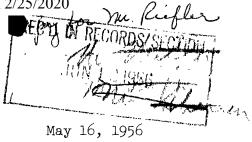
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To: All Members of the Federal Open Market Committee and Presidents of Federal Reserve Banks not now serving as members of the Committee

The enclosed memorandum on "Swaps in Treasury Bills" has been prepared as a result of the discussion of this question at the last meeting of the Federal Open Market Committee, at which the Federal Reserve Bank of New York was asked to develop further the proposal, contained in my memorandum of May 3, that limited authorization be given for "swaps" in the management of the System Open Market Account. It seems to me that such an authorization would serve, in a small way, the administration of credit policy without doing harm to free market concepts. The arguments in its favor ought to outweigh doctrinal dislikes of the whole idea of "swaps".

Yours faithfully,

Allan Sproul, Vice Chairman, Federal Open Market Committee.

Enclosure

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Confidential

JUN 1 2 1956

## SWAPS IN TREASURY BILLS

## I. The Proposal

Item 6 in my letter to the Federal Open Market Committee, dated May 3, 1956, suggests that the Manager of the System Account be given limited authority to make swaps in Treasury bills when, in the Manager's judgment, such purchases and sales would not distort the functioning of the market, and would improve the capacity of the Account to perform effectively in supplying or absorbing reserves. This authorization has current importance in view of the present imbalance among the different maturities of bills within the rather small total of bills now held in the System Account. Over the longer run, it should be possible to rearrange bill holdings whenever such rearrangement would improve the capabilities of open market operations in supplying or absorbing reserves.

As shown in the accompanying table, the System Account presently holds none of six of the thirteen Treasury bill maturities and virtually none of a seventh issue. Therefore, when the System Account wishes to sell bills in the market, it is able to accept bids on fewer than half of the bill maturities, and it sometimes is difficult to get sufficient bids on these maturities to carry out the intended selling program. Also, frequently it is advantageous to be able to execute purchase orders for foreign accounts by making sales directly from the System Account, but because of the gaps in our maturity distribution, it often is impossible to take care of foreign account orders in this way. In my judgment, the day-to-day management of the Account would be improved, and trading within the "best-price" prescription of the Committee would be facilitated, if a better alignment of bill holdings could be achieved.

The immediate problem of maturity distribution in the System Account is related to the limited holdings of bills, but there are circumstances under which it would be desirable to permit swaps in bills even when the System Account is much larger than it is presently. For example, the System Account will probably be a net purchaser of Treasury bills during much of the last half of this year. A high proportion of the bills purchased no doubt ought to be those having a January maturity or that upon roll-over will acquire a January maturity. (It is, of course, simplest and least disturbing to the market if the funds withdrawn from the banking system in January are withdrawn through redemptions of maturing bills rather than through outright sales.) However, the Account Management may be unable to purchase enough of the January maturities to provide for the System's January needs. Assuming that the purchases of bills are ordinarily handled on a regular "go-around" of the dealers, the System must depend upon the amounts of the various maturities actually available in the market at the time each go-around occurs. is no reason to expect that it will be possible to decide to put reserves into the market just at those times when January bills (or October bills that will be rolled over as January bills) are in relatively large supply. To achieve reserve objectives during the autumn, when presumably purchases will be in order, the Account Management will no doubt find again, as it always has in the past, that it must put reserves in, as needed, by taking whatever maturities of Treasury bills are offered for sale at competitive prices. And that has not, of itself, permitted an adequate concentration in the January maturities.

However, if swapping were permitted, a more nearly satisfactory solution could be found. Ordinarily a strong demand for December bill maturities develops in the market during October and November. It would be helpful if the Manager of the Account were in a position to build up the System's holdings of those maturities in September, when they are readily available as "new bills", and then later

to "swap" these December maturities for January bills as the market preference for December bills strengthens. Moreover, it would be rare indeed for the System to face a need to absorb any substantial amount of reserves in December, so that in swapping December bills to obtain January bills the System would not be reducing its effectiveness during December. And in supplying December bills as demand for them rises, the System would be helping to smooth out the functioning of the Treasury bill market, as well, over the always troublesome December period. Taken together, the January bills obtained directly, plus those that might be obtainable on such swaps as those against December maturities, should put the Account in a satisfactory position.

