CONFIDENTIAL

To Federal Open Market Committee November 4, 1964

From R. W. Stone Subject: Bankers' Acceptances

I should like to recommend that the Committee's limit on outright holdings of bankers' acceptances be raised from $75 million to $125 million. The Committee will recall that when the Federal Reserve re-entered the acceptance market in 1955 the Committee specified a limit of $25 million on outright holdings; in 1956 the limit was placed at $50 million or 10 per cent of the total volume of acceptances outstanding, whichever was less; and in 1958 the limit was specified as $75 million or 10 per cent of outstandings, whichever was less. The Committee's purpose in specifying such limits was, of course, to insure that System holdings would not become of more than marginal size in relation to total outstandings.

As will be discussed more fully below, the acceptance market has undergone substantial growth and development in recent years. The encouragement of such growth and development was a major purpose of the Federal Reserve's re-entry into the market in 1955, and I believe the System's participation in the market since that time has been a highly constructive influence in that direction. I also believe, however, that the $75 million limit--established when the market was considerably smaller than at present--is likely to impair the quality of the contribution that the System can continue to make to the acceptance market in view of the size it has now attained and the greater size it is likely to attain in the future. I think that a new limit of $125 million or 10 per cent of outstandings, whichever is less, would insure that the System's role in encouraging the further development of the acceptance market will be as effective in the future as it has been in the past.

The two sections that follow contain a brief and general review of the recent growth of the acceptance market and of the nature of the System's operations in that market. The third section deals more specifically with the kind of problem we expect to encounter with the existing $75 million limit in the context of the changes that have occurred in the acceptance market since the limit was adopted in 1958.

The Growth of the Market

The acceptance market has undergone significant change in recent years, both quantitatively and qualitatively. The quantitative growth of the acceptance field may be seen by reference to Table I, which shows the total volume of acceptances outstanding from 1955 to the present.

TABLE I

BANKERS' DOLLAR ACCEPTANCES OUTSTANDING
(month-end figures--in millions of dollars)

	High	Low	Average
1955	869	659	711
1956	967	624	745
1957	1,307	979	1,098
1958	1,529	1,194	1,367
1959	1,160	946	1,032
1960	2,027	1,229	1,529
1961	2,683	2,029	2,324
1962	2,650	2,277	2,426
1963	2,890	2,564	2,686
1964 (9 mos.)	3,175	2,983	3,093

When the System re-entered the market in 1955 the average amount of acceptances outstanding was somewhat over $700 million. By 1958 the figure had moved up to an average of about $1.4 billion before declining to the neighborhood of $1 billion in 1959. Since 1960 the total volume of acceptances has undergone a rise to the nearly $3.2 billion outstandings recorded in September 1964. If past seasonal patterns are repeated this year, the figure will move still higher by the end of the year.

The quantitative growth of the market may also be seen in terms of the rise in dealer portfolios, shown in Table II.

TABLE II

TOTAL DEALER PORTFOLIOS OF ACCEPTANCES
(millions of dollars)

	High	Low	Average of Wednesday Holdings
1955	24	*	4
1956	52	*	7
1957	74	*	10
1958	66	*	10
1959	80	*	16
1960	114	*	18
1961	105	5	23
1962	218	5	32
1963	355	29	105
1964 (9 mos.)	380	92	205

* Less than $1 million.

It will be seen from the table that the increase in dealer holdings has been particularly marked during the past two years.

There are at least two respects in which qualitative changes in the acceptance market may be noted. The first is the above-mentioned burgeoning in dealer portfolios. Dealers have come to hold larger portfolios in order to provide those seeking to buy acceptances with a substantially greater variety of names and maturity dates than were available formerly; this approach has been successful in stimulating increased interest in acceptances not only on the part of bank investors but on the part of a growing list of nonbank investors as well.

