Authorized for public release by the FOMC Secretariat on 8/21/2020

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

March 11, 1974

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Arthur L. Broida

Enclosed are (1) a memorandum from the System Account Manager, dated February 5, 1974, and entitled "Proposed expansion of authority to lend securities from System Open Market Account," together with certain attachments; (2) a memorandum from Board Staff dated Ocrober 3, 1973, and entitled "Dealer Association request for a broadening of System security lending;" and (3) a memorandum from the Committee's General Counsel, dated March 8, 1974, and entitled "Loan of System Account securities to cover dealer short sales."

It is contemplated that a preliminary discussion of the Manager's memorandum and the associated documents will be held at the forthcoming meeting of the Federal Open Market Committee.

Enclosures

Authorized for public release by the FOMC Secretariat on 8/21/2020

February 5, 1974

To: Federal Open Market Committee

From: Alan R. Holmes

Subject: Proposed expansion of authority to lend securities from System Open Market Account

Attached is a memorandum commenting on a proposal submitted by the Association of Primary Dealers in U.S. Government Securities some time ago to broaden the base of System lending of securities to Government security dealers. The proposal is for the System to lend securities to enable dealers to sell securities in demand in the market that are in short supply, against the collateral of other securities of comparable maturity held by dealers in their portfolio. The proposal, if accepted by the Committee, would facilitate the ability of dealers to establish short positions in individual issues of Government securities, but under the ground rules envisaged, would not permit the establishment by a dealer of a net short position in any given maturity area. While a case might be made on economic grounds that the ability of dealers to establish a net short position would contribute to the depth of the securities market, it would appear unwise, mainly for public relations reasons, for the System to contribute directly to such a process.

The memorandum reaches the conclusion that it would be desirable for the System to expand its lending of securities in the manner proposed by the Dealer Association provided that adequate safeguards are established to avoid abuse and, of course, subject

Authorized for public release by the FOMC Secretariat on 8/21/2020

to review by the Committee on a periodic basis. I recommend that the Committee act favorably on the proposal, provided that Counsel for the FOMC determines that the proposed activity falls within legal bounds. I would assume that this would require a finding by the FOMC that the proposed activity is "reasonably necessary for the conduct of open market operations." I recommend to the Committee that it so find.

My recommendation is based on the belief that one of the problems of the coming decade is to rebuild a more viable long-term market in Government securities in order to provide greater scope for Treasury financing in all maturity areas of the market. The exemption of $10 billion in longer-term financing from the 4-1/4 per cent interest ceiling was an important first step in providing more flexibility for sound Treasury management of the public debt; it has been followed, as you know, by action that exempts from the ceiling bonds acquired by the Federal Reserve and Treasury trust accounts. The dealer proposal would, I am convinced, contribute to that end by providing for a more stable and fluid market. This in turn would provide a better base for System open market operations and, in this sense, would appear to be "reasonably necessary for the conduct of open market operations."

Should the Committee approve the proposal in principle I would suggest that a staff group be established to work out detailed guidelines that would be submitted to the Committee for final approval.

Attachment

Authorized for public release by the FOMC Secretariat on 8/21/2020

August 24, 1973

To: Mr. Holmes

From: R. L. Cooper

Subject: Dealer Association Proposal on System Lending of Securities

About a year ago, the Association of Government Securities Dealers recommended certain changes in the ground rules under which securities held by the System Open Market Account are loaned to dealers. The principal thrust of the changes would be to broaden the System's lending authority so as to permit loans of securities needed by the dealers to cover short sales under certain conditions. Until now the Desk has only been authorized to lend securities needed to avoid delivery failures where the dealer certifies that they did not involve a short sale on his part.

