June 6, 1968

To Members of the Federal Open Market Committee and Presidents of the Federal Reserve Banks not presently on the Committee

From A. R. Holmes

Subject: System Subscriptions in Treasury Cash Refundings

The attached memorandum is designed to bring to the attention of the Committee a question that has arisen about Federal Reserve subscriptions to Treasury refunding operations in the light of new debt management techniques. As the memorandum indicates, this is a practical problem for both the System and the Treasury and does not appear to raise any fundamental questions about basic Federal Reserve-Treasury relationships. Nonetheless there are policy overtones that the Committee will want to consider carefully. Because of this it appears desirable to circulate the memorandum at this time with a view to a Committee discussion at a forthcoming meeting of the Open Market Committee. It would seem highly desirable to formulate a Federal Reserve approach and discuss it with the Treasury well in advance of the August refunding that the Treasury will be announcing in late July or early August.

Att.

CONFIDENTIAL--(F.R.)

To Federal Open Market Committee June 6, 1968

From A. R. Holmes Subject: System Subscriptions in Treasury Cash Refundings

Recent changes in Treasury debt management with respect to refunding operations have raised some questions and potential problems in handling the Federal Reserve holdings of maturing issues. This memorandum describes briefly the new technique employed in both the February and May 1968 refunding operations, reviews the handling of System subscriptions in various types of Treasury refunding operations, and proposes some changes in FOMC and Treasury procedures that would give the Federal Reserve greater flexibility in subscribing to new Treasury issues.

The February and May 1968 Refunding

In its last two refunding operations the Treasury has combined an exchange offering for the maturing issues with a cash offering. In February an exchange offering of a 7-year note for the maturing issues (including a prerefunding of August and November maturities) was combined, with a week's time lag, with a cash offering of a 15-month note. In the most recent refunding an exchange offering of a 7-year note was combined with a simultaneous offering for cash of a 15-month note.

This procedure can have several advantages from the debt management point of view over a straight exchange refunding or a straight cash refunding. First, the offering of a longer term issue in exchange for the the maturing issue lets the market decide the size of the long-term issue. While it might not always work out so well, both the February and May refundings resulted in more debt extension than a cash offering of similar maturities. In both cases, the market turned out to be willing to take more of the longer issues than it would have been prudent for the Treasury to offer for cash. Secondly, the cash offering enables the Treasury to avoid the attrition that inevitably results from a straight exchange refunding and to raise new money if it so desires. Thirdly, by raising new money in conjunction with a refunding operation, the new procedure minimizes the number of times that the Treasury has to enter the market. This is a substantial plus from the debt management point of view, and is of at least equal benefit to the Federal Reserve since it cuts back on the even keel periods that tend to inhibit the System's flexibility with respect to changes in monetary and credit policy.

By combining some of the benefits of an exchange refunding with those of a cash refunding, the new technique has advantages for both the Treasury and the Federal Reserve. There is, however, the disadvantage of limiting the System's options in exchanging its holdings of maturing issues. In both February and May the System had no choice but to subscribe for the longer term issue offered by the Treasury. Given the liquidity of the System portfolio this caused no particular problem, but it would appear to be wrong in principle for the System to be in a position where it always had to subscribe to the longer issue.

System Subscriptions in Various Types of Refunding

1. Straight Exchange Refunding

In a straight exchange refunding, the Treasury may offer holders of maturing issues the option of taking either a short-term anchor issue or a longer term note. The size of each issue is determined by the choice of holders of the maturing securities. All holders of the maturing issue entering subscriptions are assured of a par for par exchange, and any securities not exchanged are paid off by the Treasury at maturity. In such a refunding operation the Federal Reserve has complete freedom of choice as to its subscription. In practice the System has often split its subscription, in a proportion roughly equivalent to the expected public subscription to the two issues.

2. Straight Cash Refunding

A straight cash refunding enables the Treasury to avoid the attrition that is inevitable in an exchange refunding and to raise new cash if it desires. But, in a cash refunding, the Treasury faces the problem of establishing the amounts of the issues to be offered. In order to set the amounts properly it needs to know something about the System's intent to subscribe to the new issue. Similarly, the market, if it is to assess the attractiveness of the Treasury's offering, needs to know how much of the issue will have to be taken up by the public. If the Treasury is offering \$2 billion of a long-term note as part of a \$10 billion refunding operation, in which the System holds \$6 billion of the maturing issues, the attractiveness of the issue will obviously be different if the market expects the System to subscribe for \$1 billion of the longer note or to convert its entire holding into the shorter note. To avoid this uncertainty, the System has in practice, with one exception, in 1960, kept to the short end of the Treasury offering in an optional cash refunding. While the System's approach is not made explicit, the market has come to assume that the longer offering will have to be taken up by the public, and the Treasury also works on this assumption in designing the size of the issues to be offered.

