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

August 8, 1979

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann M.A.

Attached is a memorandum from Messrs. Keir and Sternlight, dated today, and entitled " Implementation of the New Legislation on Direct Treasury Borrowing from the Federal Reserve".

It is contemplated that this memorandum will be discussed at the meeting of the Committee on August 14, under agenda item 11.

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TO: Federal Open Market Committee

FROM: The FOMC Staff (Messrs. Keir & Sternlight

SUBJECT: Implementation of the New Legislation on Direct Treasury Borrowing from the Federal Reserve

Legislation, enacted in June, renewing the Treasury's authority to borrow (up to $5 billion) directly from the Federal Reserve has substantially modified the conditions under which use of this direct borrowing authority is permitted. Under the new arrangement Federal Reserve credit can be advanced directly to the Treasury only in "unusual and exigent circumstances" when authorized by the Board of Governors with at least five affirmative votes. In all other circumstances the changed legislation limits Federal Reserve assistance to the Treasury to the lending of securities from the System portfolio. The Treasury is expected to sell these securities in the open market to obtain needed cash and is required to repurchase and return the borrowed securities to the Federal Reserve within 6 months. The $5 billion ceiling on Federal Reserve assistance applies to the combination of security borrowing and direct cash assistance.1/

Under previous procedures, the direct borrowing authority was used on a number of occasions to cover short-term Treasury overdrafts incurred just prior to a large tax receipt dates. When it was determined that the Treasury had incurred an overdraft on the previous day, the Treasury arranged to sell a special certificate of indebtedness to the System,as of

1/ This security borrowing procedure was included in the new legislation at the request of Congressman Hansen. He apparently feared that reserves released to the banking system by the traditional arrangement would tend to pump up the money supply. He recommended the new procedure of borrowing securities for resale in the market because it transfers funds from the public to the Treasury and does not add (by itself) to the supply of reserves.

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the previous day; thus the overdraft was, in effect, eliminated. In situations where the cumulative total of special Treasury borrowing approached the $2 billion currently authorized by the FOMC, additional authorization had to be obtained from the FOMC to lend in excess of this total (up to the $5 billion statutory limit). Repayment was required within a month, although actual repayments typically occurred within a few days.

Under the new legislation, Treasury cash borrowing directly from the System can be arranged only after the Board, with an affirmative vote of at least five members, has determined that "unusual and exigent circumstances" justify this assistance. From the legislative history of the amended act it is not wholly clear whether the Board must make this determination in each instance of Treasury need, or whether it can specify general guidelines that delegate authority for deciding what is "unusual and exigent" to the Account Manager. While a fairly strong legal case can be made for the first of these interpretations, once the Board has made its decision whether to authorize Treasury borrowing directly from the System, the implementation of such borrowing can be carried out as before by the System Account Manager.

The other principal change in the new legislation is the provision which permits the Treasury when confronted with the prospect of an overdraft to borrow securities from the System portfolio without the need for prior Board approval. It seems unlikely that the Treasury would ever use this approach, however, since it appears that it can issue cash management securities on its own within the same time frame. Moreover, it could

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not get around a debt ceiling problem by borrowing securities from the Federal Reserve, since any such borrowing would also be subject to the debt limit.

To adjust FOMC procedures to this changed legislation, it is necessary to revise paragraph 2 of the authorization for domestic open market operations: (a) to provide for the lending of securities from the System portfolio to the Treasury; and (b) to limit Treasury cash borrowing directly from the System to occasions expressly authorized by the Board of Governors, with an affirmative vote of not less than five members. Draft revisions of paragraph 2 designed to accomplish these changes are presented below for FOMC consideration in capital letters and strike-through form.

> "The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (or, under special circumstances, such as when the New York Reserve Bank is closed, any other Federal Reserve Bank) (a) TO LEND TO THE TREASURY SUCH AMOUNTS OF SECURITIES HELD IN THE SYSTEM OPEN MARKET ACCOUNT AS MAY BE NECESSARY FROM TIME TO TIME FOR THE TEMPORARY ACCOMMODATION OF THE TREASURY, UNDER SUCH CONDITIONS AS THE COMMITTEE MAY SPECIFY; AND (b) to purchase directly from the Treasury FOR RENEWABLE PERIODS NOT TO EXCEED THIRTY DAYS, WHEN AUTHORIZED BY THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM PURSUANT TO AN AFFIRMATIVE VOTE OF NOT LESS THAN FIVE MEMBERS, for its own account (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury, provided that the rate charged on such certificates shall be a rate 1/4 of 1 percent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases."

Proposed guidelines for Desk implementation of the new security lending part of this revised paragraph 2 are presented in the Appendix.

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Background

The Treasury's direct borrowing authority was first enacted in 1942 to help facilitate the financing of World War II. Since then, the authority has been used on only 45 occasions. In every instance the volume of funds borrowed was well under the maximum permitted by law and the borrowing was terminated in a very short time.

Most of the occasions in which the authority was used were ones in which the Treasury, facing a sharp temporary drop in its balance just prior to a quarterly tax payment date, decided to borrow directly from the Federal Reserve for a few days rather than raise funds in the market. In recent years, however, the Treasury has relied increasingly on short-dated cash management bills to cover projected low points in its cash balance. As a result, its use of the direct borrowing authority has become rare. The two occasions when the borrowing privilege has been used since 1975 were both periods in which the Treasury's temporary debt ceiling was about to elapse. To help bolster balances just prior to expiration of the ceiling, the Treasury borrowed directly from the Federal Reserve. These loans were repaid as soon as new debt ceiling legislation was passed.