The ability of dealers to borrow securities from the System Account has been very helpful to the market. Since the program was instituted almost three years ago, dealers have been able to trade all maturities of Government securities with more flexibility, because if someone fails to make timely delivery of securities a dealer has purchased and subsequently sold, there is an ultimate source from which he can borrow securities to make his own delivery. Thus, each System loan of securities avoids at least one delivery failure (by the borrowing dealer) and may also avoid a delivery failure by the purchaser and by others through those hands those securities might pass during the day. It has been particularly helpful during the past year, when there has been an acute shortage of uncommitted securities available

Authorized for public release by the FOMC Secretariat on 8/21/2020

from other lenders for this purpose. There has been no discernible abuse of the privilege by dealers. The amount outstanding has recently fluctuated between $50 million and $150 million (a relatively small amount for 24 dealers) and most of the securities borrowed are returned before the expiration date of the loans. Even at the relatively small charge of 3/4 per cent per annum per day, the operation provides a moderate return over expenses to the System and thus to the Treasury.

It now appears that the dealers' extremely limited opportunities to borrow securities from other lenders have shrunken even further as some banks are reportedly in the process of curtailing their lending of securities to the dealers in order to use their unpledged securities in other ways. One way would be as collateral to borrow funds under repurchase agreements. This can ordinarily be done at rates substantially below the current rates for Federal funds, CD's or Euro-dollars. The saving in borrowing costs will usually more than offset the loss of 1/2 per cent per annum income derived from lending the securities, perhaps by a substantial margin. If the mathematics of these relationships become more widely recognized (or perhaps because they already have), the remaining sources of lendable securities may dry up completely. This would be a serious deterrent to the dealers in maintaining the active markets that the System needs for its operations.

Authorized for public release by the FOMC Secretariat on 8/21/2020

In view of the System's satisfactory experience in lending securities over a period of almost three years and of the adverse effect that a further curtailment in the market supply of lendable securities might have, directly or indirectly, on the System's ability to operate in the market, it is recommended that consideration be given to the Association's proposal for liberalizing the System's ground rules for lending securities. As noted above, the principal change suggested by the Association would be to permit dealers to borrow securities from the System to cover a special type of short sale. Under the ground rules suggested by the Dealer Association, such short sales would not of themselves tend to foster any instability in the market. On the contrary, by their very nature they should contribute toward greater stability.

In general, dealers sell securities short either to speculate on the prospect of lower prices, to hedge a long position in other issues, or to accommodate a customer who wants a particular maturity that the dealer does not have and cannot buy immediately. Of course, even if the dealer sells short to hedge or to accommodate a customer, he hopes to be able to cover the sale at a lower price, but the main purpose of his short sale in those two instances is protective or accommodative rather than speculative. Both of these types of short selling contribute to the fluidity of the market, the first by enabling the dealer to take a long position in other issues for sale by

Authorized for public release by the FOMC Secretariat on 8/21/2020

customers with greatly reduced risk to himself, and the second by increasing the dealers' capacity to offer scarce securities to prospective buyers who have limited options as to maturity. Under most market conditions, short selling for these purposes contributes to both the stability and fluidity of the market, since it enables dealers to swap securities much more freely and thus to accommodate their customers as well as to accomplish their own adjustments of position. Also, as noted in the Dealer Association proposal, it tends to smooth out those price and yield distortions that occur between similar maturities simply because a particular issue is not currently held in dealer positions or is not readily available from other holders. Short selling of issues of comparable maturity might be especially useful in avoiding the special pressure on a recently issued Treasury security that sometimes occurs when the market turns sour after a Treasury financing. Since dealers and other investors tend to have sizable holdings of the new issue at such a time, selling pressure tends to be concentrated on that issue, with a consequent exaggerated depressing effect on its price. If additional borrowing facilities were available, short selling of nearby issues might tend to spread the rate impact, making for less distortions in the yields on individual issues.

From a philosophical standpoint, therefore, this would seem to be the kind of market activity that the System should be encouraging

Authorized for public release by the FOMC Secretariat on 8/21/2020

and a good way to do it would be to lend the securities needed by the dealers for these purposes if they cannot be borrowed elsewhere. Such loans would contribute toward the preservation of the kind of a market needed by both the System, for its open market operations, and by the Treasury for carrying out its debt management program.

