



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

March 5, 1976

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida *ALB*

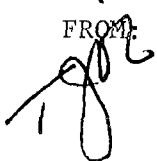
Attached are memoranda relating to the annual review of System lending of securities, from the Account Manager dated March 1, and from the Committee's General Counsel dated March 5. It is contemplated that these memoranda will be discussed at the next meeting of the Committee.

Attachments

CONFIDENTIAL (FR)
CLASS II FOMC

March 5, 1976

TO: Federal Open Market Committee SUBJECT: Review of System
FROM: Thomas J. O'Connell Lending of Securities



In a memorandum dated March 1, 1976, the Manager of the System Open Market Account has recommended that the Committee renew for a period of one year the authorization contained in paragraph 3 of the Authorization for Domestic Open Market Operations for the lending of securities from the System Open Market Account. The Manager has concluded that, although the year 1975 reflected a contraction in the volume of securities being loaned from the System Account, the effective functioning of the market in which System open market operations are conducted remains a matter of concern and that the System lending "remains vital to the smooth functioning of the market."

It is my opinion that the Committee could reasonably find that the continued lending of securities from the System Account to dealers and clearing banks is reasonably necessary for the effective conduct of open market operations, and that the continued lending of System securities, as authorized by the Authorization for Domestic Open Market Operations, is within the "incidental powers" of the Reserve Banks.

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CLASS II FOMC

March 1, 1976

TO: Federal Open Market Committee
SUBJECT: Annual Review of System Lending of Securities
FROM: Alan R. Holmes

Attached is a statistical report on the lending to dealers of securities held in the System Open Market Account since the last annual meeting of the Federal Open Market Committee in March 1975. For the first time since the System began its lending operation in 1969 this report shows a contraction in the volume of securities being loaned. This decrease in the dealer borrowings from the System Account partially reflects the increase to 1 1/2 percent from 3/4 percent (on an annual basis) in the interest rate charged, and also the Desk's continued encouragement to dealers to find alternative sources of lendable securities.

The dealers have been able to reduce their borrowing needs from the System during a period of large Treasury financing operations and in spite of the rise in the volume of dealer transactions in Treasury securities, on a daily average basis, from approximately \$3.6 billion in 1974 to \$6.0 billion in 1975, an increase of about 65 percent. This reduction in System lending was accomplished without a substantial increase in the volume of failures experienced by dealers. Given the extraordinary rise in the volume of trading, we might have expected a return of the high level of failures which prompted the System to begin

its lending operation, but the continued expansion and improvement of the automated clearing mechanism for Government securities has helped to keep failures from expanding, even though the present volume has pushed the clearing process near its capacity.

The change in our processing procedures to lending temporarily against cash during the day (with securities being delivered by the dealer later in the day) has proven to be beneficial to the clearing mechanism at the Federal Reserve and to the market. Since the "cash" technique began in June 1975, there have been only fourteen days when we were forced to hold cash overnight. The dealers involved in the failures to deliver securities by the end of the day were assessed a 6 percent penalty rate and two dealers, who had repeated failures, had their borrowing privileges suspended for a short period of time. The instances of failure to deliver securities by the end of the day against System loans of securities are very small compared to the volume of loans being processed (less than one-half of one percent) and I don't feel that it has become a problem.

The System lending provides a final outlet for relieving pressures that occur within the clearing mechanism and remains vital to the smooth functioning of the market, for it would be virtually impossible to process the present volume without such a mechanism. The effective functioning of the market in which System open market operations are conducted remains a matter of concern and accordingly I recommend that the Committee renew the authorization to lend securities for another year.

The overall operation continues to be profitable, with earnings for the New York Bank in 1975 amounting to \$1,583,242, an increase of 50 percent from 1974. Estimated expenditures needed to run the lending operations amounted to approximately 10 percent of earnings.

Attachment

STATISTICS ON FEDERAL RESERVE
LENDING OF SECURITIES

(dollars in millions)

| | March 1974 through <u>February 1975</u> | March 1975 through <u>February 1976</u> | <u>Percentage Change</u> |
|-----------------|---|---|------------------------------|
| Number of Loans | 11,107 | 9,868 | -11% |
| Total Amount | \$19,378 | \$17,891 | - 8% |

Daily Averages

| | | | |
|---------------------|---------|---------|------|
| Number of Loans | 45 | 40 | -11% |
| Amount | \$ 77.8 | \$ 72.1 | - 7% |
| Balance Outstanding | \$150.5 | \$131.1 | -13% |
| Size of Each Loan | \$ 1.7 | \$ 1.8 | + 6% |

Dealer Fail Statistics

| | <u>1974</u> | <u>1975</u> | <u>Percentage Change</u> |
|-----------------------------------|-------------|-------------|------------------------------|
| Daily Average Fails to Receive | \$293 | \$297 | + 1% |
| Daily Average Fails to Deliver | \$220 | \$229 | + 4% |

March 1, 1976