FEDERAL AGENCY ISSUES

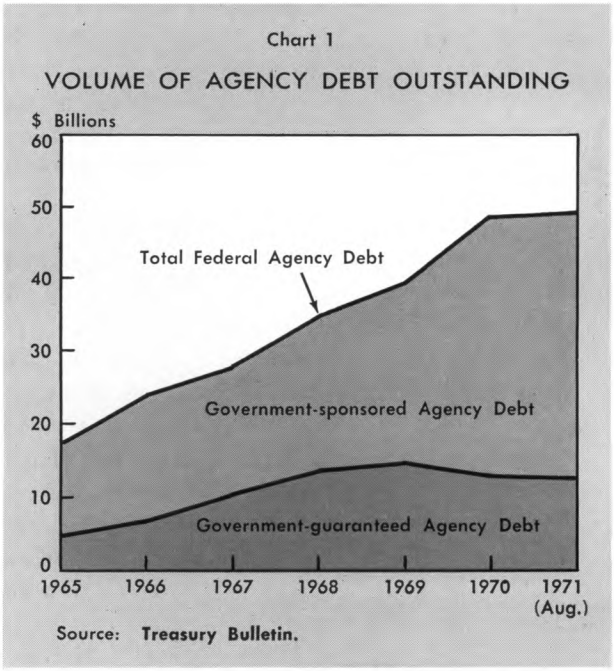
INTRODUCTION

On September 16, 1971, the Federal Open Market Committee (FOMC) of the Federal Reserve System announced that System open market operations would include output transactions in Federal agency securities. This decision was not a sudden one, for the advantages and disadvantages of operations in agency securities had been carefully weighed since 1966 when Congress broadened the System's authority to purchase agency issues. Of the factors that influenced the FOMC's decision, the rapid growth of the agency market during the past five years has been one of the most important. This article examines the characteristics of the agency market and the operating guidelines established by the FOMC to overcome potential problems that might arise as a result of System transactions in agency issues.

BASIC CHARACTERISTICS OF THE AGENCY MARKET

The Agencies Five privately owned, Government-sponsored corporations are responsible for most of the growth in the agency market. They are the Federal National Mortgage Association (FNMA), Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives, and Federal Home Loan Banks (FHLB). Since 1965, the securities of the "big five" have comprised approximately 75 percent of total Federal agency debt outstanding. The primary function of the FHLB and the FNMA is to provide funds to the mortgage and home-building markets. The other three corporations provide farm credit.

Federally operated agencies, in contrast to Government-sponsored corporations, include the Export-Import Bank, the Federal Housing Administration (FHA), Farmers Home Administration, Government National Mortgage Association (GNMA), and the Tennessee Valley Authority (TVA). GNMA was established in 1968 to assume special assistance, management, and liquidating functions previously conducted by FNMA. The Export-Import Bank supports U. S. exports through loan guarantees and insurance. The FHA provides a system of mutual mortgage insurance for builders, buyers, and mortgage-lending institutions. As a part of the Department of Agriculture, the Farmers Home Administration extends loans in rural areas for farms, homes, and community facilities. The TVA was established by an Act of Congress to assist the development of the Tennessee River and the surrounding area.



The Issues Securities of Government-sponsored and Federally operated agencies consist of short-term notes, debentures, and participation certificates. Neither principal nor interest on Government-sponsored agency issues is guaranteed by the Federal Government, although both are fully guaranteed by the issuing agencies. In contrast, the issues of Federally operated agencies are fully guaranteed by the Government. Average original maturities of outstanding Government-sponsored issues range from five months to five and one-half years (Table I). Guaranteed securities generally have a longer average original maturity, ranging from four months for TVA's notes to 15 years for TVA's debentures. Almost half of all agency securities outstanding mature within two years. The average size of Government-sponsored issues is $314 million or roughly $100 million greater than the average size of guaranteed securities. Although most agency issues, both sponsored and guaranteed, are available in denominations ranging from $1,000 to $500,000, both types of obligations are occasionally offered in smaller- or larger-than-average denominations.

There are three ways in which a new issue may

be placed on the market. First, a Fiscal Agent, or middleman, may handle the security and organize his own selling group for distribution. Second, the agency may by-pass the Fiscal Agent and place the issue directly with one or more syndicates. Third, the agency may sell the issue directly to the public. In each of these three cases the rate may be fixed, auctioned, or negotiated.

