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

March 9, 1972

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Broida

Enclosed is a memorandum from the System Account Manager, dated today and entitled "Operations in Government Agency Securities." The memorandum reviews the Desk's experience since it began outright operations in agency securities and presents a recommendation for a revision of the guidelines governing such operations.

It is contemplated that this memorandum will be discussed at the meeting of the Committee on March 21, 1972.

Arthur L. Broida

Arthur L. Broida,
Deputy Secretary,
Federal Open Market Committee.

Enclosure

CONFIDENTIAL (FR) March 9, 1972

TO: Federal Open Market Committee

FROM: Alan R. Holmes SUBJECT: Operations in Government Agency Securities.

This memorandum reviews, for the information of the Committee, the experience of the Trading Desk since it began operations in Federal Agency securities.

Outright purchases and sales of United States Government Agency securities by the System Account were authorized by the Federal Open Market Committee at its meeting on August 24, 1971 under certain guidelines designed to limit the extent of the System's involvement and the impact of its operations on the Agency market. Until then, Agency issues could be acquired only temporarily under repurchase agreements with dealers. Since the authorization was given, the Desk has purchased a total of $806.6 million Agency issues on seven occasions, using the "go-around" method of soliciting offerings in each case. The last purchases were made on February 14, 1972.

Beginning on Thursday, February 17, the Desk was faced with the prospective need for a very large absorption of reserves over the period through mid-March. As part of the program, it was decided to sell some short-term Agency issues in conjunction with sales of Treasury bills on Tuesday, February 22. In a go-around, dealers were asked to bid for Treasury bills for cash and for "a modest amount of Agency issues due within six months for regular delivery". The dealers responded with bids for about $700 million of the Agencies and the Desk sold $53.9 million. The market impact attributable to the Agency sales was very modest. Most dealers apparently welcomed the opportunity to buy Agencies from the System under the market conditions then prevailing.

After allowing for the sales and for the redemption of $14.5 million short-term issues that matured during the period, System holdings of Agency issues on February 23, 1972 were $738.1 million. These holdings included securities of eight Agencies -- the largest holding of any one Agency's securities was $465 million of FNMA issues (see attached table).

Purchases of Agency issues were begun on September 23, 1971 after the guidelines had been made public and explained in detail to the dealers. The first two go-arounds were limited to only part of the maturity range, and the Desk avoided buying a large number of individual issues, in order to enable the Reserve Bank accountants to gain some experience in handling the issues before embarking on full-scale operations. In the succeeding five go-arounds, the request for offerings was for most, or all, eligible outstanding issues (in some operations very short maturities were excluded) and there was no longer any attempt to limit the number of issues acquired and held in the System Account.

The five months' experience indicates that up to the present System operations have been taken well in stride by the Agency market. The net absorption of over $700 million of Agency securities by the System was only a small offset to the net increase of almost $4.3 billion in total Agency issues outstanding. To some modest degree, System purchases thus contributed to the market's absorption of this huge amount of new financing by the Agencies. Prices of Agency issues temporarily responded moderately to some of the System's go-arounds but there did not seem to be any great change in the status of Agencies as an investment merely because they had become instruments suitable for System open market operations. The spread between yields of Agencies and comparable maturities of

Government securities on February 23, 1972 did not change significantly from September 23, 1971 except for a narrowing in the short-term area, apparently a result of the acute scarcity of all short-term paper in the market. On the other hand, given the large volume of Agency financing, it is possible that yield spreads over Treasury issues might have widened in the absence of System purchases. There was no indication that System operations had any undue influence on the pricing of new Agency issues offered during the period. Perhaps because of fortuitous timing, the Desk did not feel inhibited at any time when it desired to buy Agencies because of new financing by some individual Agency, but this absence of restraint cannot necessarily be counted on at all times in the future.

In the first six go-arounds insured notes of the Farmers Home Administration were not considered by the Desk to be eligible for purchase because of inadequate evidence of an active secondary market in those issues (a requirement of the guidelines). Based on evidence submitted by several of the dealers, and transfer records kept at the Federal Reserve Bank of New York, it was concluded recently that a reasonably active secondary market had developed in these issues. Therefore, in the last purchase go-around, the FHA notes were included in the request for offerings and approximately $2.5 million were purchased.

