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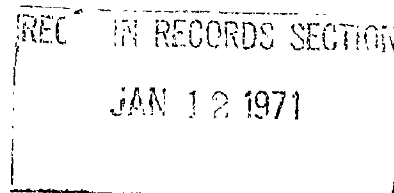
BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551



January 11, 1971

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Broida

Enclosed are (1) a memorandum from the staff dated today and entitled "Euro-dollar problem: Federal Reserve matched-sale purchase transactions," and (2) a memorandum from Mr. Hackley dated January 8, 1971, and entitled "Legality of 'matched sale-purchase transactions' to induce banks to retain Euro-dollar holdings."

It is contemplated that a preliminary discussion of these materials will be held at the meeting of the Committee tomorrow, at the conclusion of the discussion of monetary policy.

It is requested that these materials be held in strict confidence.

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

Enclosures

Note: The second copies enclosed are for the use of the Adviser accompanying you from your Bank.

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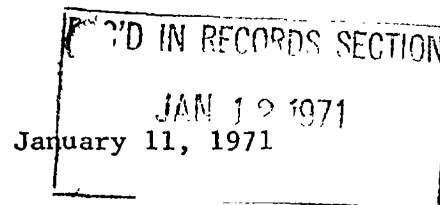

January 11, 1971

TO: Board of Governors

FROM: Division of International Finance

SUBJECT: Euro-dollar problem: Federal Reserve matched sale purchase transactions

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This memorandum outlines the technical characteristics of Federal Reserve matched sale-purchase transactions with member banks designed to help moderate repayments of Euro-dollars. Sales would be made from the System's portfolio of U.S. Government securities with offsetting purchase contracts to buy the securities back at specified future dates. The effectiveness of the matched sale purchase transactions (MSP's) (and of a special Ex-Im security issued to achieve the same objective) would be increased if certain amendments which are set forth below were made in the Board's Regulation M.

An amendment by the FOMC to its continuing authority directive would be required to implement the proposal.[1/]

In the judgment of the staff, it would be most efficient for the FOMC to specify in its continuing authority directive certain general criteria for MSP transactions, such as the method of allocation to member banks, an outside limit on the maximum outstanding volume of matched sales purchase transactions, the maximum maturity of the instrument, and the maximum interest rate spread allowable between sale and

1/ Draft language appears in the Appendix.

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repurchase price. Responsibility for making other decisions on the MSP program might then be delegated to a subcommittee, whose decisions would be dictated by operating experience.

Recommended Program:

It is recommended that the FOMC authorize a total outstanding volume of MSP's of $1-1/4 billion initially; as necessary, the Trading Desk could make such agreements at a rate of $300 million a week over the course of a month. It is recommended that FOMC require that the MSP be allocated to banks in proportion to their outstanding Euro-dollar liabilities to branches (plus branch holdings of MSP's and Ex-Im Bank securities) in the most recent computation period; reasons for rejecting other possible methods of allocation are discussed below.

The recommended maturity for the MSP (once the introductory period is passed) is four weeks, with maturity to fall shortly after the end of a computation period in order to adjust banks' holdings of MSP's to their Euro-dollar liabilities as quickly as possible. It is recommended that the Federal Reserve fix an appropriate yield spread for each offering of MSP's over the one-month Euro-dollar deposit rate, perhaps beginning with a spread of 1/8 percentage point.

Through MSP transactions, and through sale of high-yield Ex-Im Bank securities, allocated to banks along the lines set forth above, the Federal Reserve, and the U.S. Government, would share with

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the banks the cost of the Euro-dollar borrowings of their branches in excess of amounts relent abroad. The share borne by the Federal Reserve or the Government would be influenced both by the yield on the instrument and the volume of such instruments allocated. A total allocation of Ex-Im Bank securities and Federal Reserve MSP's (along the above lines) amounting to $3 billion would eliminate the excess cost on 3/8 of total Euro-dollar liabilities of about $8 billion; this would be equivalent to a cost saving of about 40 basis points on the total amount of borrowings, and may be compared to an estimated cost of Euro-dollars over domestic funds of roughly 1 percentage point.

Consultation with the Division of Research and Statistics and with the Trading Desk indicates that an MSP, patterned along these lines, could be implemented without creating serious problems for the management of domestic open market policy.

Discussion:

The particular characteristics of the proposed MSP to be examined further are the relation of the MSP to requirement-free Euro-dollar bases, the method of allocation to member banks, and the method of pricing the MSP.

