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

March 11, 1975

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Attached is a copy of a memorandum from the System Account Manager, dated March 10, 1975, and entitled "Recommendation Regarding Agency Guidelines."

It is contemplated that this memorandum will be discussed by the Committee at its meeting on March 18, 1975.

Attachment

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CLASS II - FOMC

March 10, 1975

TO: Federal Open Market Committee

SUBJECT: Recommendation Regarding Agency Guidelines

FROM: Alan R. Holmes

The System acquired a substantial amount of Federal agency obligations during 1974: holdings of agencies rose by $2.8 billion over the year, or nearly as much as the $3 billion increase in holdings of Treasury securities. While purchases of agency securities are likely to be more moderate in 1975, particularly in view of the prospectively huge availability of Treasury securities, a continuing presence in the agency market is desirable, and in my view the range of our activity in that market could soon be inhibited by the Committee's guideline which limits System holdings of any one issue to 20 percent of the amount of the issue outstanding and limits aggregate holdings of any agency's issues to 10 percent of the amount that agency has outstanding. Flexibility for the Desk to operate in a broad range of agency issues may prove especially useful in terms of potential impact on intermediate and longer term interest rates--limited though that impact might be.

Accordingly, in order to preserve agency operations as a useful tool for implementing monetary policy, I recommend increasing the limits in the guidelines for System acquisitions to 35 percent for any one issue and 20 percent for any one agency. This could be implemented through revising, as follows, the present guidelines which were approved by the Committee on August 24, 1971 and last revised on July 16, 1974:

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Present wording of Guideline 5: System holdings of any one issue at any one time will not exceed 20 percent of the amount of the issue outstanding. Aggregate holdings of the issues of any one agency will not exceed 10 percent of the amount of outstanding issues of that agency.

Proposed wording of Guideline 5: System holdings of any one issue at any one time will not exceed 35 percent of the amount of the issue outstanding. Aggregate holdings of the issue of any one agency will not exceed 20 percent of the amount of outstanding issues of that agency.

Discussion

Table I shows the leeway under Guideline 5 that the Desk had at the end of January to increase the System's portfolio over the year 1975, based on the limitation of holdings to 10 percent of the total amount issued by an agency. The theoretical leeway was just about $4.9 billion at the end of January 1975, and could be projected to expand to $5.5 billion during 1975 as agencies raise their total debt outstanding. In practical terms, however, the operational leeway is not nearly as large as these figures.

To a significant extent, our effective leeway lies in the ability to buy the issues of three agencies: Federal National Mortgage Association (FNMA), Federal Home Loan Banks (FHLB), and Federal Land Banks (FLB).

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The leeway theoretically available in the other agencies will provide the Desk with only moderate aid in most future operations. For example, the Federal Intermediate Credit Banks (FICB) and Banks for Cooperatives (BC), accounting for about $1.2 billion in theoretical leeway, offer mainly very short-term securities which are not always useful for achieving FOMC objectives despite the System's recently acquired authority to roll-over agency obligations at maturity. Almost $900 million in leeway is available in Farmers' Home Administration (FHDA) issues but large purchases of these issues are not feasible due to complex accounting problems in handling the securities. A number of other issues have theoretical leeway but the issues do not trade actively in the market and are not available in useful size for our operations.

Moreover, the effective leeway in the three major agencies is not as large as it appears. For example, the $2.8 billion leeway in FNMA, FHLB and FLB issues includes a number of issues which are not actively traded. Moreover, if the Desk attempts to purchase longer-term agency obligations, the maturity distribution of the leeway will be a restraint. At the end of January 1975 the leeway in FNMA, FHLB and FLB issues with maturities of five years or more was only $1 billion.

The limitation to 20 percent on the System's holdings of particular issues is also becoming somewhat of a constraint. At present 25 issues have a leeway of under $20 million, including 11 of the 24 eligible FNMA issues due in more than five years. There was no leeway in one of the eight eligible FLB issues due after five years and less than $20 million leeway in two of the six eligible FHLB issues due after five years.