A major feature of a cash refunding is the absence of a special subscription privilege attached to the maturing issue or issues. Subscriptions from the general public are subject to allotment by the Treasury, with the allotment percentage depending on the size of total subscriptions relative to the amount of the new issue being offered. A subscription paid for in cash by the Federal Reserve Banks would of course come under the \$5 billion limitation on direct lending to the Treasury under the proviso clause of

Section 14(b)(1) of the Federal Reserve Act. On the other hand, an exchange by the Federal Reserve of securities held in its portfolio for new securities issued by the Treasury does not come under such statutory limitation. Thus as a practical matter the Federal Reserve is precluded from using cash to pay for a new Treasury issue which is offered to the public.

In order to enable the Federal Reserve to exchange its holdings of a maturing issue or issues in a cash refunding (and thus avoid the reserve drain that would occur if the System's holdings ran off at maturity) the FOMC worked out with the Treasury in 1960 an arrangement whereby the Treasury would give full allotments to the Federal Reserve System, Government investment accounts, state and local Goverments, foreign Governments and central banks, international financial institutions of which the U. S. is a member, and publicly administered pension funds. Until November 1963 these "bedfellows" were allowed full allotments on any subscriptions entered. Since that time they have been allowed full allotments only to the extent that they held the maturing issue at the time of the announcement of the refunding.

The Treasury had earlier proposed (in 1958) that a special allotment of the new issue or issues be given the Federal Reserve corresponding to its holding of the maturing issues with the remainder being offered to the public. At that time the FOMC had reservations about any debt management moves that distinguish in any way between the securities held by the Federal Reserve Banks and the securities held by other investors. The thought apparently was that, if the Treasury were to give the System special treatment in financing operations, the System could be pressured to help the Treasury in these operations. There were also the possibilities that preference for the System could be criticized on the grounds of equity or that such preference might open the way to pressure for treating System holdings of Government securities in a different manner from holdings of others. The FOMC felt, however, that the grouping of the System with the bedfellows enumerated above was sufficient to remove that objection.

While the Treasury's original 1958 proposal was rejected by the FOMC on policy grounds, counsel for the Committee found no legal problems with the procedure suggested by the Treasury. The strong Committee feelings about the need for bedfellows undoubtedly made good sense at the time, when pre-accord Treasury-Federal Reserve relationships were still fresh in mind and free market principles had to be firmly established. As far as basic Federal Reserve-Treasury relationships are concerned, however, the procedure suggested by the Treasury in 1958 would not, at this time, appear to be particularly objectionable from the System's point of view.

Basically, what is needed is a way for the System to roll over its holding of maturing issues while maintaining an arm's length relationship with the Treasury, specifically ensuring that the terms of the Treasury offering meet the test of the market and are not based on special System support of the offering. None of these basic principles would be violated if the Treasury (a) offered the public (including the bedfellows other than the Federal Reserve and the Government Trust Accounts) new securities for payment in cash subject to allotment with the amount of the offering equal to public holdings of maturing issues plus any new cash the Treasury wanted to raise and (b) offered additional amounts of identical securities to the Federal Reserve and Government Trust Accounts to be paid for by the exchange of securities then held by them. To be successful the new issues would have to meet the test of the market, and the greater flexibility provided the Federal Reserve to exercise options in a cash refunding would help ensure that the System did not hold too great a percentage of any particular maturing issue.

The question of the bedfellows should not be overemphasized, since it is not essential to the practical problem that the Treasury and Federal Reserve face. Nevertheless, since the issue arose at the time the Treasury first experimented with a cash refunding, it would appear useful for the Open Market Committee to reassess its position at this time. If the Committee should decide that it feels the bedfellows are no longer needed, this view should be expressed to the Treasury. Final decision as to the ultimate disposition of the bedfellows, however, might best be left to the Treasury. The Treasury may, in fact, find it difficult to rescind the full allotment privilege for the bedfellows because some state and local Governments, international institutions, public pension funds, and others may have become accustomed to the practice. On the other hand, the Treasury has at times had complaints from institutional investors who have not had the full allotment privilege and have found it difficult to understand why foreign central banks or local Governments are allowed to stand in a preferred position to other investing domestic institutions. Full allotments for the Federal Reserve--which is prohibited by law from making cash subscriptions to Treasury offerings, except under direct borrowing provisions and where runoffs of maturing issues affect the reserve base of the banking system--are far easier to understand and justify.

