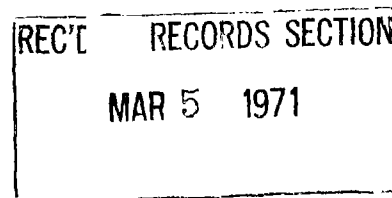




BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551



March 4, 1971

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

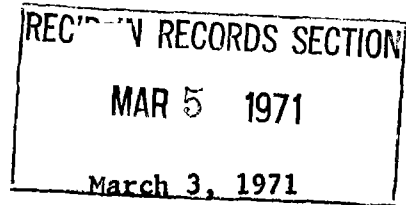
FROM: Mr. Broida

There is enclosed a copy of a memorandum from the System Account Manager dated March 3, 1971, and entitled "Review of System lending of Government securities." This is the memorandum referred to under Item 8 of the agenda for next Tuesday's meeting of the Committee.

A handwritten signature in cursive script that reads "Arthur L. Broida".

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

Enclosure



CONFIDENTIAL (FR)

To: Federal Open Market Committee Subject: Review of System lending
From: Alan R. Holmes, Manager of Government securities
System Open Market Account

A brief review of System lending of Government securities is presented at this time in order that renewal of the lending authority can be considered at the regular annual meeting on March 9, 1971.

The lending of Government securities held in the System Open Market Account has continued at a steady pace in the past several months since the Committee last considered the lending authorization (November 17, 1970). In holding down the volume of delivery failures, the lending authority has been an essential ingredient in the smooth functioning of the Government securities market and hence necessary for the effective conduct of System open market operations. The lending of securities has been particularly valuable in recent months when the normal operation of the securities market was threatened by a possible disruption of insurance coverage--not that System lending by itself could have assured normal functioning in the market if insurance coverage had lapsed--but the threat of disrupted coverage was another element of uncertainty that could have interacted with, and seriously aggravated, the problem of delivery failures. The threat of disrupted insurance coverage, while quiescent at the moment, is not yet entirely removed.

During the full year 1970 the Federal Reserve Banks of New York and Chicago both loaned securities to dealers. A total of 2,588 loans were made, amounting to \$5.1 billion. On average about 10 loans

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totaling \$20.3 million were made each day and the average daily balance outstanding was about \$40 million. The largest balance outstanding during the period was \$139.3 million on May 4, 1970. Subsequent to increasing the maximum term of loans from three days to five, there have been very few requests for extensions and 75 per cent to 80 per cent of the loans have been repaid within three days. Gross earnings from interest charged on the loans were \$292,286 for the New York Bank and \$13,976 for the Chicago Bank.

System lending has been helpful in smoothing out the functioning of the Government securities market by reducing the amount of delivery failures in a period of mounting volume of transactions. Since the inception of System lending, dealers have found the facility to be a most useful backstop to conventional lending channels, despite the penalty rate charged for the service over the rate charged by conventional lenders.

Recently, as dealers became more acquainted with the facility, average weekly fails to receive and fails to deliver have decreased significantly--which, of course, is the main purpose of the lending function. From November 12, 1970, to February 24, 1971, average daily fails to receive declined to \$215 million from the \$732 million average for the previous six months; and average daily fails to deliver declined to \$92 million from the \$371 million reported for the previous six months.

In light of the essential role which the lending of securities has continued to fulfill since it was first authorized in October 1969,

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it is recommended that the Committee continue the authorization to
lend on the same basis as before--to avert or minimize delivery
failures. Periodic reports will be continued to be presented to the
Committee.