BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 3, 1973

To Federal Open Market Committee

Subject: Dealer association request for a broadening of System security lending

From Board Staff

The association of Government security dealers has requested the Federal Reserve to consider a broadening of the present System program of lending Government securities to primary dealers. Under existing arrangements, as you know, the Desk is authorized to lend securities to dealers only as needed to avoid delivery failures. No short selling is involved in such arrangements since the dealers participating already have purchased from customers an equivalent (though as yet undelivered) amount of the issues borrowed.

The more liberal security lending arrangements now requested by the association would permit a dealer to borrow securities from the System to make short-sales, but such borrowings would have to be collateralized with issues of adjacent maturity already held in the dealer's position. Under this arrangement, although the dealer would be taking a short position in the particular issue borrowed, his net position in the maturity sector surrounding that issue would be hedged by the security provided as collateral. This requirement to supply collateral with a nearby maturity is designed to discourage dealers from using the more liberal arrangement as a means of establishing a strictly speculative <u>net</u> short position. Given this constraint, dealers would be expected to use the more liberal short-selling arrangement chiefly to accomodate customer demands for scarce issues not presently held in position, or to establish a hedge against their existing long positions.

The mechanics of the new dealer proposal are spelled out by staff of the Trading Desk and the dealer association in the accompanying memo and attachment. Key arguments for and against the proposal are summarized below. The Board staff lean toward a negative view of the proposal.

Pro Arguments

(1) Expanded System lending of Government securities to primary dealers is needed to counter the deepening shortfall in the volume of such securities available for lending from private sources. The volume of Government securities loaned to dealers by private institutions has tended to contract in recent years as Federal Reserve and foreign central bank holdings of such debt have grown more rapidly than the total, leaving smaller amounts in private hands. At the same time, many of the large commercial banks that typically lend securities to Government dealers have adopted liability management policies that minimize their need for liquid assets. This has made it possible for such banks to reduce their holdings of marketable Treasury debt to little more than the amounts needed to cover collateral requirements, on such things as State and local government deposits. Finally, persisting money market tightness has very recently encouraged some key banks that previously had loaned Government securities to dealers to use their unencumbered Treasury collateral instead as a means of obtaining short-term funds from non-financial corporations on reverse repurchase agreements. Short-term funds acquired on reverse RP's have recently been much less costly to bankers than funds available from alternative sources.

(2) Expanded System lending of Treasury issues to primary dealers would help to offset the short-fall in lendable securities from private sources and improve the technical efficiency of the Government securities market. During recent years the reduced supply of Treasury securities available for lending from private sources has made it difficult for dealers to accommodate customers' demands for scarce issues. As a result, trading has been somewhat inhibited, and the lack of sufficient dealer arbitraging has tended to maintain distortions in the structure of yield relationships. If System lending of Treasury securities to primary dealers is liberalized as recommended, trading activity will tend to be augmented; investors will find their needs being accommodated more readily; and price and yield distortions among issues of comparable maturity will tend to be smoothed out.

(3) The improved market performance resulting from a liberalized program of System short-selling would facilitate Desk transactions for System and customer accounts and provide support for Treasury debt operations.

(4) Since the proposed liberalization of System security lending would facilitate Desk transactions in the market, such a change can be viewed as reasonably necessary for the conduct of open-market operations.

Con Arguments

On its face the contention that a more liberal System program of lending Treasury securities would enhance the general technical performance of the Government securities market seems persuasive. But it is not so clear how significant this net improvement would really be. Moreover, implementation of the proposal could create some equity problems among different types of market participants. If instances of inequity were then to be highlighted in the press, they could pose troublesome political questions for the System. In particular, under the glare of publicity, it might become quite difficult for the System to demonstrate persuasively that security lending is in fact necessary to the conduct of open-market operations.

(1) Since access to the System portfolio for borrowing of Treasury issues would be limited to primary dealers, other investors active in trading Government securities would be at some disadvantage relative to dealers. In particular, when the more liberal dealer lending arrangement was first inaugurated, investors who had established net long positions to take advantage of scarcities in given securities would now find the value of these positions partly eroded because dealers could borrow the scarce issues from the System. To the extent dealers did use their liberalized security borrowing privileges to improve service to customers and to enhance the fluidity of the market, this would of course represent a net benefit. But if the privilege were sometimes used simply to enhance the dealers' own profits at the expense of other market participants, it might begin to be questioned. Given the demonstrated ingenuity of dealers, it is not easy to anticipate in advance all of the ways in which such a new privilege might be used. While precisely drawn Desk guidelines defining the limits of allowable practice and careful monitoring of dealer short-selling performance could presumably prevent significant abuses, the task of surveillance would probably be more demanding than under the existing security lending arrangements.

(2) Even if abuses of an expanded System security lending program proved in practice to be minor, it would be preferable to have improved lending resources developed by regular market participants, responding to normal profit incentives. Reportedly, savings and loan associations and Federal Home Loan Banks, among others, are beginning to provide such services to obtain the additional earnings provided. And some of the recent curtailment of commercial bank lending of securities is undoubtedly a temporary phenomenon related to the extreme recent tightness of money markets.

(3) It might be made to appear that the Federal Reserve had elected to help a select group of dealers "bear" the U. S. Government securities market. The potential for such a misunderstanding of the operation might make it difficult clearly to demonstrate the technical market advantages of the lending arrangement. If the operation were misunderstood and were questioned, for example, in Congressional hearings, the statutory issue of whether the Federal Reserve really possesses authority to enter into short-selling arrangements with dealers might be highlighted. Although this same question could, of course, be raised regarding the existing arrangement for System security lending, the fact that it does not actually involve dealer short-selling makes it less likely to receive special Congressional attention.

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All things considered, evidence on the likely advantages to be obtained from a broadened program of System security lending does not appear to be sufficiently compelling to justify the political risks inherent in the change. These political risks would be reduced if the Treasury (through trust accounts) were willing to participate in the arrangement, but this possibility seems unlikely. In addition, question may be raised whether the advantages anticipated are sufficient to meet the statutory requirement that the operation is necessary to the conduct of System open-market policy.