely essential. Furthermore, the authorization could be permitted to remain on the books to allow the possibility of its use should circumstances develop that make it highly desirable.

APPENDIX

Federal Reserve's Historical Involvement in the Bankers Acceptance Market

The Federal Reserve Act encouraged the development of a bankers acceptance market in the United States. Prior to the Act, it was thought that national banks did not have the power to accept time drafts. The Act allowed banks to accept time drafts and made certain BAs eligible for purchase or discount at Reserve Banks. Federal Reserve Banks first began arranging RPs on securities, including BAs, during World War I. The practice of employing RPs, including those on BAs, fell into disuse in the 1930's.

In 1955, the FOMC authorized the purchase of BAs on an outright and temporary basis for the account of the Federal Reserve Bank of New York. (The practice of purchasing Government securities under RP was re-authorized somewhat earlier.) This was done to encourage the redevelopment of the market and to demonstrate official recognition of "the high quality and special usefulness" of BAs in international trade. The need for official assistance and encouragement dwindled as the market grew in the late 1950's and 1960's. As a result, the Committee on Discounts and Credits of the Conference of Presidents of the Federal Reserve Banks recommended in 1968 that System transactions in BAs be undertaken only for monetary policy purposes, an approach the Desk has since maintained.

In 1974 the BA market was subjected to substantial pressures. The Franklin National Bank's failure heightened concern over the quality of individual bank credits, and this was exacerbated by the withdrawal of a major dealer from the BA market. At the same time fairly low dealer holdings of Government securities made it difficult at times for the Account Manager to supply reserves in the normal course of open market operations. In these circumstances the FOMC raised the limit on the System's BA holdings to $500 million, from $125 million, recognizing that purchasing BAs would be of some help in achieving policy objectives and help a market subject to volatile price swings and possible disorderly conditions. (Also, the increases permitted the Desk some flexibility in handling foreign account sales of BAs should the market be unreceptive.)

Later that year the Federal Reserve halted its practice of guaranteeing BAs purchased by foreign accounts, a move that generated some anxiety by participants who feared it would reduce the demand for BAs. In this environment the limit on the System's outright holdings was raised again to $1 billion. Actual outright holdings of BAs rose from around $65 to $70 million early in 1974 to a high of about $750 million in January 1976.

While these developments demonstrated the System's flexibility in responding to current potential problems, they also illustrated possible areas of vulnerability. In particular, the rise in System holdings increased the risk that the Desk might be forced to reject a specific bank name, given the FOMC's requirement that only "prime" names be purchased. In sensitive and fragile times such a rejection would certainly exacerbate a bank's problems. After weighing these considerations and the impact on market psychology of a System withdrawal of the New York Reserve Bank's guarantee of BAs to its customers, the FOMC decided in 1976 to foster a gradual reduction in the outright portfolio to $200 million. The reduction generated little concern in the market. In 1977 the FOMC went still further, deciding to discontinue outright operations for the System in BAs. Such operations were not making a significant contribution to achieving reserve objectives and were a continuing source of possible embarrassment if particular bank names were to come under question. By late 1977 the outright portfolio had been phased out.