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

July 11, 1974

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Attached is a memorandum from the System Account Manager, dated July 10, 1974, and entitled "Limit on Outright Holdings of Bankers' Acceptances."

It is contemplated that this memorandum will be discussed at next Tuesday's meeting, following agenda item 7.

Attachment

CONFIDENTIAL (FR)

TO: Federal Open Market Committee July 10, 1974

FROM: Alan R. Holmes SUBJECT: Limit on Outright Holdings of Bankers' Acceptances.

The prolonged pursuit of a restrictive monetary policy is producing considerable strain in all areas of the financial and securities markets. As a result some undesirable side effects are appearing that could erupt into a crisis at any time. In this environment it seems prudent for the Committee to equip the Trading Desk with as complete a variety of tools as possible so that the Desk can take immediate decisive action on the Committee's behalf in order to avoid or deal with such trouble spots as may develop.

One tool of open market operations already available is the purchase of bankers' acceptances. However, System outright holdings of these obligations are close to the limit of $125 million set by the Committee in November 1964. The attached memorandum from Mr. Cooper recommends that the Committee review this limit and raise it to $500 million. This would merely bring it in line with the growth in acceptances outstanding from $3 1/4 billion to $11 3/4 billion over the past 10 years. The proposed limit would still be less than 5 percent of outstanding acceptances as it was in 1964.

The increase in the limit would equip the Desk to deal with one potential trouble spot while at the same time taking other action to offset any undesired reserve effects. It would also enlarge the potential for providing permanent reserves in the event the supply of Government and Agency securities falls short of the System's requirements as they have from time to time in the recent past.

I, therefore, recommend that the Committee amend paragraph 1(b) of its authorization for domestic open market operations as follows:

> (b) To buy or sell in the open market ..... prime bankers' acceptances .... provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed $500 million.

Attachment

TO: Mr. Holmes July 10, 1974

FROM: R. L. Cooper SUBJECT: System Operations in Bankers' Acceptances.

The severe strains that have developed in all areas of the financial and securities markets require that the System be prepared to deal with troublesome situations that may develop in various markets while at the same time ensuring that reserve objectives are met. One area in which the System may operate is the bankers' acceptance market, through outright purchases and repurchase agreements. However, System outright holdings of acceptances are limited by the FOMC to $125 million at any given time. (There is no limit on the amount of acceptances that may be acquired and held under repurchase agreements.) At the close of business on July 10, outright holdings of acceptances by the Federal Reserve Bank of New York were about $115 million, leaving a leeway of only about $10 million that may be bought outright under the present authorization. Once the limit of $125 million is reached, future purchases may be made only to the extent that acceptances mature -- a very slow process that usually occurs at the rate of $5 to $15 million per week. It is therefore recommended that the FOMC limit of $125 million on outright holdings of acceptances be raised to $500 million in order to accomplish the following purposes:

1. Increase the Desk's potential for providing reserves at a time when opportunities to acquire other instruments are

frequently inadequate.

2. Anticipate the possibility that current strains in the money markets and the banking system may be exacerbated to a point requiring quick and forthright action by the Committee, perhaps in the form of large-scale purchases of bankers' acceptances along with other eligible short-term paper.

3. Enable the System to absorb acceptance sale orders from foreign central banks if it suits the objectives of monetary policy, thereby giving the Desk the same flexibility in handling foreign account acceptance orders as it already has on orders involving Government and Agency securities.

If the Committee agrees to the recommended enlargement of the present limit on outright holdings of acceptances, it is further recommended that the Federal Reserve Bank of New York discontinue its policy of buying only "three-name" acceptances, thereby eliminating the need for dealers to endorse acceptances sold outright to the System and its foreign accounts. This change in policy would accomplish the following purposes:

1. Bring System requirements in line with those of other market participants, none of which require three names on acceptances they buy.

2. Enable the System to purchase acceptances from those dealers most able to supply them at the best rates, without the limit of "endorsement lines" based on the individual dealer's size and capital.

3. Enable dealers to sell acceptances freely to the System and its accounts without the inhibitions imposed by the assumption of sizable contingent liabilities.

The background and considerations leading to these recommendations are discussed below in detail.

Limitation on Purchases

Since November 1964, outright holdings of acceptances by the Federal Reserve Bank of New York for its own account have been limited, in effect, to $125 million by the continuing authority directive of the Federal Open Market Committee. At that time the limit was increased from $75 million because acceptances outstanding had expanded to a new record level of about $3 1/4 billion. Thus, the FOMC agreed with the Account Management's recommendation that the limit on System holdings be kept meaningful relative to the expanding size of the acceptance market while avoiding the possibility of the System dominating the market. A contingent limit of 10 percent of acceptances outstanding (if smaller than the absolute limit of $125 million) was never effective due to the steady growth of acceptances outstanding and was eliminated in the latest authority directive as amended effective April 1, 1974.