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The Committee established guidelines for outright agency operations based on the view that agency operations should not be undertaken in special support of any particular area of the agency market but should conform to the reserve and other objectives of System policy, and that the System should not become the dominating factor in the agency market. In particular, the purpose of Guideline 5 was to try to minimize the impact of System purchases and holdings of individual agency issues on the market price of those issues, to minimize the replacement problem at maturity (since originally there was no provision for roll-over) and to avoid either the appearance or the fact of direct System support of any new issue.

The original limits of Guideline 5 were set at a low level because the agency market was much smaller than the Treasury market, the System had no experience in outright operations in agencies, and initial operations would be experimental in nature. Experience gained over the past 3 1/2 years has shown that the agency market is capable of absorbing fairly sizable System purchase operations without undue impact on yields or other market relationships. There is no reason to believe that moderate increases in the proportions of System holdings of agency debt will have excessive impact on the market or result in our dominance of the market. Raising the limits of Guideline 5 as recommended would not imply any special support of any particular area of the agency market but would, in fact, facilitate the Desk's ability to achieve the expressed desire of the Committee to use agency operations as an integral part of total System open market operations. A System

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holding of up to 20 percent of an agency's obligations would seem to be consistent with these objectives.

As for increasing the limit of holdings of any one issue to 35 percent, this would appear to be an appropriate concomitant to the 20 percent limit on the holdings of any agency's total issues, in order to provide reasonable flexibility of operation for the Desk. The figure does not seem excessive now that the Desk has the authority to roll-over issues at maturity. System holdings of a number of Treasury issues are higher than this proportion; holdings of certain Treasury bills climb above 40 percent and holdings of individual Treasury coupon issues are as high as 72 percent.

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Table I

System Leeway to Purchase Agency Securities
(In millions of dollars)

Agency	Outstanding Debt Obligations 1-31-75	Amount System is Authorized to Hold Under 10% Provision of Guideline 5	System Holdings 1-31-75	Leeway 1-31-75		Ten Percent of[2] Projected Increase in Amounts Outstanding During 1975		Estimated Leeway for Year 1975	
FNMA	28,030	2,803	2,143	660		220		880	
FHLB	23,337	2,334	1,163	1,171		-350		821	
FLB	13,246	1,325	532	793	2,624	300	170	1,093	2,794
FICB	8,606	861	210		651		130		781
BC	3,682	368	74		294		90		384
GNMA*	4,280	428	70		358		-0-		358
FHDA	10,041	1,004	225		779		80		859
EXIM	2,893	289	155		134		90		224
WMTA	845	84	82		2		20		22
GSA	692	69	9		60		30		90
PS	250	25	25		-0-		-0-		-0-
	95,902	9,590	4,688		4,902		610		5,512

* - Includes only participation certificates.
1/ Source: U.S. Treasury
2/ Source: Salomon Brothers.

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Table II

Dollar Volume of Outright System Transactions in Treasury Notes and Bonds and Federal Agency Securities
(in millions of dollars)

	Treasury Notes & Bonds Purchases	Federal Agency Securities Purchases	Sales	Redemptions	Net Increase
1971 (4 months)	1,142	485	-0-	-0-	485
1972	1,582	1,197	145 5/	225	827
1973	1,417 1/	865 3/	-0-	239	626
1974	1,747 2/	3,083 4/	-0-	319	2,764
1975 (2 months)	722	376	-0-	95	281
TOTAL	6,610	6,006	145	878	4,983

1/ Includes $816 million purchased from customer accounts.
2/ Includes $381 million purchased from customer accounts.
3/ Includes $167 million purchased from customer accounts.
4/ Includes $148 million purchased from customer accounts.
5/ Represents sales in the market of $54 million and $91 million of issues due within one year on February 22, 1972 and August 24, 1972, respectively.