



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

March 17, 1981

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

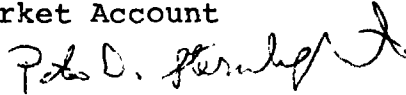
FROM: Murray Altmann *M.A.*

Attached are memoranda relating to the scheduled review of System lending of securities, from the Manager for Domestic Operations dated March 10, and from the Committee's General Counsel dated March 16. These memoranda will be discussed at the forthcoming meeting of the Committee.

Attachments

March 10, 1981

To: Federal Open Market Committee Subject: Annual Review of System
From: Peter D. Sternlight Lending of Securities
 Manager for Domestic Operations
 System Open Market Account



Attached is a statistical report on the lending to dealers of Treasury securities held in the System Open Market Account since the last annual meeting of the Federal Open Market Committee in March 1980. The data show a decrease in the number of loans made, although the average size of loans has increased. Market delivery failures, which the lending facility is designed to alleviate, rose somewhat in calendar year 1980 and the dealers were slower in returning securities than in recent years, so the daily average volume of System loans outstanding rose by 44 percent to \$199 million.

Dealer volume of trading activity again reached record levels in 1980. Trading turnover surpassed the previous record volume of 1979 by almost 40 percent, to a daily average level of approximately \$18.3 billion, as the market attempted to distribute the large amount of securities issued by the Treasury in its financing operations in a highly volatile period. Given this extraordinary increase in trading activity, it is surprising the volume of loans and delivery failures have not risen substantially. The volume of trading may have put strains on the automated clearing mechanism for Government securities as the incidence of computer disruptions throughout the System increased to the point where the dealer community views these disruptions as the rule rather than the exception. It

should also be noted that a computer disruption could cause a chain reaction that could multiply an original fail several times, slowing the entire process, which may account for the slower rate of return of loans and the higher balances.

There is no question that the System lending plays a useful role in helping to hold down the volume of delivery failures, and in relieving clearing pressures as the System's wire network is being pushed to and sometimes beyond its capacity. As such, I believe the lending operation can be said to be reasonably necessary to the smooth functioning of the market in which the System conducts Open Market Operations. I therefore recommend that the Committee renew the authorization to lend securities for another year.

The overall operation continues to be profitable. Earnings for the Federal Reserve Bank of New York in 1980 amounted to \$3,017,948. This figure is up about 45 percent from 1980 paralleling the increase in the average balance outstanding. Estimated expenditures needed to run the lending operation amount to less than 10 percent of earnings.

Attachment

STATISTICS ON FEDERAL RESERVE
LENDING OF SECURITIES
(dollars in millions)

	<u>March 1979 through Feb. 1980</u>	<u>March 1980 through Feb. 1981</u>	<u>Percentage Change</u>
Number of Loans	10,641	10,009	- 6
Total Amount	\$19,663	\$25,198	+28

DAILY AVERAGES

Number of Loans	43	40	- 7
Amount	\$ 79.0	\$ 101.6	+29
Balance Outstanding	\$ 138.0	\$ 198.7	+44
Size of Each Loan	\$ 1.8	\$ 2.5	+39

DEALER FAIL STATISTICS

	<u>1979</u>	<u>1980</u>	
Daily Average Fails to Receive	452	500	+11
Daily Average Fails to Deliver	358	404	+13

March 16, 1981

To: Federal Open Market Committee

Subject: Review of System

From: Neal Petersen 

Lending of Securities

I have reviewed the memorandum dated March 10, 1981 from the Manager for Domestic Operations System Open Market Account to the Committee recommending that the Committee renew for another year, or until the next annual meeting of the Committee in March 1982, the authorization contained in paragraph 3 of the Authorization for Domestic Market Operations for the lending to dealers of Treasury securities held in the System Open Market Account.

The Manager's report notes a decrease in the volume of loans made from the 1979 level, although the average size of loans increased. In this connection the Manager indicates that market delivery failures, which the lending facility is designed to alleviate, rose somewhat during 1980 resulting in the daily average volume of System loans outstanding increasing by 44 per cent to \$199 million over the 1979 figures.

The Manager's report emphasizes the volume of trading activity which again reached record levels in 1980. The trading turnover surpassed the previous record volume in 1979 by almost 40 per cent to a daily average level of approximately \$18.3 billion, reflecting the large amount of securities issued by the Treasury in its financing and refinancing operations in a highly volatile period. The Manager suggests that this increased volume may have put strains on the automated clearing mechanism for Government securities and notes that the incidence of computer disruptions throughout the System increased in 1980 to the degree that the dealer community viewed these disruptions as more normal than the exception. The Manager suggests that such computer disruptions could cause a chain

-2-

reaction that could multiply an original failure by several times and that this possibility may account for the slower rate of returns and their higher balances.

Given the increasing volatility of the market and the continued risk of serious fails in that market, and the useful role that System lending plays in holding down the delivery failures and in relieving clearing pressures, the Manager recommends that the Committee renew the authorization to lend securities for another year as reasonably necessary to the smooth functioning of the market in which the System conducts Open Market operations. In this regard the Manager notes that this activity is cost effective and continues to be profitable.

Based upon the Manager's report it would be reasonable for the Committee to conclude continuation of the System lending activity for the ensuing year will aid in the efficient functioning of the Government securities market in which the Manager operates in executing the Committee's directives, and that the elimination of this authorization could cause possible dislocations to market mechanisms which could adversely affect the System's conduct of Open Market operations. Accordingly, on the basis of the representations in the Manager's report it is my opinion that the Committee could find that the lending of securities from the System account to dealers and clearing banks is reasonably necessary for the effective conduct of Open Market operations, and that the continued lending of System securities, as authorized by the Authorization for Domestic Open Market Operations is within the "incidental powers" of the Reserve Banks pursuant to section 4 of the Federal Reserve Act.