## II. Techniques

It would be anticipated that most swaps in bills, if they were to be authorized by the Committee, would be made at the dealers' initiative. At present, nearly every day the Trading Desk hears through dealer conversations of swaps in process, or swaps being sought. Most swap requirements of the Account could probably be met by acting on only a small part of the possibilities mentioned to the Trading Desk in the course of a normal day's work. Sometimes one dealer could handle both sides of the swap, while at other times the most convenient arrangement would involve one dealer on the purchase side and another on the sale.

An occasional swap has been worked out in the past, when the Trading Desk has happened to have a swap order for a foreign account or a purchase and sale for two foreign accounts that fitted dealer requirements. Of course, the Trading Desk is always careful in executing such transactions to assure the best price, recognizing that on a swap transaction determination of what constitutes "best price" must weigh both sides of the operation. There has been no instance in which any such swap has had any market repercussions.

If swaps in bills were to be authorized for the System Account, there is consequently no reason to expect that they would be disturbing or misleading

to the market. In the first place, they ordinarily would not be undertaken in large volume. Individual transactions would be kept in scale with the customary swap situations arising in the market. In the second place, as noted earlier, such transactions would usually be initiated by the dealers, and since any dealers involved would be exposed to both ends of the swap they would be fully aware that bank reserves had not been affected.

On those occasions when the requests from dealers for swaps either were not in sufficient volume or were not in the proper maturities to meet our requirements, some initiative for canvassing the possibility of swaps might come from the Trading Desk. There would never be any difficulty in revealing the nature of the transaction. As a general principle, it would not be feasible to attempt a full go-around on these transactions, and it would be necessary to attempt to locate a competitive price on both ends of the swap by direct negotiation with dealers that were known to be interested in buying or selling the maturities involved. Whether the swap was at the dealers' initiative or the System Account's initiative, and whether both sides of it were executed with one dealer or each side handled by a separate dealer, only prices competitive with the market would be accepted. Participants in any such transactions would, in the course of the negotiations, be given enough information to make it clear that a swap was involved and not an outright purchase or sale.

Swaps between bill maturities are an important part of total activity in the Treasury bill market. Dealers are constantly searching about the market to find particular maturities of bills their customers want, against which they offer to sell bills they have in position, or attempting to work out swaps that will bring them a better distribution in their positions. Distribution of dealers' awards of new bills each week ordinarily involves a large volume of switching to obtain other maturities. Sometimes the working out of a given objective will involve two or more transactions, in which a dealer will swap bills of one maturity against another maturity in order that he might then swap these bills with

someone who is looking for them and who has the maturity the dealer set out originally to find. System Account swapping to provide for policy objectives would, therefore, be consistent with standard operating practice in the bill market.

To summarize, the Manager of the Account would follow these operating practices in his use of the authority to enter into swaps in bills.

- A. Whenever possible, the bills needed to maintain a balanced distribution in the Account or to provide for a specific need, such as the January runoffs, would be acquired in the course of regular purchases, in preference to other maturities, so that the need for swap transactions could be minimized.
- B. Swaps would be made only occasionally. There would be no need to consider making swaps every day, nor every week.

  The Account Management would have no reason to be continually "fussing around" in the Treasury bill market, and the dollar volume of swaps on any one day or within any one week would ordinarily be relatively small.
- C. As a matter of operating practice, swaps usually would be undertaken at the initiative of the market, representing dealer requests that happened to fit System needs and on which the pricing was competitive.
- D. On those occasions when the System Account took the initiative in exploring possible transactions, the dealers contacted would, as a matter of course, be given enough information to make it clear that a swap is involved.

## Classification of Treasury Bill Holdings in System Open Market Account

(In thousands)

Treasury Bills		Holdings 5/15/56*
Due	5/24/56	\$ 45,270
11	5/31/56	97,500
11	6/ 7/56	38,700
11	6/14/56	-
11	6/21/56	51,100
11	6/28/56	46,700
11	7/ 5/56	500
11	7/12/56	<b>≠</b>
f1	7/19/56	-
11	7/26/56	•
11	8/ 2/56	31,400
11	8/ 9/56	-
Ħ	8/16/56	
		\$311,170

<sup>\*</sup> Commitment basis