In order to assure that the System lends securities only against the protective and accommodative types of short selling described above, the Association proposal suggests certain additions to the ground rules. The most important is a requirement that when a short sale is involved, the collateral submitted against the loan of securities should consist of issues of approximately the same maturity and that they must be already held in the borrowing dealer's position (see table, page 2, Association proposal attached). With such a requirement, the loan itself would not enable the dealer to go net short in any given maturity area and, therefore, would not directly facilitate the establishment of purely speculative short positions. The Association proposal also suggests limits on the size of such loans made in the aggregate to any one dealer or, in the aggregate, to all dealers combined. The present ground rules covering loans to one dealer to avoid delivery failures limits them to $50 million of any one issue of bills, $10 million of any one issue of interest-bearing securities and $150 million in the aggregate to any one dealer. There is no limit on the aggregate amount of loans to all dealers combined

Authorized for public release by the FOMC Secretariat on 8/21/2020

(except that reached by multiplying $150 million by the number of dealers eligible to borrow). If the FOMC agreed to System lending against short sales, and wanted to set up separate limitations on those loans, they might be set at some lesser amount, e.g., an aggregate of $75 million to one dealer.

The Association proposal suggests that the loans be made for 15 days instead of the five days (subject to renewal at rising rates) presently employed on delivery failure loans. It can reasonably be argued that a longer period of time is required for the dealer to search out a supply of a particular issue sold short than is needed when the dealer has already purchased an issue and the seller has temporarily failed to make timely delivery to the dealer. Whether the time should be 10, 12, or 15 days is a matter of judgment. It seems logical, however, that if a significantly longer period of time is allowed on the original loan, there should ordinarily be no extensions or renewals. It should be understood that failure to repay at the maturity of the loan will most likely result in the sale of the collateral by the Desk and the purchase of the security borrowed, with the dealer liable for any additional cost over the sale price of the collateral. Because of the longer time period involved, the collateral should afford a somewhat greater margin of protection against changes in market prices even though the collateral, being of comparable maturity, should change in price at the same rate as the borrowed security.

Authorized for public release by the FOMC Secretariat on 8/21/2020

It might also be desirable to charge more interest on a loan against a short sale than applies on a loan against a delivery failure. The present charge is 3/4 of one per cent per annum, with the rate usually doubled for each one-day extension beyond the original five-day maturity. If an additional safeguard against abuse were desired, the basic rate for loans against short sales might be set at 1 per cent per annum.

If the proposal were adopted, it should apply to all maturity categories of Government securities. The Association also suggests that the System lend Agency issues but there are two reasons why that would not seem feasible at present. First, System holdings of individual Agency issues are still relatively small so that size limitations would have to be quite restrictive. More importantly, perhaps, there would be much greater risk of default or long extensions on the loans because of the greater scarcity of Agency issues in the market compared with Government issues. Past experience with delivery problems on outright purchases of Agency issues indicates a strong likelihood that dealers could not repay some of the loans at maturity (and that the System might have great difficulty in buying in the issue in default regardless of price). Therefore, it seems that consideration of lending Agency issues should be deferred until:

1. the Agency market is larger and broader than it is at present, and

2. the System's holdings of particular issues is considerably larger.

Authorized for public release by the FOMC Secretariat on 8/21/2020

It should be noted that separate ground rules governing loans against short sales would complicate the administration of the lending program. There are already differences in our ground rules applying to loans to banks against shortages in the clearing arrangement. Another set of ground rules would necessitate even more careful policing of our loans to determine the circumstances giving rise to the request, i.e., whether a simple failure to receive securities purchased or a short sale for accommodative purposes was involved. The maturity of the loan, the requirements as to collateral, and perhaps the rate charged would be different in either case.