3. Combined Exchange and Cash Refunding

The use of a combined exchange and cash operation by the Treasury presents a somewhat different set of problems with regard to System subscriptions. As far as the Treasury and the market are concerned, setting of the amount of the cash issue to be offered raises the same problem as in a straight cash refunding. For this reason the Treasury did not offer the System or the bedfellows an opportunity to receive a full allotment on subscriptions to the shorter (cash) issue to the extent they held the maturing issues. An additional technical problem is presented when the combined cash and exchange offering is conducted in two parts--as in February--with the cash financing following the exchange offering with a time lag of a week or so.

Summary and Proposals

To summarize the situation with respect to System subscriptions to Treasury refundings where an option is offered:

In a straight exchange refunding the System has full discretion with respect to its subscription.

In a cash refunding the System, with one exception, has in practice limited its subscription to the shorter issue offered.

In a combined exchange--cash offering the System has in practice been limited to the longer issue offered.

While there are good technical reasons--as enumerated above--for this rather anomalous situation, it does not seem desirable for the System subcription to be predetermined by the Treasury's choice of a particular debt management technique. The following proposals for a change in System and Treasury procedures with respect to System subscriptions in a cash or combined exchange-cash offering would, it is believed, give the System maximum flexibility, while retaining the desirable flexibility for the Treasury in its choice of debt management techniques, and avoiding market uncertainty with respect to the size of issues offered to the general public for cash. Handling of the bedfellows would depend on FOMC and Treasury policy decisions, but would not alter the basic approach.

The most simple approach would be for the Treasury--in an optional cash refunding--to offer to the public a specified amount of each issue equivalent to public holdings of the maturing issues and to simultaneously announce that additional amounts of either issue would be alloted to the Federal Reserve, to the extent it held the maturing issues, and to Government Trust Accounts. At the same time it could provide, if desired, for full allotments for the list of bedfellows that are now given this special privilege. For purposes of setting the amount of the issues to be offered to the public, the bedfellows in any event would be treated as part of the public. The securities to be offered would obviously have to meet the test of the market, but the market would know the precise amount that would be awarded to the public, thus solving the practical problem that the Treasury faces in fixing the size of the issue to be offered. Under this procedure the System would not be put in any position of subservience to the Treasury. In fact, its flexibility would be increased since it could exercise an option to subscribe to either or both issues without creating any problems for the market. There would be no question of the System subscribing for more of the new issues that it held of the maturing issues, and in line with the advice of counsel in 1958 and 1960, there would be no question of Treasury direct borrowing from the System involved.

The same procedure could be followed in either a straight cash refunding or for the cash portion of a combined exchange-cash refunding.

The following illustration presents the way the Treasury might have approached its May refunding operation under the procedures proposed above. At that time issues maturing May 15 totaled $8 billion, of which approximately $3.9 billion were held by the public, $3.6 billion by the Federal Reserve and $0.5 billion by Government Trust Accounts. The exchange portion of the operation would have been precisely as it was in May--all holders of the maturing issues would have been granted the right to exchange their holdings of the maturing issues for the 6 per cent 7-year note. In making its announcement of the cash offering, however, the Treasury would have said that it was offering $3 billion to the public of a 15-month 6 per cent note, and in addition it would issue additional amounts of that issue to the Federal Reserve and the Trust Accounts to the extent they did not subscribe to the longer term note. Additionally to the Federal Reserve and the Trust Accounts, the bedfellows could have been granted full allotments in the cash offering to the extent they held the maturing securities at the time of the announcement, but the bedfellows' allotments would have come out of the $3.6 billion amount offered to the public. In that case the System could have split its $3.6 billion rollover between the 7-year and 15-month issues.

A special problem exists when a combined exchange-cash offering is separated over time, as was the case in the February refunding. At that time the cash portion of the combined operation followed the exchange offering by a week. The separation, which permitted the market to concentrate on one operation at a time, and which could give the Treasury the opportunity to assess attrition before setting the precise amount of the cash issue, appears to be a useful debt management technique rather than a substantially different approach from the simultaneous exchange-cash operation undertaken in May. It would therefore appear desirable for the System to retain the same option to subscribe for either issue. The fact that settlement date for the cash issue would normally come after the maturity date of the issues being refunded would create a problem of what to do with the System's holdings of the matured issue slated for exchange into the issue being offered for cash.