Although the historical record shows that the direct borrowing authority has been used infrequently for only limited periods, the authority was, nevertheless, amended (as noted) by the last Congress to insure that its use remains limited. Board and Treasury officials in their comments on the amended legislation pointed to the record of sparing use of the old direct borrowing authority and assured the Congress that the old authority was subject to tight control by the FOMC and would not be abused. It was

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also pointed out that the Treasury, in periods when it needs to raise cash quickly to cover a short-term drain on its balance, will probably prefer to issue cash management bills rather than borrow securities from the Federal Reserve and sell them in the market. Despite these assurances, the Congress elected to amend the law.

While the new legislation is more restrictive, it does not present serious problems for Treasury cash management or for operation of the System's open market account. Direct borrowing is still clearly available for use in any national emergency, which was the reason it was first introduced. The relatively infrequent use made of the old borrowing authority indicates that the Treasury, with the development of its cash management bill technique, can generally meet its short-term cash requirements without need for Federal Reserve assistance. Moreover, since the issuance of cash management bills appears to be a more efficient method of raising funds on a short-term basis than borrowing securities from the Federal Reserve for resale in the market, it appears that this new authority will seldom be used.

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APPENDIX

Lending of System Securities to the Treasury

The Congress has amended the Federal Reserve Act to authorize the Federal Reserve Banks, subject to the direction and regulations of the Federal Open Market Committee, to lend U. S. obligations to the Secretary of the Treasury so that the Treasury can sell those securities in the market to meet short-term cash requirements. While the practical usefulness of this new procedure is uncertain--since it appears that the Treasury would ordinarily prefer to sell a new issue of securities in the market--to provide maximum flexibility for contingencies (and since the authority for the new procedure has been established by law), it seems appropriate to have the machinery set up so that the technique of lending securities to the Treasury could be employed on short notice if desired.

In the event the Treasury should seek to borrow System-owned obligations, the following guidelines are proposed to supplement the amended authorization presented on page 3 of the preceding memo. The intent is to establish procedures that will parallel, to some extent, the guidelines applicable in the past to direct Treasury borrowings of funds from the Federal Reserve, as well as the procedures now applicable to Federal Reserve lending of securities to primary dealers in Government securities:

1. Securities loaned to the Treasury would be limited to issues of Treasury bills in a maximum amount of $2 billion par value without additional Committee approval. Should Treasury require a larger amount, the Manager could seek the approval of the Committee for the additional amount up to the $5 billion legal limit set by Congress.1/

1/ The $5 billion statutory limit applies to the combination of securities loaned and cash loaned, but the two forms of assistance would probably not occur together.

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2. The term of any one loan would be for a maximum of 15 business days without prior Committee approval. Should Treasury requirements indicate a need longer than 15 business days, the Manager could seek Committee approval for any extension of the loan within the legal limit of six months set by Congress. (The Treasury would normally repay within 15 days, with proceeds of its own market borrowing or net cash receipts.)

3. The Treasury would pay a fee to the Federal Reserve for the borrowed securities at a rate of 1/4 of 1 percent per annum. (See subsequent discussion of this point.)

4. The Treasury would be required to pledge collateral to the System to be held in lieu of the securities out on loan. A non-interest bearing note equal to the par value of the Treasury bills borrowed would meet this requirement.

5. The loaned securities will be deducted from the New York Reserve Bank's participation in the System Account (or, under special circumstances, such as when the New York Reserve Bank is closed, the participation of any other Federal Reserve Bank or Banks.)

In discussions with Treasury officials, they have indicated disagreement with the suggested 1/4 percent charge for borrowing securities (item 3). The rationale for proposing a modest charge of this type is that it would seem to preserve an appropriate arms-length (though still closely coordinated) relationship between the Treasury and the Federal Reserve. The Treasury would also of course pay an interest rate to the market in order to borrow funds against the Federal Reserve's securities. (Such a rate would probably be similar to the rates the Fed pays when reserves are absorbed through short-term matched sale-purchase transactions.) At the same time the Fed would continue to earn interest on the securities it temporarily loaned to the Treasury. The dollar amounts involved in a fee of, say, 1/4 percent per annum, would be modest. For example, on a $2 billion overnight loan, the fee works out to about $14,000.

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The charge of 1/4 percent would be much less than the 1-1/2 percent rate charged by the Fed to lend securities to primary dealers to avert delivery failures. The smaller charge to the Treasury seems quite appropriate, since the lending charge to dealers has been set deliberately at a level designed to encourage the dealers to look elsewhere for lendable securities before turning to the Fed. But it also seems consistent with the program for lending securities to dealers that there be at least some modest charge to the Treasury. The suggested charge would also be less than the 1/2 to 3/4 percent charge typically set by commercial banks or other private institutional lenders for such loans.

It is argued in opposition by Treasury representatives that no charge should be made,since the Treasury would already be paying a market price to borrow funds when it sells the borrowed securities in the market. The Congressional intent in setting up the new procedure was to make sure the Treasury met "the test of the market" and they would be doing this by selling the borrowed securities. To add another 1/4 percent would mean that the proposed 1/4 percent fee provides the Treasury with an incentive to sell new securities in the market, rather than borrowing existing securities from the Federal Reserve for resale.

On balance, the Account Management would prefer that a fee be charged, as proposed, but there would be no great problem if the Committee decided against including this feature.