One other suggestion, not related to short sales, was made by the Association. This was that the System permit dealers to "exchange" registered issues (delivered in good form) for coupon issues held by the System, with the payment of a 1/32 exchange fee. The purpose is to avoid delays in deregistering notes and bonds, particularly during the 30-day period prior to interest payment dates. Thus a dealer who bought registered securities in deliverable form could turn them in for deregistration, sell the issue immediately and borrow the coupon issue from the System to make delivery. As soon as the registered security was processed and the coupon issue was delivered to the dealer, he would return the loan. This question has been discussed before and it was concluded that such loans would not be feasible because:

Authorized for public release by the FOMC Secretariat on 8/21/2020

1. the registered securities in "good form" might turn out to have some defect in documentation that would delay their deregistration unduly, and

2. while the security is still in registered form, there may be legal questions as to its ownership and the nature of the System's claim on the dealer and on the security.

One way to avoid the latter problem would be for the dealer to put up securities other than the registered issue as collateral to the loan of the coupon bonds. This would still leave the first problem as to undue delays in deregistration. If the System were willing to make open-ended maturity loans repayable when the coupon security is delivered to the dealer, and the dealers were willing to put up other collateral against the loan, such accommodation might accomplish a useful, although not a major, benefit to the market.

Attachment

Authorized for public release by the FOMC Secretariat on 8/21/2020

(ASSOCIATION PROPOSAL)

FEDERAL RESERVE LENDING OF U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES TO DEALERS

1. The Matter of Market Performance

In recent years, private domestic holdings of marketable Treasury securities have declined. This drop in the tradable supply of securities in private hands, coupled with the apparent increase in the average size transactions in financial markets, has accentuated the scarcity of many Treasury issues. Those issues in which Federal Reserve, Treasury trust account, foreign central bank and individual investor buying has been concentrated, have often become hard to find in the market.* The volume of public deposits that may or must be collateralized by Treasury securities has increased, further adding to the scarcity of tradable securities.

As a result, many Treasury and Agency issues have become increasingly hard to borrow. This has made it much more difficult to execute the block-sized transactions often desired by investors and has tended to create distortions in yield relationships among intrinsically similar securities.

2. The Basic Case for Federal Reserve Lending of Securities

Many Treasury and Agency issues are becoming increasingly hard to borrow, particularly when commercial banks need their own holdings for collateral requirements.

Lending of securities by the Federal Reserve will:

a. Facilitate "Open Market" desk transactions, both for System account and for customer accounts, including those of foreign central banks.

b. Smooth out price and yield distortions among similar maturities, thus adding to investor appeal of Treasury and Agency issues as being part of the most perfect market place.

c. Eliminate the need for dealers to hold up decisions to trade until borrowing facilities can be ascertained.

d. Make for a more viable market, thus benefiting the Treasury and Federal Agencies. The widening of investor interest in Federal Agencies in recent years as these securities have enjoyed better markets, is certainly evidence of this.

*See Addenda Enclosed

Authorized for public release by the FOMC Secretariat on 8/21/2020

3. The Scope of Federal Reserve Lending Should Include All Treasury Bills, Notes, and Bonds, as Well as Federal Agency Issues Held in the Federal Reserve Portfolio

Various issues in all these categories are either temporarily or consistently difficult to borrow. For example, the Treasury Bill market which should be the most viable of all markets with certain exceptions, is the least tradable. At present, all Treasury Bills, other than the most recent 3-month, 6-month, 9-month and 1-year Bills, are difficult in which to make markets because of the lack of borrowing availability.

4. Nature of Collateral Pledged against Securities Borrowed from the Federal Reserve System

All dealer borrowing would, of course, be collateralized. The collateral would have to represent issues held in position rather than privately borrowed by the dealer. The issue submitted as collateral, all appropriately margined, would have to be of a nearby maturity according to the following table:

Maturity of Borrowing	Maturity of Issues Eligible for Collateral*
Treasury Bills	Within 30 days, either side
0 - 2 Year Notes & Bonds	Within 3 months, either side
2 - 5 Year Issues	Within 6 months, either side
5 - 10 Year Issues	Within 1 year, either side
Over 10 Year Issues	Any other issue in the over 10 year maturity area

*Whenever Treasury Bonds or Notes are announced for refunding on a rights exchange basis by the Treasury, they immediately become "Rights," and enjoy a broad market; consequently, if borrowed must be returned to the Federal Reserve within 2 business days of the announcement.