Relation to requirement-free bases. The MSP could, as a matter of principle equally well be made with the U.S. head office or with the foreign branch. If the MSP is sold to the head office, there would be

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no necessary reduction in head office liabilities to foreign branches; the head office could purchase the MSP with the funds that otherwise might be used to repay Euro-dollar borrowings from branches. Thus, the bank would retain its requirement-free base, unless it took specific steps to reduce its base.

However, if the MSP were acquired directly by the branch (as would be the case with the Ex-Im security), there would ordinarily be a reduction in head office liabilities to branches as the branch paid for the security by reducing its claim on the head office.

It would be advisable to amend Regulation M to provide specifically that a bank's requirement-free base should not be reduced by amounts of MSP's or Ex-Im securities held by the branch.

Method of allocation. The security should be allocated among banks according to the volume of head office liabilities to branches plus branch holdings of MSP's (and Ex-Im securities) in the most recently completed computation period. This method of allocation would probably provide the best balance of equity and effectiveness. Banks with large outstanding head office borrowings from branches would obtain large allocations; banks that held MSP's at head offices and repaid borrowings following the initial allocation would obtain smaller amounts at future allocations.

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Alternative methods of allocation that attempt to exert additional leverage on banks to maintain borrowings appear likely to involve significant inequities and/or deficiencies in coverage. Two examples are given below (on the assumption that the MSP's are held at head office):

a) MSP's could be allocated in such a way that banks that maintained Euro-dollar borrowings at or close to a recent level (e.g. the average in the December computation period) would receive larger allocations in proportion to their borrowings. Thus, one could provide that banks would receive allocations equal to X per cent of their Euro-dollar borrowings so long as borrowings (in the current computation period) were not more than 10 per cent below the December average, but otherwise allocations would be equal to 1/2 X per cent of borrowings.

This method of allocation would place banks that had maintained borrowings at or close to original base-period levels at a disadvantage compared to banks that had reduced borrowings earlier. A bank that reduced its Euro-dollar borrowings in February 1971 would obtain a smaller allocation than it would have obtained had it made the same reduction in early December. Such a method of allocation would be inconsistent with the commitment in the Board's press release of November 30, 1970:

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> Although the steps announced today were deliberately made of modest scale, the Board has under review other measures that might be adopted for the purpose of tempering the repayment of Euro-dollars while avoiding penalty to banks that operate so as to retain their reserve-free bases.

b) Alternatively, one might provide that banks' eligibility to acquire the MSP would be inversely related to the shortfall of their Euro-dollar borrowings from the original base (May 1969 or November 1970, whicever is higher). Most of the MSP's will, in any event, be allocated to banks that in the December computation period were close to their original historical bases; these banks account for 75-80 per cent of total Euro-dollar borrowings. Allocating them a significantly larger than proportionate share of the MSP's would result in only a minimal allocation for banks that have repaid substantial amounts of Euro-dollars. Yet, these latter banks still have substantial amounts of borrowings outstanding; three major New York City banks that have reduced borrowings by 30-40 per cent from May base levels, still account for about $2 billion of borrowings.

A formula for allocation providing that banks with borrowings of at least 80 per cent of May 1969 bases (or November 1970 bases, if higher) would obtain MSP's equal to X per cent of borrowings, and other banks only 1/2 X per cent of borrowings, would encourage banks not to repay below 80 per cent of the original base, but might well appear to

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sanction repayments down to this level. It would probably be inadvisable to imply sanction of such a reduction (which would total nearly $1-1/2 billion, if it were general.)

It should be noted that there would be little or no basis in equity for application of a formula that used the original May 1969 base--given the widely differing positions of individual banks in May 1969.[1/] Moreover, a special formula would be required for banks that have been using minimum bases (3 per cent of deposits) and are now required to establish historical bases by January 20.

Neither the MSP nor the Ex-Im security should be transferable to other banks, particularly in view of the fact that either would count toward avoiding reduction of a bank's requirement-free base. Transferability would result in sale of the allocations by banks that did not value their bases highly to banks that would retain their bases anyway. Thus, the MSP (or Ex-Im security) would tend to substitute for the most stable component of Euro-dollar borrowings.

Maturity. The MSP is more likely to be an effective technique for inducing banks to retain Euro-dollar borrowings if its maturity is relatively short; the shorter the maturity, the more closely branch or head office holdings of it can be matched to the bank's performance in retaining Euro-dollars.

1/ If an auction technique were used as a method of distributing a limited supply, banks that wished to maintain reserve-free bases anyway would bid most strongly for the securities, since the yield to them on the preferential asset would be pure gravy. As a result, the yield under the auction could be bid down to a point where it was not attractive to banks on the margin between repaying or retaining Euro-dollar borrowings.