Comparison of yields on alternative agency securities shows that issues of Federally operated agencies generally have a higher yield than do Government-sponsored securities. However, average yields on all agency obligations are somewhat higher than yields on comparable Treasury securities. For example, yields on short-term agency issues average 30 to 60 basis points above yields on Treasury bills or Treasury issues of like maturity. To some degree, this yield difference may reflect the "no guarantee" aspect of agency debt. However, it is unlikely that the U. S. Government would permit default of agency debt. Of greater importance is the thinness of the agency market when compared to the market for Treasury securities. Since the average size of agency issues is considerably less than Treasury issues and the number of market participants is fewer, there is greater risk of adverse price movement when investors sell their holdings. Even so, since 1965, yields on agency issues have fluctuated only slightly more than yields on Treasury issues of comparable maturity.

The yield disparity between short-term Treasury debt and short-term agency debt has fluctuated during the past five years and has been greatest during periods of tight money when the general level

Table I

COMPARISON OF AGENCY ISSUES

	Guaranteed	Avg. Original Maturity (Months)	Avg. Yield 1971	Avg. Size (Mil.)	Denomination Size (Thous.)	Frequency of Issue	Method of Issuance[2]	Taxed By[3]
A. Government-sponsored corporations								
1. FNMA								
a. Notes	No	5	n.a.	n.a.	$ 5 - $ 1,000	Monthly	A, B	F, S, L
b. Debentures	No	65	5.54	286	$10 - $ 500	Monthly	A, B	F, S, L
2. Banks for Cooperatives								
a. Debentures	No	6	4.69	286	$ 5 - $ 100	Monthly	A	F
3. Federal Home Loan Bank								
a. Notes and Bonds	No	46	5.45	293	$10 - $ 1,000	Monthly	A, B	F, S
4. Federal Intermediate Credit Bank								
a. Debentures	No	9	4.99	438	$ 5 - $ 500	Monthly	A	F
5. Federal Land Banks								
a. Bonds	No	64	5.55	265	$ 1 - $ 100	Bi-Monthly	A	F
B. Government-guaranteed agencies								
1. Export-Import Bank								
a. PC's	Yes	72	5.48	200	$ 5 - $ 1,000	Last Issue	B	F
b. Debentures	Yes	54	5.41	400	$ 5 - $ 1,000	Apr. 1, 1970	B	F
2. Federal Housing Administration								
a. Debentures	Yes	n.a.	n.a.	6	$50 - $10,000[1]	n.a.	n.a.	F
3. Farmers Home Administration								
a. Notes	Yes	119	6.96	219	Each Issue Varies	Quarterly	A, B, C	F
4. GNMA								
a. PC's	Yes	145	6.00	124	$ 5 - $ 1,000	No Longer Issued		F, S, L
5. Tennessee Valley Authority								
a. Notes	Yes	4	5.13	183	Multiples of	Monthly	A	F
b. Bonds	Yes	180	7.10	69	$1,000	Quarterly	B	F

1. Dollars
2. A. Use Fiscal Agent; B. Issue Direct to Syndicate; C. Issue Direct to Public.
3. F—Federal, S—State, L—Local

Source: **Securities of the United States Government and Federal Agencies,** First Boston Corporation, 1970; Bond Buyer; Salomon Brothers' quote sheet; Morgan Guaranty Trust Company's quote sheet; telephone contact with each agency.

Table II

PERCENTAGE DISTRIBUTION OF OWNERSHIP

Agency	Commercial Banks	Mutual Savings Banks	Insurance Companies	Savings & Loans	Corporations	State & Local Govts.	U. S. Govt.	All Other*
1965								
Banks for Cooperatives	28.4	5.5	2.6	1.3	8.2	9.3	0.6	44.2
Federal Home Loan Banks	24.7	6.3	3.8	4.7	9.6	5.7	....	45.2
Federal Intermediate Credit Banks	25.8	5.7	2.6	1.0	7.1	7.4	0.7	49.8
Federal Land Banks	18.7	6.6	4.7	0.7	2.4	7.9	0.1	59.0
FNMA	6.3	5.5	4.3	4.3	2.2	26.9	....	50.5
Total** Outstanding	20.8	6.0	3.8	2.7	6.0	10.0	0.2	50.3
1971								
Banks for Cooperatives	25.5	1.5	0.8	4.5	2.9	9.9	....	54.9
Federal Home Loan Banks	20.9	5.0	1.1	10.2	1.0	3.8	....	58.1
Federal Intermediate Credit Banks	24.6	2.6	0.7	5.4	2.7	6.7	....	57.2
Federal Land Banks	20.7	4.3	2.0	3.0	2.3	6.9	....	60.9
FNMA	21.0	5.8	1.3	7.8	1.6	8.5	....	54.0
Total** Outstanding	19.7	4.8	1.9	6.1	1.5	8.5	4.2	53.3

* Includes all owners of agency issues who do not report in Treasury Survey of Ownership.