5. Suggested Guidelines for Lending

a. Time limit: Since the basic purpose is to facilitate market making, the time limit for borrowing should be "15 days or less," at the borrowing dealer's option. This amount of time will permit dealers to search out private supply, or to locate private sector lending sources.

b. Borrowing cost: The cost to dealers should be 1/4 per cent higher than the standard 1/2 per cent fee currently charged by private sector lenders.

Authorized for public release by the FOMC Secretariat on 8/21/2020

c. Size limits on lending any one issue: To retain a measure of flexibility, the Federal Reserve might set a percentage of its holdings of each issue it will lend to all dealers, combined.

d. Size limits on lending to any single dealer, of a combination of issues: The Federal Reserve could consider setting a total amount it would lend to any one dealer of an issue or combination of issues.

e. Notice by dealers to borrow: The time deadline for dealers to borrow from the Federal Reserve should be 1:00 p.m. (for settlement the same day)--which is the present day and satisfactory arrangement.

   (1) Dealers would be prepared to try to notify the Federal Reserve even a day earlier, whenever they know of a "next day" delivery that will require borrowing.

   (2) When Book Entry is in effect, the Federal Reserve should consider extending the deadline to a later hour in the afternoon.

f. Federal Reserve calling of securities lent to dealers: Should a dealer be borrowing Treasury Bills or other issues from the Federal Reserve, and the Open Market desk decides to sell out the issue involved (thereby eliminating the issue from its borrowing availability list), the dealer should have first option to "buy in" at the "best price" which could be not less than a .01 per cent lower yield than the best bid of a non-borrowing dealer, and 1/32 higher price on coupon issues.

Conclusion

Because securities borrowed by a dealer from the Federal Reserve must and can only be collateralized by similar maturities held in "long position," these borrowing facilities will not add to the dealer's ability to establish net short positions in any of the five maturity classifications. In many conditions, the ability to fill actual bids for technically scarce issues (by being able to borrow the securities to make delivery) will broaden markets to the benefit of all concerned.

Authorized for public release by the FOMC Secretariat on 8/21/2020

General Footnote on "Registered" Issues

Dealer purchases of "registered" Treasury and Agency notes and bonds frequently involve subsequent delays in getting the issues into "coupon" form.

This is particularly true during the 30-day period just prior to interest payment dates.

It is suggested that the Federal Reserve permit dealers to exchange "registered" issues (delivered in good form) for "coupon" issues held by the System, with the payment of 1/32 exchange fee.

Authorized for public release by the FOMC Secretariat on 8/21/2020

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 3, 1973

To Federal Open Market Committee

From Board Staff

Subject: Dealer association request for a broadening of System security lending

The association of Government security dealers has requested the Federal Reserve to consider a broadening of the present System program of lending Government securities to primary dealers. Under existing arrangements, as you know, the Desk is authorized to lend securities to dealers only as needed to avoid delivery failures. No short selling is involved in such arrangements since the dealers participating already have purchased from customers an equivalent (though as yet undelivered) amount of the issues borrowed.

The more liberal security lending arrangements now requested by the association would permit a dealer to borrow securities from the System to make short sales, but such borrowings would have to be collateralized with issues of adjacent maturity already held in the dealer's position. Under this arrangement, although the dealer would be taking a short position in the particular issue borrowed, his net position in the maturity sector surrounding that issue would be hedged by the security provided as collateral. This requirement to supply collateral with a nearby maturity is designed to discourage dealers from using the more liberal arrangement as a means of establishing a strictly speculative net short position. Given this constraint, dealers would be expected to use the more liberal short-selling arrangement chiefly to accommodate customer demands for scarce issues not presently held in position, or to establish a hedge against their existing long positions. While this would not produce a

Authorized for public release by the FOMC Secretariat on 8/21/2020

net short position in a given maturity area, it would, of course, make it easier for dealers to run lower average net long positions.