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With a maturity of four weeks, holdings could be adjusted following the end of each computation period; banks that repaid borrowings would obtain correspondingly smaller allocations upon maturity of their current holdings.

Pricing. It is recommended that the Federal Reserve set both the sale and the repurchase price on the MSP, as well as specifying an allocation for each bank. These prices would be fixed to provide a yield to the bank equal to the one month Euro-dollar deposit rate plus a small margin (e.g., 1/8 percentage point); at current Euro-dollar rates the yield would be about 6-1/4 per cent. Additional information on appropriate pricing may be obtained from the experience in offering the Ex-Im security.[1/]

An alternative technique that was examined by the staff was for the Desk to solicit bids from each bank for its specified allocation. The bank making the bid would presumably attempt to guess the Desk's reservation price. But given the purpose of the MSP (and the constraint that allocations reserved for one bank would not be offered to another bank), it was not clear how the Desk could arrive at meaningful reservation prices. Thus, it appeared advisable, at least in the initial offerings, for the Federal Reserve to set a price that clearly covered the cost of Euro-dollars plus a reasonable margin.[2/]

1/ The one-month rate would be appropriate both in light of the maturity of the MSP and of the fact that about 45 per cent of the Euro-dollar deposits of foreign branches mature within one month.

2/ Little is known about tax considerations that might affect the willingness of foreign branches to acquire securities. The issue is probably not significant so long as the margin between the yield on the MSP and the cost of Euro-dollars is very small.

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Amount. Although the MSP, as outlined above would provide no special marginal incentive for banks to retain Euro-dollar borrowings, it would lessen the costs to banks of retaining requirement-free bases. (Alternative methods of allocation would provide marginal incentives, but at some cost in coverage or equity; see pages 5-7 above.) The cost sharing could take the form of either a high rate of return (over and above the cost of Euro-dollars) on a small volume of MSP, or a slight margin over the Euro-dollar rate on a larger volume of MSP's. By and large, the latter form of cost sharing would be preferable from the standpoint of minimizing the political risk.

If one assumes total liabilities to branches are $8 billion, an offering of $2 billion of MSP's (at a yield equal to the cost of Euro-dollars to the bank) would eliminate the excess of cost to banks on 1/4 of their total borrowings. This would be equivalent to a cost saving of 25 basis points on the total amount of borrowings. It would be a somewhat greater cost saving on that portion of their Euro-dollar borrowings that the banks are considering repaying, since in any case borrowings would not be repaid completely. If banks repaid $2 billion of borrowings in addition to reducing their liabilities to branches by $2 billion to enable the branches to acquire the securities, the second-round allocation to refund the maturing MSP would provide a larger cost saving: the $2 billion of refunding MSP's would be allocated to banks

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with $6 billion of borrowings (together with maturing MSP's); the cost saving would be 33 basis points on average outstanding borrowings. Thus, it would probably not be necessary to issue MSP's equal to the total volume of borrowings; at some point the cost saving would be sufficient to induce banks to preserve the remainder of their bases.

It would appear that a combined authorization of MSP's plus Ex-Im securities of, say, $3 billion would represent an adequate amount for planning, at least initially. Issuance of this amount would enable the Federal Reserve and the Government together to cover almost one-half of the excess cost of total Euro-dollar borrowings--at the present 1 percentage point cost of Euro-dollars over domestic funds--and to cover a somewhat higher proportion of the excess cost on those borrowings that are potentially subject to repayment. The entire amount may not be required, but the need can best be assessed only after the response of banks to the initial tranches has been determined.

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APPENDIX

Add the following paragraph 4 to the Continuing Authority Directive With Respect to Domestic Open Market Operations:

"4. For the purpose of moderating movements of Euro-dollar liabilities of member banks, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for the System Open Market Account, to enter into special agreements ('paragraph 4 agreements') with member banks providing for the sale of U.S. Government securities by the Reserve Bank to the member bank on a cash or regular delivery basis, and for the purchase by the Reserve Bank from the member bank of the same amount of the same issues of securities within __ weeks or less, subject to the following conditions:

"A. A member bank shall be eligible to buy securities under paragraph 4 agreements in an amount equal to a specified fraction of its (A) daily average deposits described in § 204.5(c) of Federal Reserve Regulation D and (B) daily average net balances described in § 213.7(a)(1) (reduced by the daily average amount of any deposits subject to § 204.5(c)), each for the latest computation period as described in the specified sections. The fraction, which shall be the same for all member banks, shall be specified from time to time by the Federal Open Market Committee, or on behalf of the Committee by the Subcommittee named in paragraph 6 of the authorization for System foreign currency operations.