Until recently the limit of $125 million has not interfered in any way with the attainment of System objectives. The System's outright holdings of acceptances have generally fluctuated roughly between $35 million and $100 million and the Desk has concentrated its acceptance operations mainly in repurchase agreements, on which the Committee imposed no aggregate limit. However, outright purchase of acceptances has remained a tool of open market operations for the provision of permanent reserves even though acceptances were used mainly for the provision of temporary reserves. Recently, outright holdings have been crowding the upper limit of the range mentioned above and at the close of business on July 10, total holdings were about $115 million.

During the past year or so, the Desk has been encountering recurring difficulty in providing even the reserves needed under a severely restrictive monetary policy. Collateral for repurchase agreements has been persistently short of the Desk's needs and the sizable acceptance holdings of dealers have enabled the Desk to achieve a substantial supplement to its repurchase agreements against Government and Agency securities. The provision of more permanent reserves has also been inhibited from time to time by shortages of Treasury securities. At such times, acceptances might also be purchased outright by the System in moderate size if the limitation on holdings were increased.

In view of the severe strains in all financial and securities markets at present, the Committee might also want to be prepared to step into all "eligible" markets without delay should a crisis develop. The acceptance market has demonstrated all of the symptoms of severe strain apparent in other money and securities markets. Chief among the signs is the hyper discrimination shown by investors in choosing the banks whose acceptances they will buy. Spreads of as much as 50-75 basis points have developed between rates for acceptances of the top 10-15 banks and those of their regional competitors. Dealers, in turn, have restricted their purchases and some are "brokering" regional bank names in order to cut down on their own risks and carrying costs. If this process continues, the acceptance market may cease to function, perhaps with irreparable damage to this important mechanism for the financing of foreign trade. As a matter of precaution it would be well for the Desk to be empowered to intervene in this market in size if it beomes necessary in order to accomplish the Committee's objectives.

Another area in which the System should have flexibility to act quickly and in size involves holdings of acceptances by foreign central bank accounts handled by the New York Reserve Bank. These holdings presently total about $850 million. They represent the investment of dollar holdings of those banks and are generally held to maturity. Occasional sales are executed in the market, usually without any significant impact. However, given the severely strained condition of this and other markets, the Committee should consider the possibility that a sizable amount of these holdings could be suddenly pressed for sale by the foreign accounts. Given the hyper discrimination of investors as to bank names and the fact that foreign holdings include a broad cross section of all active names, it might be difficult to liquidate any sizable amount of the paper. If reserve objectives were conducive, System absorption of some part of the sales could be very helpful. The ability to do this would also require a larger leeway as to total holdings.

The suggested enlargement of the leeway from $125 million to $500 million is based on the following considerations. The limit has not been changed for almost ten years. Meanwhile, total acceptances outstanding have increased from about $3 1/4 billion in November 1964 to almost $11 3/4 billion at present. A limit of $500 million would be less than 5 percent of the total amount outstanding at the close of May 1974. This would be roughly the same percentage of outstandings as the $125 million limit was in 1964. It would also give the System ample leeway to operate in size in this market should it become necessary.

Removal of Endorsement Requirement

The Federal Reserve Bank of New York is reportedly the only buyer of acceptances that requires "three-name" paper.

In order to supply three names, the dealers endorse the acceptances they sell the System and its foreign accounts, thereby assuming a contingent liability for which the dealers are paid a 1/16 percent endorsement fee. This policy was established in the early days of the System and of the acceptance market. Given the present maturity of the market and the lack of this requirement by all other investors in the paper, it appears that the System requirement is archaic. It serves no practical purpose, since the dealers are in effect guaranteeing the obligations of some of the largest banks in the country and add little, if anything, to the quality or safety of the paper. Furthermore, there is some question whether, if an accepting bank failed, the System would want to hold the dealers to their liability as endorsers for any large amount if it might precipitate dealer failures on top of a bank failure.

The contingent liability of dealers arising out of the endorsements can inhibit the dealers in their ability and willingness to sell acceptances to the System. This is particularly true in today's shaky markets in which some strong and well-managed banks occasionally become the subject of disquieting rumors. To the extent dealers become unwilling to endorse any but the top 10-15 bank names, regional banks are deprived of an opportunity to have their acceptances sold to the Ssytem. This aggravates the problems of discrimination already affecting those banks.

The endorsement requirement also makes it impossible at times for the System to tap all sources of acceptances. In order to make the requirement meaningful, endorsement lines are set up by the Desk, based on dealer size and capital. Thus, at any given time, theSystem may not be able to buy acceptances from a small dealer with a good supply because he has already reached the limits of his endorsement line.

For these reasons it is recommended that the System discontinue the requirement for dealers to endorse acceptances sold outright to the System. This would give the System maximum flexibility as to what dealers it buys from, make all acceptances in the dealer market more readily available to the System and remove an archaic practice not followed by any other participant in the market.