The mechanics of the new dealer proposal are spelled out by staff of the Trading Desk and the dealer association in Mr. Holmes' memo and the attachments thereto. Key arguments for and against the proposal are summarized below. The Board staff lean toward a negative view of the proposal.

Pro Arguments

(1) Expanded System lending of Government securities to primary dealers is needed to counter the deepening shortfall in the volume of such securities available for lending from private sources. The volume of Government securities loaned to dealers by private institutions has tended to contract on balance in recent years as Federal Reserve and foreign central bank holdings of such debt have grown more rapidly than the total, leaving smaller amounts in private hands. At the same time, many of the large commercial banks that typically lend securities to Government dealers have adopted liability management policies that minimize their need for liquid assets. This has made it possible for such banks to reduce their holdings of marketable Treasury debt to little more than the amounts needed to cover collateral requirements, on such things as State and local government deposits. Finally, persisting money market tightness has encouraged some key banks that previously had loaned Government securities to dealers to use their unencumbered Treasury collateral instead as a means of obtaining short-term funds from non-financial corporations on reverse

Authorized for public release by the FOMC Secretariat on 8/21/2020

repurchase agreements. Short-term funds acquired on reverse RP's have been less costly to bankers than funds available from alternative sources.

(2) Expanded System lending of Treasury issues to primary dealers would help to offset the short-fall in lendable securities from private sources and improve the technical efficiency of the Government securities market. During recent years the reduced supply of Treasury securities available for lending from private sources has made it difficult for dealers to accommodate customers' demands for scarce issues. As a result, trading has been somewhat inhibited, and the lack of sufficient dealer arbitraging has tended to maintain distortions in the structure of yield relationships. If System lending of Treasury securities to primary dealers is liberalized as recommended, trading activity will tend to be augmented; investors will find their needs being accommodated more readily; and price and yield distortions among issues of comparable maturity will tend to be smoothed out.

(3) The improved market performance resulting from a liberalized program of System short-selling would facilitate Desk transactions for System and customer accounts and provide support for Treasury debt operations.

(4) Since the proposed liberalization of System security lending would facilitate Desk transactions in the market, such a change can be viewed as reasonably necessary for the conduct of open-market operations.

Con Arguments

On its face the contention that a more liberal System program of lending Treasury securities would enhance the general technical performance of the Government securities market seems persuasive. But it is not so

Authorized for public release by the FOMC Secretariat on 8/21/2020

clear how significant this net improvement would really be. Moreover, implementation of the proposal could create some equity problems among different types of market participants. If instances of inequity were then to be highlighted in the press, they could pose troublesome political questions for the System. In particular, under the glare of publicity, it might become quite difficult for the System to demonstrate persuasively that security lending is in fact necessary to the conduct of open-market operations.

(1) Since access to the System portfolio for borrowing of Treasury issues would be limited to primary dealers, other investors active in trading Government securities would be at some disadvantage relative to dealers. In particular, when the more liberal dealer lending arrangement was first inaugurated, investors who had established net long positions to take advantage of scarcities in given securities would now find the value of these positions partly eroded because dealers could borrow the scarce issues from the System. To the extent dealers did use their liberalized security borrowing privileges to improve service to customers and to enhance the fluidity of the market, this would of course represent a net benefit. But if the privilege were sometimes used simply to enhance the dealers' own profits at the expense of other market participants, it might begin to be questioned. Given the demonstrated ingenuity of dealers, it is not easy to anticipate in advance all of the ways in which such a new privilege might be used. While precisely drawn Desk guidelines defining the limits of allowable practice and careful monitoring of dealer short-selling performance could presumably prevent

Authorized for public release by the FOMC Secretariat on 8/21/2020

significant abuses, the task of surveillance would probably be more demanding than under the existing security lending arrangements.

(2) Even if abuses of an expanded System security lending program proved in practice to be minor, it would be preferable to have improved lending resources developed by regular market participants, responding to normal profit incentives. Reportedly, savings and loan associations and Federal Home Loan Banks, among others, are beginning to provide such services to obtain the additional earnings provided. And some of the curtailment of commercial bank lending of securities in 1973 may have been a temporary phenomenon related to the extreme tightness of money markets.

