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

October 12, 1972

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Arthur L. Broida

Enclosed is a memorandum from the System Account Manager dated October 11, 1972 and entitled "Semi-annual Review of System Lending Operations," and also a memorandum from the Committee's General Counsel, dated today and entitled "System Lending of Government Securities."

It is contemplated that these memoranda will be discussed at the November meeting of the Committee, when more time should be available than at the meeting next Tuesday.

Arthur L. Broida

Arthur L. Broida
Deputy Secretary
Federal Open Market Committee

Enclosures

October 11, 1972

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Mr. Holmes

Subject: Semi-annual Review of System Lending Operations

At the organization meeting of the Federal Open Market Committee in March 1972, the Committee renewed the authorization for the lending of Treasury securities from the System's portfolio. The experience since the March meeting indicates that the lending of securities by the System continues to contribute to the effective functioning of the U.S. Government securities market and so facilitates Desk open market operations.

Dealers' reports on delivery failures involving U.S. Treasury securities indicate failures to deliver or receive securities have been increasing recently in contrast to the previously steady reduction of failures since the System initiated its lending operation in November 1969. In the six-month period ended August 31, 1972, delivery failures averaged $213 million daily, up about $35 million from the preceding six-month period, but still only about one-half of the volume of failures that prevailed just before the System began its lending activities.

There are undoubtedly multiple reasons for the increase in failures. Because of a shortage of collateral available against short-term investment funds, which has been reflected in the relatively low rates on secured RP's, securities that might have been available for lending have been used for RP's--thus reducing the supply available for lending. The generally bearish market outlook held by most professional participants through most of the period has been reflected in sizable dealer short positions, a development that undoubtedly worked to increase delivery failures in general--not just where short sales were directly involved. Also, the markets have become more active and accustomed to larger-sized transactions at a time when an increasing volume of securities has been put away in official accounts. Whatever the reasons, however, it is almost certain that if the System had not been engaged in lending securities, the volume of failures would have been significantly greater, thereby inhibiting the dealers' ability to make markets.

During the period from March through August 1972, the System made 1,918 loans to dealers involving $3,513 million of Treasury securities. The average size of the loans remained around $2 million but the average number of new loans made each day rose--from 11 in the preceding period to 15. As before, virtually all loans continued to be written for the maximum five-day period authorized by the Committee, but most were returned within three days. A total of 19 loans involving $30.4 million of securities, about 1 per cent of the loans made during the interval, were extended past their maturity dates at rates ranging from 1-1/2 to 4-1/2 per cent in accordance with the schedule of penalty rates authorized by the Committee. (The maximum extension was three business days.) Included in the overall lending volume were 16 loans totaling $21.3 million to six New York City banks participating in the Treasury securities clearing arrangements. These loans, designed to facilitate use of the clearing arrangements and thereby reduce handling and storage of securities in physical form, are made on an overnight basis only. All of these loans were repaid the following business day.

On the basis of the experience since March, I would recommend that the Committee find that the lending of securities continues to be reasonably necessary for conduct of open market operations and that it make no change in the provisions of the continuing authority directive relating to the lending of securities, subject to review at semi-annual intervals.

CONFIDENTIAL (FR) October 12, 1972

To: Federal Open Market Committee Subject: System lending of

From: Mr. Hackley Government securities.

In his memorandum to the Committee dated October 10, 1972, Mr. Holmes has recommended that the Committee find that System lending of Government securities continues to be reasonably necessary for the conduct of open market operations and that no change be made in the provisions of the continuing authority directive relating to such lending of securities, subject to review at semiannual intervals.

Paragraph 3 of the continuing authority directive provides that, in order to insure "the effective conduct of open market operations", the FOMC authorizes and directs the Federal Reserve Banks to lend U. S. Government securities to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Reserve Bank. This authority was granted in October 1969 as a means of mitigating the adverse effects of failures to deliver or receive securities. The need for this authority was last reviewed in March of this year.

As I have indicated in previous memoranda, there is no provision of law that expressly authorizes the Reserve Banks to lend Government securities. If the authority exists, it must be derived from the statutory authority of the Reserve Banks to exercise "such incidental powers as shall be necessary to carry on the business of banking within the limitations prescribed" by the Federal Reserve Act. Consequently, the question whether the lending of securities is within the statutory authority of the Reserve Banks must depend upon the factual question whether this activity is reasonably necessary to the effective conduct of open market operations.

Mr. Holmes' memorandum indicates that failures to deliver or receive securities have increased in the last six months and that, on the basis of the experience since last March, the lending of securities continues to be reasonably necessary for the conduct of open market operations.

If the Committee concurs in the judgment of Mr. Holmes with respect to the factual question, it is my opinion that lending of securities as authorized by the continuing authority directive is presently within the incidental powers of the Reserve Banks.