The following example illustrates the problem and possible alternative solutions to it, of which one appears far preferable. Suppose the Treasury announces on May 1 that it is offering a long-term note in exchange for issues maturing on May 15 with the books open on Monday to Wednesday May 6 to 8. In addition it announces that it will combine this exchange with a cash offering of 15-month notes to be made on Friday, May 10, to pick up the attrition on the exchange and to raise $2 billion in new money with the books open on Wednesday, May 13, and payment on May 20. The amount of the maturing issues is $8 billion of which the Federal Reserve holds $3.5 billion and Government Trust Accounts $0.5 billion. Suppose that the System decided that it would be appropriate to subscribe to $1 billion of the longer term issue and $2.5 billion of the short-term issue. The System would then enter a subscription of $1 billion for the longer term note and on May 15 would exchange that amount of the maturing issue for the new note. Additionally, it would enter a subscription on May 13 for $2.5 billion of the 15-month note.

There would then remain the question of what to do with the matured $2.5 billion of securities that was earmarked for subscription to the cash issue until the May 20 payment date. It would obviously make little sense for the Treasury to pay off these notes at maturity, both because of the reserve impact of such payment and because it could raise legal questions about whether the System was making an actual exchange or whether it was subscribing directly to the new cash issue.

There are four possible approaches to this question, of which the fourth appears to be desirable and, hopefully, clear of legal questions.

First, the System could hold the issues maturing May 15 without interest and surrender them on May 20 in exchange for the new issue. This would, however, be contrary to normal market practice and might create a dangerous precedent for an arm's length Treasury-Federal Reserve relationship.

Second, the System might exchange its $2.5 billion of maturing securities for a 5-day special certificate issued by the Treasury, and in turn exchange that certificate for the new 15-month note on May 20. The special Treasury certificate would presumably have to be subject to the $5 billion limit set in Section 14(b) of the Federal Reserve Act on purchases of securities by the Federal Reserve Banks from the Treasury. And there are apparently legal questions as to whether the System's exchange privilege can be extended through the medium of the special certificate, and whether the System's direct purchase from the Treasury is extinguished when the exchange of the special certificate for the notes is effectuated. There are also problems with respect to the bedfellows that along with the System and the Goverment Trust Accounts have been granted full allotments in cash exchanges. It is not clear whether the Treasury, for example, would be willing to issue special certificates to the bedfellows, or whether such an offering would prove attractive to them.

Third, the Treasury might pay interest for an extra five days on the matured securities to those holders who were granted full allotment privileges and elected to exchange into the cash offering on May 20. This would presumably, however, require special legislation similar to that permitting the payment of interest on matured savings bonds. Seeking of such legislation would not be a practical short run--at least--solution to the problem.

Fourth, the Treasury might date the cash issue offered to the public for payment on May 20 as of May 15. The System would pay for its subscription on May 20 by presenting its May 15 maturities. At the same time, cash subscribers would have to pay five days accrued interest in addition to the subscription price. This is a normal market practice and should not in any way detract from the success of the Treasury offering. (Alternatively, the Treasury might, on occasion, use the predating technique as an additional "sweetener" on the cash financing as it has often done in the past--i.e., allow the cash subscribers part or all of the extra five days interest.) Those subscribers who were allowed full exchange privileges in the cash refunding could then exchange their maturing issues without loss of interest and with no violation of normal market practices. If the Treasury concurs in the approach, this alternative would appear to be the simplest and most satisfactory.

Conclusions and Recommendations

I would view the problem outlined in this memorandum as a practical problem of blending System procedures for the exchange of maturing Government securities with desirable debt management techniques, and not as a substantive problem involving fundamental Federal Reserve-Treasury relationships. There are obvious policy and legal overtones, however, and the matter requires the Committee's attention. I would recommend that the Committee approve in principle the proposals outlined above involving the Federal Reserve-Treasury procedures in a cash refunding or in a simultaneous exchange-cash operation such as took place in May. I would also recommend that the Committee approve in principle the procedures described above in a combined exchange-cash operation separated by a short time period such as in February, using the fourth alternative listed. All of these proposals will of course require legal review by Counsel for the Committee.

It perhaps bears repeating that while the question of the bedfellows is involved in any change of Federal Reserve-Treasury procedures with respect to cash refinancings, the proposals suggested above can be adopted with or without any changes in the continued association of these groups with the Federal Reserve in an exchange privilege in a cash financing. As the memorandum indicates I can see no real reason for System bedfellows, at this time. If the Committee decides to reverse the position taken in 1960 this change in position should be communicated to the Treasury. In this event, however, it would seem appropriate to let the Treasury make the final decision with respect to their status.