(3) It might be made to appear that the Federal Reserve had elected to help a select group of dealers "bear" the U. S. Government securities market. The potential for such a misunderstanding of the operation might make it difficult clearly to demonstrate the technical market advantages of the lending arrangement. If the operation were misunderstood and were questioned, for example, in Congressional hearings, the statutory issue of whether the Federal Reserve really possesses authority to enter into short-selling arrangements with dealers might be highlighted. Although this same question could, of course, be raised regarding the existing arrangement for System security lending, the fact that it does not actually involve dealer short-selling makes it less likely to receive special Congressional attention.

. . . .

All things considered, evidence on the likely advantages to be obtained from a broadened program of System security lending does not

Authorized for public release by the FOMC Secretariat on 8/21/2020

appear to be sufficiently compelling to justify the political risks inherent in the change. These political risks would be reduced if the Treasury (through trust accounts) were willing to participate in the arrangement, but this possibility seems unlikely. In addition, question may be raised whether the advantages anticipated are sufficient to meet the statutory requirement that the operation is necessary to the conduct of System open-market policy.

Authorized for public release by the FOMC Secretariat on 8/21/2020

March 8, 1974

To: Federal Open Market Committee

From: Thomas J. O'Connell

Subject: Loan of System Account Securities to cover dealer short sales

This memorandum is concerned with the legality of a proposed broadening of the present lending activity of securities held in the System Account so as to include lending of government securities to cover security dealers' short sales under certain conditions. At the present time, the Desk is authorized to lend securities from the System Account in order to avoid dealer delivery failures. Such loans are made only when a dealer certifies that the loan of securities is not necessitated by a short sale on his part.

In considering this matter, I have reviewed memoranda from Messrs. Holmes and Cooper of the New York Bank, dated February 5, 1974, and August 24, 1973, respectively, and a memorandum from the Board Staff, dated October 3, 1973. In essence, the New York Bank concludes affirmatively on the issue of expanding the lending authority from the System Account. The Board Staff memorandum of October 3 takes a negative position on the proposition, stating the conclusion that adverse consequences override the stated benefits to flow from this proposal originally submitted to the New York Bank by the Association of Primary Dealers in U.S. Government Securities.

I believe that the major issue involved in this question is a policy issue and that any legal question presented can be answerd in

Authorized for public release by the FOMC Secretariat on 8/21/2020

a relatively simple manner, as follows. The authority of Federal Reserve Banks to lend securities held in the System Account is derived from the statutory authority of the 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. Of the several banking functions expressly authorized for performance by Reserve Banks, one is the purchase and sale of securities in the open market. The FOMC has determined that a necessary activity incident to the effective conduct of open market operations on the part of the Reserve Banks is the lending of securities from the System Account to dealers and clearing banks. Thus, the critical determination that is needed to be reached as a premise for authorization to conduct lending activities with respect to the securities in the System Account is that such lending is reasonably necessary to the effective conduct of System open market operations. Such determination has, as commented earlier, been made with respect to the lending of System Account securities in order to avoid delivery failures on the part of dealers.

As in the case of the authorization to lend securities in order to avoid delivery failures, it is my opinion that System Account lending activities can be enlarged to cover dealer short sale transactions provided that the Committee makes a finding that such transactions are reasonably necessary to the effective conduct of open market operations. In the latter connection, while I make no pretense

Authorized for public release by the FOMC Secretariat on 8/21/2020

of competence to evaluate the policy arguments raised for and against by the New York Bank and Board Staff memoranda, I do note with interest that a condition proposed to be imposed incident to this activity would be that the borrowing ability of a dealer would be conditioned upon the collateralizing of his borrowings with the issuance of adjacent maturities already held in his possession. Such collateral deposit requirement would appear to guard against the possibility that the dealer would establish a strictly speculative net short position.

In summary, I am unable to find any statutory impediment to the expansion of the lending authority with respect to the System Account, providing that such determination of expansion is preceded by a finding by the FOMC of the nature above described.