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

September 12, 1979

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 September 10, and from the Committee's General Counsel dated September 12. These memoranda will be discussed at the forthcoming meeting of the Committee under agenda item 8.

Attachments

September 10, 1979

TO: Federal Open Market Committee

SUBJECT: Review of System Lending of Securities

FROM: Peter D. Sternlight PDS
Manager for Domestic Operations
System Open Market Account

Attached is a statistical report on the recent history of the lending to dealers of Treasury securities held in the System Open Market Account. The report indicates a modest contraction in the number of loans made and a rather substantial drop in the daily average dollar amount of loans and in the average balance outstanding since the annual meeting of the Federal Open Market Committee in March 1979. This decline in activity occurred during a period when the volume of trading in Treasury securities surpassed the record volume $10.9 billion in 1977 to reach a daily average of approximately $12.6 billion, an increase of about 16 percent.

The table also gives the System lending activity and trading volume statistics over the last five to six years. The number and amount of System loans is less now than in the 1974-1975 period even though trading activity has increased about 300 percent. The number of dealers who have the privilege of borrowing from the System portfolio has also increased from about 28 in 1974 to 35 at present.

Reviewing the past several years, the System's lending activity has not kept pace with the rise in total trading volume or the increased number of dealers the Desk does business with. Two factors help to explain this situation. First, our basic loan charge of 1 1/2 percent, which is about 3/4 to 1 percent higher than other sources, has provided an incentive to dealers to find other sources before turning to us. Second, we have pointedly encouraged those dealers who used the facility relatively actively to seek out borrowing from other sources.

Over the years the Account Management has noted a number of factors that we feel have influenced the volume of our lending operations--increasing trading volume, large Treasury borrowing needs, scarcities of securities in the hands of traditional lenders, and occasional delivery delays due to computer problems inside and outside the Federal Reserve system. By and large, these factors are still present today. For instance recent computer problems have caused delays in transferring securities and many of the dealer borrowings are related to these either real or anticipated delays in receipt of securities. Most borrowings from the System portfolio are returned within one or two days and dealers have indicated to us that many of their borrowings are precautionary in nature--made when they anticipate that securities, if received at all, would come too late in the day to be able to effect redeliveries.

While the System's lending of securities does not solve all the delivery problems in the market, I do feel that it provides a reliable last resort source of lendable securities, thereby preventing more severe dislocations to the market mechanism. Should this source of securities be eliminated or made to be so costly as to become useless I believe it would have a noticeable adverse impact on the market in which we carry out the Committee's directives. In this sense, I believe that the lending facility continues to be reasonably necessary to the implementation of System open market operations.

At the same time, the lending of securities continues to be a profitable operation. At the Federal Reserve Bank of New York alone (which effects the bulk of the loans) income from loans of securities during the January - August 1979 period was about $1.15 million--providing an annual rate of income of about $1.73 million. While this income rate would be down about 41 percent from 1978, roughly paralleling the decline in the daily average outstanding balance, the income is still far in excess of expenses--which have been running at slightly under 10 percent of the receipts figure.

Based on the foregoing considerations I recommend that the current lending authorization be renewed until the next annual meeting of the Committee in March 1980.

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

	March 1978 through February 1979	March 1979 through August 1979	Percentage Change
Number of Loans	10,080	4,830	
Total Amount	$24,215	$8,599	

Daily Averages

	March 1978 through February 1979	March 1979 through August 1979	Percentage Change
Number of Loans	40	38	- 5
Amount	$ 96.9	$ 67.2	-31
Balance Outstanding	$193.1	$ 102.1	-47
Size of each Loan	$ 2.4	$ 1.7	-29

Dealer Fail Statistics

	1978	Jan.through July 1979	
Daily Average Fails to receive	$354	$306	-14
Daily Average Fails to deliver	$283	$288	+ 3

Daily Averages

	# of loans	Amount	Outstanding Balance	Size
Mar.74 - Feb.75	45	$77.8	$150.5	$1.7
Mar.75 - Feb.76	40	$72.1	$131.1	$1.8
Mar.76 - Feb.77	38	$82.4	$144.4	$2.2
Mar.77 - Feb.78	32	$81.8	$158.3	$2.6
Mar.78 - Feb.79	40	$96.9	$193.1	$2.4
Mar.79 - Aug.79	38	$67.2	$102.1	$1.7

Daily Average Dealer Transactions
(in billions)

	1974	$ 3.6
	1975	$ 6.0
	1976	$10.5
	1977	$10.9
	1978	$10.3
(Mar.-Aug.)	1979	$12.6

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September 12, 1979

TO: Federal Open Market Committee

FROM: Neal L. Petersen
General Counsel NLP

SUBJECT: Review of System Lending of Securities

I have reviewed a memorandum dated September 10, 1979 from the Manager for Domestic Operations of the System Open Market Account to the Committee recommending that the Committee renew until the next annual meeting of the Committee in March 1980 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 number of loans made, the daily average amount of loans, and the average balance outstanding since the annual meeting of the Committee in March 1979. Nevertheless, the report supports the conclusion that the Desk's ability to lend against normal delivery problems constitutes a cost-effective and reasonable support of Open Market operations.

In that regard the report indicates that the System's lending of securities provides a reliable last resort source of lendable securities thereby preventing more severe dislocations to the market mechanism occasioned by real or anticipated delays in the receipt of securities by dealers. Therefore, the conclusions in the report that the Government securities market in which the Federal Reserve Open Market operations are conducted would not function as efficiently as is presently the case without the continuation of the lending facility and that elimination or increase in the cost to dealers of the facility would have a noticeable adverse impact on the market in which the Desk operates to carry out the Committee's directives are reasonably supportable.

Accordingly, on the basis of 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.