Throughout the period, the basic accounting records relating to par value, interest accruals, amortization of premium or discount, and earnings have been kept by hand while awaiting the development of a computer program to handle the work. However, the existing computer program has been able to participate aggregates of these items among the Reserve Banks. It is expected that a new computer program will be completed shortly, thereby relieving the current burden of manually accounting for the Agency portion of the System Account.

Some other practical problems -- while not serious -- have occurred in handling the Agency operations and should be brought to the Committee's attention. Because of the large number of individual issues involved, and the tendency for some dealers to make a number of small offerings of the same issue on a price scale, go-arounds in Agency issues have tended to take longer to complete than is the case for Government securities. Meanwhile, the Agency market is practically immobilized while the dealers await the acceptance or rejection of their offerings by the Desk. This has been dealt with by placing some limits on the time allowed for the dealers to present their offerings after the Desk initiates a go-around. Nevertheless, the operations still take longer than those in Government coupon issues. Delivery failures are more frequent because of the extremely limited opportunities for the dealers to borrow Agency issues. Consequently, temporary substitutions of other securities on deliveries to the System are more numerous than in Government securities, which are much larger issues and, therefore, more easily borrowed. This, of course, complicates deliveries and adds to the work in all areas of the bank involved. The delivery failures sometimes occur because, unlike Government securities, most Agency issues cannot be transferred over the System wire service so that dealers can only deliver securities physically held in New York.

Another potential problem arises out of the Committee's guideline governing Agency purchases that limits System holdings of any one issue to 10 percent of the amount of that issue outstanding. The limit has already been reached for two issues, one a $403 million FICB and the other a $250 million FNMA issue. This has, in effect, removed these issues from the list of those eligible for future System purchase. As additional operations are undertaken, more and more issues will be affected by this limitation. While a limit as low as 10 percent seemed reasonable when the System launched its Agency operations, the demonstrated ability to operate in this market on a moderate, nondominating scale makes it appropriate to review the limitation in light of the recent experience and of the prospective attainment of the 10 percent figure in more and more cases. In view of these considerations, the Account Management recommends that the Committee revise the limit on System holdings to 25 percent of any issue, with the understanding that the Desk would approach this higher limit more slowly than was the case with the 10 percent level. (It may be noted in this connection that System holdings of Treasury bill issues constitute about 30 percent of the total amount outstanding, with holdings of some issues reaching 47 percent. In the case of Treasury coupon issues outstanding in total amount of up to $1.5 billion System holdings range up to nearly 20 percent of the total outstanding, while for some of the larger Treasury coupon issues the System's proportion is 50 percent or higher.)

Attachment

PURCHASES AND SALES OF AGENCY ISSUES
SEPTEMBER 23, 1971 - FEBRUARY 23, 1972
(in thousands of dollars)

	COOP	FHLB	FICB	FLB	FNMA	GNMA	EX-IM BANK	FHA	TOTAL
Purchases									
1971 - Sept. 23	1,000	12,600	17,000	12,400	18,000	-	-	-	61,000
30	-	7,850	-	-	27,030	-	-	-	34,880
Nov. 5	-	23,450	14,575	5,500	35,205	4,200	-	-	82,930
26	5,625	19,300	51,335	3,815	75,765	5,000	-	-	160,840
Dec. 16	17,200	12,550	39,020	13,275	45,315	9,300	8,700	-	145,360
1972 - Jan. 5	-	9,200	-	10,900	143,055	4,000	5,600	-	172,755
Feb. 10	550	11,530	2,100	9,270	120,855	-	2,000	2,502	148,807
Total Purchases	24,375	96,480	124,030	55,160	465,225	22,500	16,300	2,502	806,572
Sales									
1972 - Feb. 22	10,000	-	38,935	5,000	-	-	-	-	53,935
Redemptions	8,025	-	6,475	-	-	-	-	-	14,500
Holdings- Feb. 23, 1972	6,350	96,480	78,620	50,160	465,225	22,500	16,300	2,502	738,137