** Includes issues not itemized.

Source: **Treasury Bulletin.**

of interest rates was high. In contrast, the spread between yields on long-term agency and Treasury debt has been constantly rising since 1965. This continued increase in the disparity between the yields is the result of not only tight monetary policy but also the relatively sharp growth in long-term agency issues.

Ownership of Agency Issues The Treasury Survey of Ownership reveals that commercial banks consistently have been the most active buyers of agency securities, holding about 20 percent of the total outstanding agency debt (Table II). From 1965 to 1971, the ownership distribution has not changed appreciably except in one area. In 1965, state and local governments owned 27 percent of FNMA's outstanding issues, while commercial banks held only 6 percent. By 1971 this pattern reversed itself because state and local governments, faced with tight liquidity positions, began selling-off their holdings of FNMA securities to help meet their financial needs. During the same period, commercial bank investment portfolios increased in dollar volume and included larger holdings of agency securities.

FOMC OPERATIONS IN AGENCY ISSUES

The Guidelines In 1966, Congress authorized the Federal Reserve to conduct open market transactions in agency issues, but until September 1971, the System limited activity in agency securities to repurchase agreements. The FOMC postponed the decision to operate in agency issues for a number of reasons. First, it was feared that transactions in agency obligations might be subject to political pressures and, thus, might conflict with the broad objectives of general monetary policy. Second, it was felt that System activity in agency issues might, because of the thinness of the market, result in an undesirable dominance of the market by the Federal Reserve. Third, outright transactions in agency debt would encounter technical problems, since agency obligations cannot be rolled-over at maturity like Treasury debt. Finally, since the agency market is highly fragmented, compared to the Treasury security market, the FOMC felt that this fragmentation would hinder operations.

At its August 24, 1971, meeting, the Federal Open Market Committee voted to conduct outright trans-

Table III

DISTRIBUTION OF OUTSTANDING MARKETABLE AGENCY ISSUES BY AGENCY, SIZE OF ISSUE AND CURRENT MATURITY
October 8, 1971

(amounts in millions)

	Maturing: Under 2 Years #	Under 2 Years Amount	2 to 5 Years #	2 to 5 Years Amount	Over 5 Years #	Over 5 Years Amount
Federal Intermediate Credit Banks						
0 - $199 million						
200 - 299 million	2	$ 403	2	$ 436		
300 and over	9*	4,839*				
Federal Home Loan Banks						
0 - $199 million						
200 - 299 million	4	900	7	1,716	2*	400*
300 and over	6*	2,610*	4*	1,250*	1	350*
Banks for Cooperatives						
0 - $199 million	1	100				
200 - 299 million	3	863				
300 and over	2*	765*				
FNMA—bonds, notes and debentures						
0 - $199 million	3	346			2	348
200 - 299 million	6	1,350	4	950	6*	1,400*
300 and over	10*	3,950*	11*	4,750*	3*	900*
GNMA—PC's						
0 - $199 million	8	220	11	300	17	655
200 - 299 million	2	525			2*	475*
300 and over	2*	780*			6*	3,015*
Federal Land Banks—bonds						
0 - $199 million	3	379	3	428	2	298
200 - 299 million	2	430	2	420	2*	509*
300 and over	8*	3,166*	5*	1,580*	1*	300*
Ex.-Im. Bank-PC's and debentures						
0 - $199 million			1	150		
200 - 299 million					1*	250*
300 and over	2*	800*				
TVA—notes and bonds						
0 - $199 million			3	250	8	525
200 - 299 million						
300 and over						

SUMMARY OF OUTSTANDING MARKETABLE AGENCY ISSUES BY SIZE OF ISSUE AND CURRENT MATURITY

(amounts in millions)

Total Issues

	Under 2 Years #	Under 2 Years Amount	2 to 5 Years #	2 to 5 Years Amount	Over 5 Years #	Over 5 Years Amount
0 - $199 million	15	$ 1,845	18	$ 1,128	29	$1,826
200 - 299 million	19	4,471	15	3,523	13	3,034*
300 and over	37	16,910*	20	7,580*	11	4,565*
Totals	71	23,226	53	12,231	53	9,425

* Indicates issues that would be eligible for outright System operations under the proposed guidelines.

