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TO: Federal Open Market Committee

FROM: Peter M. Keir

SUBJECT: System role in syndicated underwriting of long-term Treasury bonds.

An important question for monetary policy is raised by the Treasury plan to offer $250 million long-term bonds for competitive bidding by private underwriting syndicates. Financial underwriters in evaluating this Treasury proposal have noted that the winning syndicate will have difficulty stabilizing the price of the new issue during the underwriting period. They have, therefore, asked whether there are any circumstances in which the long-term Government bond market might be supported by Federal Reserve transactions.

On October 17 -- before the next meeting of the Open Market Committee -- representatives from the Treasury and the Federal Reserve Bank of New York will be meeting with financial underwriters in New York City for a question-and-answer session on the Treasury proposal. Since the question of possible Federal Reserve support will be raised at that time, the Open Market Committee may wish to consider having a prepared statement that can be read to the underwriters, outlining generally the policy approach which the Federal Reserve will take.

The most logical Federal Reserve approach would seem to be for the System Account Management to follow an "even-keel" policy during the Treasury underwriting period just as it does in other types of Treasury financings. Because the term "even-keel" may imply more in the way of Federal Reserve assistance to the market than the Committee would in fact be willing to provide, however, any prepared statement should probably eschew the "even-keel" terminology and state at least in a broad way what the policy includes and does not include in order to avoid building up any false expectations among prospective underwriters. Misunderstanding on this score might cause the underwriters to underestimate the market risk of the financing and to overbid for the new issue.

It may thus be useful for the Committee to address itself to a clarification of "even-keel" policy at two levels: (1) how it would be defined in public statements to the underwriters, and (2) how it would be interpreted for internal operating purposes. This memorandum focuses on the second of these levels of Committee consideration. It attempts to spell out what appear to be the elements of "even-keel" policy as they have been applied to past Treasury financings, and to suggest how these precedents might be applied to the Treasury's syndicated underwriting.

Elements of "even-keel" policy

(1) The Federal Reserve policy of maintaining an "even-keel" during periods of Treasury financing has been treated basically as a commitment to avoid any System action which might lead those active in the Government securities market to conclude that monetary policy has changed or is about to change.

(2) This commitment clearly means no change in the discount rate and no change in member bank reserve requirements during the "even-keel" period.

(3) It evidently means also avoiding changes in bank reserve availability and in the tone of the money market large enough to raise questions about policy objectives.

(a) General market churning at times of Treasury financing may necessitate somewhat higher levels of free reserves than would otherwise be needed to maintain the status quo in money market conditions. The market should be sufficiently sophisticated about this need, however, to avoid any imputation of policy change to the higher reserve figure. On the other hand, a sharply lower average reserve figure in such circumstances risks interpretation as a change in policy.

(b) To realize the objective of maintaining a steady money market, the Account Management is customarily prepared during Treasury financings to make repurchase contracts readily available to Government security dealers as their underwriting positions grow, if other sources of financing tend to dry up.

(c) Similarly, in Treasury cash operations when banks are important underwriters, the increase in required reserves needed to cover expanded tax and loan accounts is usually supplied by the System in order to keep money conditions from tightening on the payment date.

(4) The precise period to be covered by an "even-keel" commitment has never been well-defined, but at the minimum it seems to mean the time span running from the week that the Treasury meets with its advisory committees, just prior to the announcement of financing terms, through the payment or settlement date on the new Treasury issues. Some might say that the "even-keel" period carries beyond

the settlement date, to the extent that primary underwriters continue to have large undistributed positions in the new issues.

(5) "Even-keel" policy makes no commitment to maintain yields or prices on Government securities. It merely states that the System will avoid overt policy actions and will try to prevent changes in money market atmosphere which by themselves might encourage the market to discount expected changes in monetary policy. Yields may change as a result of other market influences, such as a large gold outflow, a rash of favorable business news, or the development of congestion in capital markets. The "even-keel" policy does not include any commitment to take the action needed to offset rate changes attributable to such causes.

(6) Operating guidelines established by the FOMC for the Account Management no longer expressly prohibit purchases of "rights" and "when-issued" securities in Treasury financings, nor do they prohibit operations in outstanding securities with maturities adjacent to the new issues. In practice, the Account Management has continued to refrain from open market operations expressly intended to influence Treasury financings. At times, however, when coupon issues have been bought in lieu of Treasury bills, purchases have included potential "rights" as well as recently offered Treasury issues not yet fully distributed. Market participants might, therefore, conclude that present operating techniques would permit System support purchases in long-term bonds even in circumstances when the market was not disorderly.

"Even-keel" and syndicated underwriting

From points (1) through (5) of the foregoing it would appear that application of the usual "even-keel" approach to the upcoming Treasury bond financing would amount, in effect, to saying that in the absence of disorderly market conditions no direct System support of the long-term market would be forthcoming. Underwriters of the new bond would have the assurance that no basic System policy changes would be initiated which might disturb the market during the underwriting period. But they would not receive any other assistance from the "even-keel" approach.

For example, since the System limits its repurchase contracts to short-term Government securities, dealers active in the winning underwriting syndicate could not expect to receive any repurchase accommodation for carrying positions in the new bonds. Similarly, since the increase in member bank reserve requirements resulting from the bond financing would very likely be only nominal, the System would not be adding appreciably to the basic reserve supply. Finally, to the extent that bank participants in the winning underwriting group attempted to borrow at Reserve Banks, discount window officers would presumably continue to consider these demands in light of existing borrowing regulations and would not grant any special dispensation to accommodate positions in the new bond.

In short, the underwriters of the new Treasury issue would be expected to bear the full market risk of the operation just as they do in corporate and municipal bond financings, with one major exception:

they would have an assurance of no basic monetary policy change during the underwriting period which underwriters of corporate and municipal securities do not have.

The "even-keel" period might be somewhat different in a syndicated underwriting operation than in a regular Treasury financing. Presumably the Treasury would announce the general terms of its new bond -- i.e., the coupon and maturity -- about three weeks in advance of the competitive bidding. In this period prospective bidders would try to obtain tentative purchase commitments from ultimate investors. The bidding would then occur and the winning group would proceed to distribute the issue under the terms of its syndicate agreement.

It seems clear that the System could not reasonably commit itself to an "even-keel" approach for the full period from the announcement of Treasury terms on the new bond, through the bidding date, and into the syndicate distribution period. A possible alternative would be to begin the "even-keel" policy a few days before the competitive bidding, and then to maintain it for a week or two while the bond is being distributed.

In conclusion, the key issues which the Committee may wish to consider concerning the Treasury underwriting are (1) whether to adhere to an "even-keel" policy; (2) what types of commitments such a policy implies -- to the Treasury, and to the underwriters; and (3) over what time period would the "even-keel" policy be in effect.