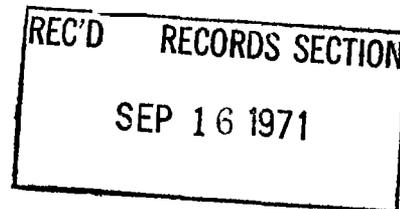




BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551



September 16, 1971

CONFIDENTIAL (FR)

TO: Federal Open Market Committee SUBJECT: System lending of
FROM: Mr. Broida Government securities

Enclosed are memoranda from the System Account Manager and the Committee's General Counsel, dated September 15, 1971, on the subject of System lending of Government securities. It is contemplated that these memoranda will be discussed at the meeting of the Committee to be held on September 21, under agenda item 5.

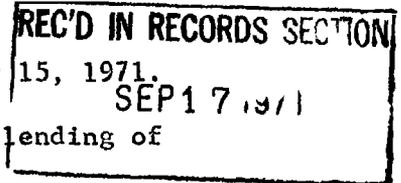
A handwritten signature in cursive script that reads "Arthur L. Broida".

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

Enclosures

CONFIDENTIAL (F.R.)

September 15, 1971.



To: Federal Open Market Committee

Subject: System lending of

From: Mr. Hackley

Government securities.

On October 7, 1969, the Committee amended its continuing authority directive with respect to domestic open market operations by adding the following paragraph:

"In order to insure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U. S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time."

At the time of that action, it was understood that the authorization for lending of Government securities would be reviewed semiannually. In a memorandum to the Committee dated September 15, 1971, Mr. Holmes, Manager of the System Open Market Account, has reviewed the use of this authority and in effect recommended that it be continued. His memorandum notes that no loans of Government securities have so far been made to banks participating in Government securities clearing arrangements conducted by Federal Reserve Banks but that it is expected that such loans may be made, even though infrequently.

When the proposal for lending of Government securities by the New York Reserve Bank was first advanced in 1968, I expressed the opinion (in a memorandum dated July 10, 1968) that it was doubtful whether the Reserve Banks had authority, under the circumstances then stated, to make such loans of Government securities. The opinion was based on the fact that the law does not expressly authorize such loans of securities; that, under section 4 of the Federal Reserve Act, a Reserve Bank may exercise "such incidental powers as shall be necessary to carry on the business of banking within the limitations prescribed by this Act"; but that no evidence had been submitted in support of the conclusion that such lending of securities was reasonably necessary to carry out the express statutory authority of the Reserve Banks to conduct open market operations. At that time, it was asserted only that the lending of Government securities would be "convenient" or an "aid" in connection with the conduct of open market transactions.

When the matter was again considered in the summer of 1969, it was then indicated by the Manager of the System Open Market Account that the factual situation had changed substantially and that loans of Government securities in order to avoid delivery failures were reasonably necessary to effectuate open market operations. On that basis, I expressed the view, in a memorandum dated August 25, 1969, that the lending of Government

Federal Open Market Committee

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securities could properly be regarded as within the incidental powers of the Reserve Banks if the Open Market Committee, as well as the Manager, determined that the situation was such that the lending of such securities was "reasonably necessary to the effective conduct of open market operations and the effectuation of open market policies". Following that opinion, the authorization for lending of Government securities was given by the Committee in October 1969.

Obviously, the legality of lending of Government securities depends upon a factual determination that such lending is reasonably necessary to enable the Reserve Banks to carry out effectively their authority to engage in open market transactions. It is not enough that the lending of Government securities might be helpful or convenient in the transaction of operations in Government securities or that it would facilitate operations of the Treasury Department.

Mr. Holmes' memorandum of September 15, 1971, explicitly states that "the System's lending of securities is still deemed necessary to the effective functioning of the Government securities market and hence to the conduct of System open market operations". It also states that, while no such loans of securities have yet been made to banks participating in Government securities clearing arrangements, the availability of this authority is expected to improve the working of the clearing arrangement and expedite progress toward full utilization of book entry procedures for holding and transferring Government securities and that "in turn the development of book entry procedures is regarded as essential to the effective conduct of System open market operations."

If the Committee agrees with the Manager's judgment and determines that continuance of the authorization at this time is still reasonably necessary to the effective conduct of open market operations, it is my opinion that the lending of Government securities as presently authorized by the Committee may properly be regarded as embraced within the incidental powers of the Reserve Banks.

REC IN RECORDS SECTION

SEP 16 1971

September 15, 1971

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Alan R. Holmes

Subject: System Lending of
Securities

At the annual meeting of the Federal Open Market Committee in March 1971, the Committee renewed the authorization for the lending of securities from the System Account. In light of experience since that time, the System's lending of securities is still deemed necessary to the effective functioning of the Government securities market and hence to the conduct of System open market operations.

During the six months since the meeting, 1,302 loans totaling \$2,984.9 million have been made to dealers under circumstances similar to those envisioned when the authorization was originally granted in October 1969. The average size of the loans remains around \$2 to \$3 million. Although usually made for five days, most loans are repaid within two or three days and only 16 loans were extended during the six-month period, at penalty rates ranging from 1-1/2 to 4-1/2 per cent.

Despite increasing mechanization of delivery procedures and the conversion of additional accounts to book entry, the problem of delivery failures remains serious enough to call for continued System lending of securities in order to facilitate effective functioning of the market. Even with the benefit of System lending of securities, dealers' fails to receive and to deliver averaged \$121 and \$90 million daily, down from \$215 and \$92 million in the four months preceding the March meeting of the Committee. Fails would be increased significantly if the System lending facility were not available, thus inhibiting the dealers' ability and willingness to make markets.

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The Committee has also authorized overnight loans of securities from the System Account to banks participating in Government securities clearing arrangements conducted by Federal Reserve Banks. Up to the present, no loans have been made for this purpose. In New York, the only district in which such a clearing arrangement is now conducted, on those occasions when a bank fails to settle its account with the clearing arrangement, its reserve account is debited overnight and the securities are delivered by the bank early the next day.

In light of the expanded use of the clearing arrangement, and the prospect of still more active use as book entry moves ahead, the Desk now plans to activate the lending authorization in cases where a bank cannot deliver by noon the following day, with terms and conditions as approved earlier by the Committee. We would expect this type of loan to be made infrequently but its potential availability is expected to improve the working of the clearing arrangement and hence expedite progress toward full utilization of book entry procedures for holding and transferring Government securities; in turn the development of book entry procedures is regarded as essential to the effective conduct of System open market operations. A special contract for overnight lending to banks in the clearing arrangement has been prepared and the Desk plans to meet this need if it arises.