Note: The above tabulation does not include discount notes of FNMA and TVA, Farmer's Home Administration insured notes and, tax-exempt housing notes and bonds backed by the full faith and credit of the U. S.

actions in Federal agency securities for the purposes of widening the base of System operations and adding breadth to the agency market. Accompanying this authorization was a set of stringent guidelines designed to guard against the pitfalls the System feared. The guidelines[1] are:

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

3. As an initial objective, the System would aim at building up a modest portfolio of agency issues, with the amount and timing dependent on the ability to make net acquisitions without undue market effects.

4. System holdings of maturing agency issues will be allowed to run off at maturity, at least initially.

5. Purchases will be limited to fully taxable issues for which there is an active secondary market. Purchases will also be limited to issues outstanding in amounts of $300 million or over in cases where the obligations have a maturity of five years or less at the time of purchase, and to issues outstanding in amounts of $200 million or over in cases where the securities have a maturity of more than five years at the time of purchase.

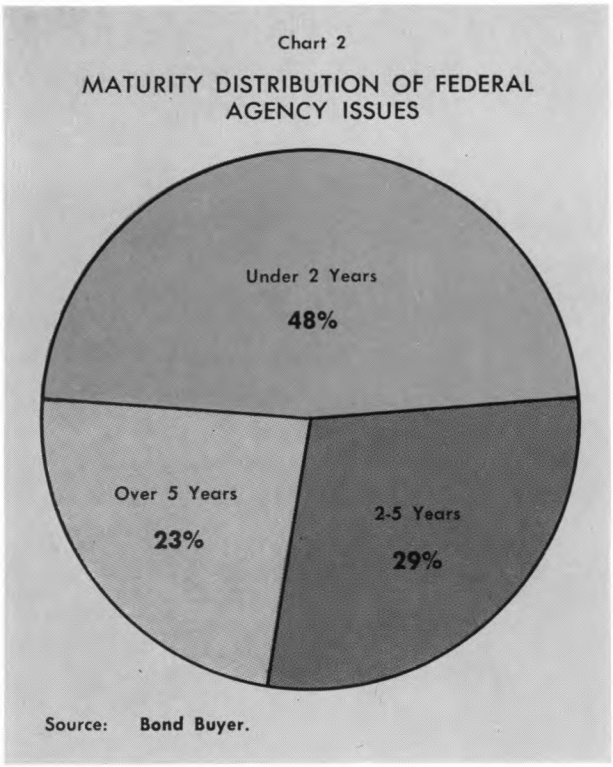
6. System holdings of any one issue at any one time will not exceed 10 percent of the amount of the issue outstanding. There will be no specific limit on aggregate holdings of the issues of any one agency.

7. No new issue will be purchased in the secondary market until at least two weeks after the issue date.

8. All outright purchases, sales and holdings of agency issues will be for the System Open Market Account.

Guidelines 1 and 2 emphasize that System operations in agency obligations will be conducted only as another means of implementing general monetary

[1] Federal Reserve Board press release, September 19, 1971.



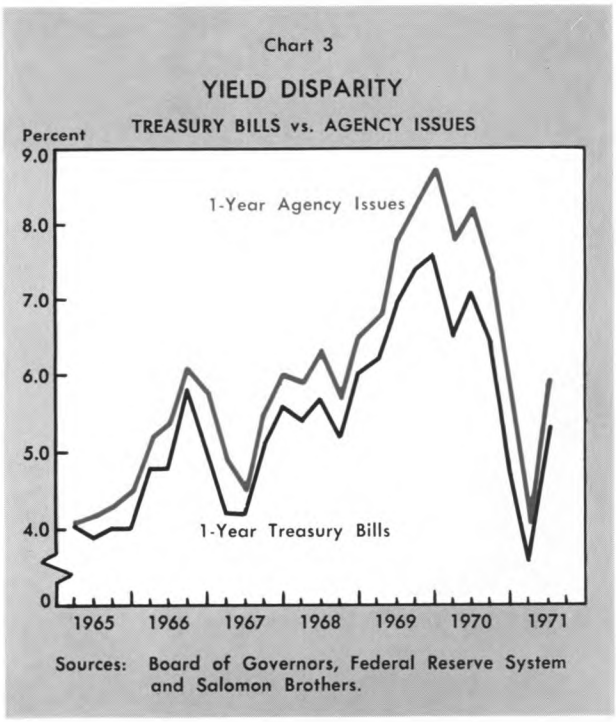
policy. These guidelines are designed to counter possible future pressures on the Committee to bolster particular sectors of the economy. As a tool of monetary policy, agency transactions could be helpful when it is desirable to supply reserves without exerting downward pressure on Treasury bill rates. These operations would focus chiefly on the short-term market, thus having minimal effect on long-term rates.