A second qualitative change in the market is the extent to which acceptances have come to be integrated with other short-term instruments as money market paper. As I have indicated in Committee discussions on other occasions, the number and variety of participants in the money market are growing, and the degree of aggressiveness and sophistication they exhibit in keeping their cash balances fully employed is also increasing. These participants move their funds in and out of the whole range of money market instruments with great fluidity in response to shifting rate differentials. As a refelction of the role of acceptances in this trend, several large banks in New York City and a major one on the West Coast have recently moved responsibility for the management of their acceptance portfolios from banking departments proper, where such responsibility had been for many years, to their money market desks, where acceptances are actively traded in and out, as money positions shift, and are swapped back and forth with other instruments as rate relationships change.

System Operations in the Acceptance Market

System operations in the acceptance market have been geared primarily to seasonal changes in the demand for acceptance credits. Thus our holdings tend to rise when a seasonal increase in demand for acceptance credits pushes total outstandings upward (they reach a peak around the end of each year), and to fall when outstandings decline. The seasonal changes to which our operations are primarily addressed do not manifest themselves on a day-to-day basis nor, unless the seasonal tides are running strongly, do they necessarily show up on a week-to-week basis. Yet we must, with great frequency, make decisions with respect to our holdings, since some part of those holdings matures nearly every day. If we are clearly in the midst of a seasonal movement, we adjust our outright holdings upward or downward by some marginal amount (typically $1 million to $5 million) over the course of a statement week, according to the direction of that seasonal change. But if we are not in the midst of a seasonal movement--as is the case during considerable stretches of time each year--our general practice is to leave our outright holdings unchanged or to adjust them upward or downward, by these same marginal amounts, according to the direction of change of our holdings of Government securities. In this limited sense we have used changes in outright holdings as a minor supplement to operations in Government securities.

While changes in outright holdings are too small to be of much significance as a supplement to operations in Governments, the recent burgeoning of dealer portfolios of acceptances has provided useful opportunities to undertake repurchase agreements in a volume that has at times been an important supplement to such operations. As the Committee knows from our weekly and other reports, we have often taken such opportunities and have made a significant volume of repurchase agreements against acceptances as an alternative to operations in Treasury bills as a means of supplying reserves. Indeed, we now have on the books $52 million of repurchase agreements against acceptances.

The Problem We Expect to Encounter

Until the last two years, the rise in our outright holdings that occurred with the seasonal expansion in outstandings fell considerably short of the Committee's $75 million limit, but in 1963 our holdings rose to within $16 million of the limit, and last year they rose to within $5 million. The major reasons for this difference are to be found in the level of dealer portfolios and in our understanding of the Committee's intent with respect to operations in acceptances. We have felt that the Committee desires not only that our holdings be marginal in relation to total outstandings, but also that changes in those holdings be marginal in relation to private activity in the market. Prior to 1963, dealer portfolios tended to be relatively small, as indicated earlier. Thus, while a rise in holdings to the vicinity of the limit might have been appropriate in view of the increase in outstandings, such a rise would, in our judgement, have involved taking too great a share of dealer portfolios. In the past two years, however, dealer portfolios rose substantially in the final month or two, when outstandings were also undergoing the customary seasonal rise. Hence it was possible effectively to address operations to the seasonal rise in outstandings without taking more than a marginal share of dealer portfolios. This year, dealer portfolios, which are already large ($253 million), may well reach an all-time high by December 31, so that our holdings can very likely rise seasonally without doing violence to the "marginal principle". But with the market having attained its present size, and with the seasonal expansion in outstandings just getting under way, we may closely approach the $75 million limit well before the rise in outstandings has run its course--unless our operations were so scaled down as to fall short of achieving their maximum effectiveness.

The suggested limit of $125 million would, I think, insure that the System's participation in the acceptance market will be as helpful in the future as it has been in the past. And I wish to emphasize that we have not regarded, and would not regard, any limit the Committee may specify as a target to be reached. Whether a $125 million limit, if adopted, would be reached would depend entirely on circumstances. Even if such a limit were reached, our holdings would constitute a slightly smaller proportion of outstandings than would holdings of $75 million in 1958, when that limit was adopted.