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

March 13, 1979

CONFIDENTIAL (FR)
CLASS II-FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann M.A.

Attached are memoranda relating to the annual review of System lending of securities, from the Deputy Account Manager dated March 5, and from the Committee's Assistant General Counsel dated March 9. These memoranda will be discussed at the forthcoming meeting of the Committee under agenda item 12.

Attachments

March 5, 1979

TO: Federal Open Market Committee

FROM: Peter D. Sternlight
Deputy Manager
System Open Market Account

SUBJECT: Annual Review of System Lending of Securities

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 1978. The data show an increase in both the number and total dollar volume of loans processed by the Desk. Largely reflecting the increased dollar volume of new loans, daily average loans outstanding rose by 22 percent to $193 million. Market delivery failures, which the lending facility is designed to alleviate, decreased somewhat in calendar year 1978, as did the volume of trading activity. Delivery failures still remained high, however.

The growth in System loans occurred during a period of rising interest rates, an environment in which failures became increasingly costly to the dealer market. Trading activity in Treasury securities declined from the previous year's record by 4 percent, to a daily average of about $10.3 billion.

A variety of factors probably account for the growth in loans of securities.

1. A year of increasing monetary restraint caused banks, which are usually a major source of lendable securities, to reduce

their holdings of Government securities and to use securities intensively as collateral to borrow funds under repurchase agreements.

2. Other holders of Treasury issues also apparently used their holdings more actively to raise funds through repurchase agreements, as such funds could be reinvested in other instruments at a pick-up in yields.

3. During much of the year, Federal Reserve open market operations tied up large amounts of collateral, especially at times when Treasury balances rose to high levels at the Federal Reserve. Late in the year, this problem was relieved when the Treasury instituted its program of note balances at commercial banks, but under that program the banks had to collateralize the new note balances--in part with Treasury issues.

4. As the dollar came under heavy pressure in the foreign exchange markets and foreign central banks acquired dollars, a large part of these takings were reinvested in short-term marketable Treasury oblications--thus depleting market supplies, especially of short bills.

5. Dealers' expectations of rising rates caused them to hold only minimal inventories. While the System does not lend to a dealer to deliver securities he has sold short, the prevalence of very small positions, and of efforts at times to cover short positions, tends to aggravate delivery problems.

In combination, the factors cited above caused pressures in the borrowed securities market to increase last year. In the view of the System Account Management, the System's lending program helped to relieve these pressures, and thus materially assisted the smooth functioning of the market. Without the lending facility, the volume of delivery failures could be expected to rise and the market would not work as efficiently as it has in the past. Accordingly, in our view the lending of securities remains reasonably necessary to the efficient functioning of the market in which we conduct Federal Reserve open market operations. We therefore recommend that the Committee renew the authorization to lend securities for another year.

We feel that our present scale of loan charges poses an adequate incentive to dealers to seek out other sources before turning to the Federal Reserve. These charges start at 1 1/2 percent, compared to the 1/2 to 3/4 percent typically charged by other lenders, and escalate to 6 percent if the loan period is extended. Even so, we plan to intensify our efforts to remind dealers that the facility is meant only to supplement normal sources for borrowing securities and is not to be considered a primary resource.

The overall operation continued to be profitable. Earnings for the New York Bank in 1978 amounting to $2,972,762, an increase of about 24 percent from 1977. Estimated expenditures needed to run the lending operation amount to less than 10 percent of earnings.

Statistics on Federal Reserve
Lending of Securities
(dollars in millions)

	March 1977 through Feb. 1978	March 1978 through Feb. 1979	Percentage Change
Number of Loans	8,048	10,080	+25
Total Amount	$20,297	$24,215	+19

Daily Averages

Number of Loans	32	40	+25
Amount	$ 81.8	$ 96.9	+18
Balance Outstanding	$ 158.3	$ 193.1	+22
Size of Each Loan	$ 2.6	$ 2.4	- 8

Dealer Fail Statistics

	1977	1978	
Daily Average Fails to receive	$453	$354	-22
Daily Average Fails to delivery	$342	$283	-17

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March 9, 1979

TO: Federal Open Market Committee

SUBJECT: Review of System Lending of Securities.

FROM: Robert E. Mannion
Assistant General Counsel

In a memorandum dated March 5, 1979, the Deputy Manager of the System Open Market Account recommends that the Committee renew for a period of one year the authorization contained in paragraph 3 of the Authorization for Domestic Open Market Operations for the lending of securities from the System Open Market Account. The Deputy Manager's reports indicate an increase in the Desk's lending to dealers during 1978, and it is clear that the Desk's ability to lend against normal delivery problems constituted a cost effective and reasonable support of open market operations. Absent the System's lending of Treasury securities, the report concludes that the government securities market would not function as efficiently as it does and that continuation of the lending facility is reasonably necessary to the efficient functioning of the market in which Federal Reserve open market operations are conducted. The Deputy Manager recommends that the authorization to lend securities be renewed for another year.

On the basis of the Deputy 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.