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

April 9, 1973

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Attached are two memoranda, from the System Account Manager and from the Committee's General Counsel, dated today, on the subject of System lending of Government securities. It is contemplated that these memoranda will be discussed at the meeting of the Committee on April 17, 1973.

Arthur L. Broida
Deputy Secretary
Federal Open Market Committee

Attachments

April 9, 1973

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Alan R. Holmes, Manager
System Open Market Account

Subject: System Account Lending of Securities

The lending of securities from the System Account has expanded markedly during the period since November 21, 1972, when the Committee last extended the lending authorization. The number of loans since September 1, 1972, the cutoff point in the last report to the Committee, totaled 2,956 and aggregated $4.9 billion, an increase of 1,038 loans and $1.4 billion, respectively, over the previous reporting period. The figures are not strictly comparable because the Desk established trading relationships with three new dealers during the most recent period, but borrowing by these particular dealers accounted for less than 4 per cent of the total loans extended. On a daily average basis, the Desk made 21 loans totaling about $35 million, with a balance of about $65 million outstanding at the end of the day. These three averages were up about 40, 28, and 27 per cent from the previous reporting period.

Included in the total loans for the period were 32 overnight loans totaling $39.8 million to five New York City banks that participate in the Treasury securities clearing arrangements. This was twice the number of such loans made in the previous six-month period to facilitate the use and operation of the clearing arrangement and promote the expansion of book-entry for Government securities.

For the year 1973 to date, a daily average of 25 loans totaling $42 million were made, with a daily average balance of $80 million outstanding. The percentage increases in these averages since 1970, the first full year of the lending operation, are shown on the following table:

		Percentage Change Over		
Daily Average	1973	1972	1971	1970
Number of loans	25	59%	132%	141%
Total Amount	$ 42 mil.	50	82	105
Balance	$ 80 mil.	54	75	102

Despite the increase in volume, no problems of an administrative or mechanical nature were encountered during the period, and the Committee's guidelines on lending appeared to be functioning smoothly. Virtually all loans continued to be made for the full five-day period, but most were repaid before maturity, generally in two days. Over the period 53 loans, totaling $60.6 million, were extended beyond their original maturity dates at rates ranging from 1-1/2 to 6 per cent. This compared with 19 extensions totaling $30.4 million in the previous six-month period. The sharp increase in extensions was concentrated in the three months, January to March 1973, when over-all loan activity expanded markedly and when the scarcity of securities in the market became most pronounced.

The operation continues to be a profitable one for the System. Over the past six months earnings amounted to $294,000 compared with $402,000 for the calendar year 1972. Expenses amounted to roughly 1/10 of earnings.

The expansion in System lending activities during the last six months did not reflect any deterioration in back-office operations at the dealer firms. Rather, it reflected the growing shortage of securities available from other lenders for this purpose. Commercial banks, the principal lenders of securities, were cutting back on their investments in Government securities because of burgeoning loan demand and prolonged uncertainties about the probable direction of interest rates. At the same time, the banks found their collateral requirements for Treasury tax and loan accounts sharply increased in the wake of the severe crisis in foreign exchange markets, when extremely heavy takings of dollars by foreign central banks had to be invested either in marketable Government securities or in special Treasury obligations. This process stripped the market of securities and simultaneously flooded the Treasury with funds that would otherwise have been raised by issuing additional marketable obligations. The System's restrictive policies also produced high levels of member bank borrowing from the System, which had to be collateralized, in many cases with Government securities.

The extreme scarcity of securities was also evident to the Desk in its daily operations to affect reserves. Repurchase agreements were difficult to negotiate because of the shortage of both Government and Agency securities, even though the dealers were sometimes requested more than once on a given day to ferret out customer collateral. On a few occasions the Desk was unable to accomplish its reserve objectives fully and had to tolerate tighter money market conditions than the Committee desired.

Despite the increased lending of securities by the System, dealer fails to receive or to deliver securities averaged almost $300 million per day, up 37, 64 and 39 per cent from the three previous six-month periods reported to the Committee. To a large extent, this was probably due to the heavy short position of dealers in intermediate coupon issues, which could not be alleviated by the Desk under the current ground rules established by the Committee. However, System lending prevented a further aggravation of the general fail situation in those cases that met the Committee's standards for Desk action.

Under these circumstances, System lending of securities remains reasonably necessary to the effective functioning of the market and hence to the effective conduct of System open market operations. Indeed, the facility is, if anything, more necessary now than in other recent periods. The dealers' ability to function is dependent to some considerable extent on access to sources of securities that can be borrowed. The prospect of costly fails to deliver strongly inhibits dealers in their willingness to make commitments, including those required by the Desk in achieving the objectives of the Committee, the Treasury and foreign central bank correspondents. Accordingly, on the basis of the experience since last November, I recommend that the Committee find that the lending of securities continues to be reasonably necessary for the conduct of open market operations and that it make no change in the provisions of the Authorization for Domestic Open Market Operations relating to the lending of securities, subject to review after six months.

CONFIDENTIAL (FR) April 9, 1973

To: Federal Open Market Committee Subject: System lending of Government securities.

From: Mr. Hackley

In his memorandum to the Committee dated April 6, 1973, Mr. Holmes, the Manager of the System Open Market Account, has recommended that, on the basis of experience since last November, the Committee find that the lending of securities continues to be reasonably necessary for the conduct of open market operations and that the Committee make no change in the provisions of the Authorization for Domestic Open Market Operations relating to the lending of securities, subject to review after six months.

As I have indicated in earlier memoranda, there is no provision of law that expressly authorizes the Reserve Banks to lend securities. If the authority exists, it must be derived from the statutory authority of the Reserve Banks to exercise "such incidental powers as shall be necessary to carry on the business of banking within the limitations prescribed" by the Federal Reserve Act; in other words, lending of securities is within the authority of the Reserve Banks if it is reasonably necessary to carry out an express power, i.e., the purchase and sale of securities in the open market. Consequently, the authority for the lending of securities must depend upon the factual question whether that activity is reasonably necessary to the effective conduct of open market operations.

This authority was first granted by the Committee in October 1969 as a means of mitigating the adverse effects of failures by dealers to deliver or receive securities. As amended at that time, the Authorization for Domestic Open Market Operations provides in paragraph 3 that, in order to insure "the effective conduct of open market operations", the Committee authorizes and directs the Federal Reserve Banks to lend U. S. Government securities to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Reserve Bank. The Committee's Regulation, as amended February 1, 1973, after enumerating the kinds of open market operations in which the Reserve Banks may engage, provides that the Reserve Banks are authorized and directed "to engage in such other operations as the Committee may from time to time determine to be reasonably necessary to the effective conduct of open market operations and the effectuation of open market policies."

The Manager's memorandum of April 6, 1973, states that lending of securities from the System Account has expanded markedly since November 1972, when the Committee last extended the authorization. The memorandum cites recent developments that have led to an extreme scarcity of securities and states that, as a result, on some occasions the Desk was unable to accomplish its reserve objectives fully. It concludes that this facility "is, if anything, more necessary now than in other recent periods".

In these circumstances, if the Committee concurs in the Manager's judgment, it is my opinion that lending of securities as authorized by the Authorization for Domestic Open Market Operations is presently within the incidental powers of the Reserve Banks.