The problem of System dominance in the agency market has been reduced by the establishment of guidelines 3, 5, 6, and 7. Under these guidelines, 81 issues totaling $32 billion would have been eligible for trading as of October 1971 (Table III). The average size of each eligible issue in 1971 was approximately $395 million compared to $100 million in 1967. Comparison of the agency market with the Treasury security market shows that the ratio of agency debt to Treasury debt has increased from 5½ percent in 1960 to 28 percent in 1971. By limiting System holdings to 10 percent of a single agency issue at any one time, the FOMC has further reduced the risk of System dominance. By comparison, the System currently holds about 26 percent of the one- to five-year Treasury securities. Furthermore, as seen in Table IV, dealer activity in agency issues compares favorably to activity in Treasury coupon issues maturing within one year. In view of these guidelines and developments, System dominance in the agency market is not expected.

One of the System's main concerns about transactions in agency issues was the obvious technical problems that would arise. Guidelines 4 and 7 are designed to counter such problems. Since agency obligations are not issued in a manner similar to Treasury securities, it is not always possible to roll-over or replace the issues at maturity. Furthermore, refunding operations are generally irregular. New securities may or may not be issued immediately when outstanding issues mature.

Guideline 8 merely answers a procedural question. All purchases of agency securities are to be held in the System Open Market Account, not merely in the Account of the Federal Reserve Bank of New York.

The Question of Fragmentation Because agency issues have widely varying characteristics, the market for agency issues is highly fragmented. This fragmentation has been a principal deterrent to System operations in the agency market. Although the market has grown significantly during the 1960's, it has not consolidated. Moreover, during the past several years, new agencies such as the United States Postal Service, Farmers Home Administration, and Federal Home Loan Mortgage Corporation have appeared. Many others, such as the environmental finance agency and the rural development bank, have been proposed. Of all existing agencies, only the



Farm Credit Administration has made any effort toward consolidation of its debt.

A Federal Financing Bank has been proposed by the Treasury Department to help reduce the fragmentation of agency debt. The Bank would be created to purchase debt of Federally operated agencies and in turn issue its own, more homogeneous, debt to the public. However, this Bank would not purchase issues of Government-sponsored agencies now in existence; thus the effective reduction of fragmentation is uncertain. It has been estimated that the consolidation of the debt of Federally operated agencies would create an additional $6 billion of eligible debt, still leaving $10.5 billion of sponsored agency debt ineligible for open market purchases (Table IV). Even so, because System open market operations are confined to larger issues, the Government-sponsored agencies might be encouraged to consolidate their own debt.

Table IV

AVERAGE DEALER POSITION AND TRANSACTIONS IN AGENCY SECURITIES AND TREASURY COUPON ISSUES BY MATURITY

(in millions)

	Agency Issues		Treasury Coupon Issues	
	Within 1 year	After 1 year	Within 1 year	After 1 year
Dealer Position				
1969	332	251	250	299
1970	469	305	351	642
1971*	479	467	268	887
Transactions				
1969	224	137	140	357
1970	270	227	162	481
1971**	231	459	184	728

*Through August.

**Through September.

Source: Board of Governors, Federal Reserve System.

Table V

ESTIMATE OF ADDITIONAL ELIGIBLE DEBT WITH CONSOLIATION

(in billions)

Direct agency debt—marketable and nonmarketable	$11.2
Less marketable debt of GNMA and Ex.-Im. already considered eligible	5.3
Net additional eligible debt	$ 5.9

Source: **Treasury Bulletin** and Board of Governors, Federal Reserve System.

CONCLUSION

The rapid growth of the Federal agency market led to the FOMC's decision to include agency issues in open market operations. Anticipated problems, such as System domination of the market, led to carefully drawn guidelines to control transactions in agency securities. The System has set an exacting course for its activities, but exactly what effect FOMC operations in the agency market will have on issue size and maturity, or the agencies themselves, remains problematical.

B. Gayle Burgess

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