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"B. The aggregate amount of paragraph 4 agreements outstanding at any one time shall not exceed $__ billion.

"C. Paragraph 4 agreements, which shall be non-transferable, shall specify prices for the sale of securities to the member bank and for the subsequent purchase of securities by the Reserve Bank from the member bank, in such a manner that the net yield to the member bank under the agreement is not more than __ basis points in excess of the current market rate on one-month Euro-dollar deposits.

"D. Within the limitations set forth above, the terms of paragraph 4 agreements, and the timing and size of specific offerings of such agreements, shall be subject to such directions as may be issued from time to time by the Federal Open Market Committee, or on behalf of the Committee by the Subcommittee referred to in paragraph 4A above."

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JAN 12 1971

CONFIDENTIAL (FR)

January 8, 1971.

To: Federal Open Market Committee

From: Mr. Hackley

Subject: Legality of "matched sale-purchase transactions" to induce banks to retain Euro-dollar holdings.

It has been suggested that, as a means of inducing American banks to retain Eurodollar liabilities, the System might offer Government obligations for sale to banks having such liabilities, with a simultaneous agreement to purchase such obligations at a specified date at a rate that would provide the banks with an attractive yield. This memorandum relates to the legality of such "matched sale-purchase" transactions.

Although in form such transactions would involve the sale and purchase of Government securities, it might be contended that in substance they would amount to a borrowing of money by the Reserve Banks and that the Reserve Banks have no authority to borrow money. At times in the past, purchases of securities with agreements to resell them at a certain date (straight "RP's") have been questioned as constituting loans of money rather than legitimate open market operations; but the validity of such transactions now appears to have the legal support of almost 50 years of "administrative practice" known to Congress. Although matched sale-purchase transactions have been used as a tool of domestic monetary policy since 1966 without legal challenge, they are not supported by such a long period of administrative practice.

One of the arguments advanced in the past in support of straight RP's is that, even if they amount to "loans", the Reserve Banks have statutory authority to lend money to both member banks and to individuals, partnerships, and corporations on the security of Government obligations. The Reserve Banks do not, however, have authority to borrow money - which, it might be argued, is the effect of matched sale-purchase transactions.

It might be contended that the proposed matched sale-purchase transactions would not be designed to effectuate legitimate purposes of Federal Reserve open market operations. Traditionally, such operations have been regarded as designed to affect the reserves of member banks and thereby to regulate domestic bank credit. The present proposal would be aimed solely at persuading American banks to retain Eurodollar holdings in order to prevent an outflow of dollars to foreign central banks that might threaten a reduction of the U.S. gold stock. It appears to be conceded that the Desk might have to offset the proposed transactions by substantial purchases of securities in order to effectuate current monetary policy; and this fact suggests that the proposed transactions would not be within the usual concept of open market operations.

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On the other hand, there are considerations that would appear to support the legality of the proposed transactions.

In the first place, although it is not believed to be a strong argument, the transactions would be in the form of sales and purchases of Government securities and thus literally within the scope of the express authority of the Reserve Banks.

Even if in substance the transactions should be regarded as Reserve Bank borrowings, they would be no different in this respect from matched sale-purchase transactions conducted since 1966 as a means of absorbing bank reserves. The legality of such transactions has not been questioned and "administrative practice", even for a period of less than five years, might be regarded by a court as supporting the validity of the transactions. In this connection, it may be noted that in recent years drawings by the System under its network of "swap" arrangements have in effect constituted borrowings of money and that the legality of such drawings has not been questioned.

Finally, with respect to the purpose of the proposal, the System's foreign currency operations have been designed to "help safeguard the value of the dollar in international exchange markets" rather than to affect member bank reserves and bank credit. Such foreign currency operations were upheld legally in 1962 not only by Counsel for the FOMC but by the Treasury's General Counsel and, reportedly, by the Attorney General of the United States.

Section 12A of the Federal Reserve Act provides that the time, character, and volume of open market operations shall be governed with a view "to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country". It may be argued that, like foreign currency operations, the proposed securities transactions would clearly have a bearing, even though indirectly, upon the general credit situation of the country.

While the question is not free from doubt, it is my opinion, particularly on the basis of analogous precedents, that the proposed matched sale-purchase transactions contemplated by the present proposal would be legally supportable.