

CONFIDENTIAL -- (F.R.)

March 18, 1960

To Members of the Federal Open Market
Committee and Federal Reserve Bank
Presidents not presently serving on
the Committee.

From John J. Larkin

Subject: Recent Government of
Canada Financing

The Government of Canada announced on Monday, March 14, the terms of a financing operation designed to refund \$329 million 2 3/4 per cent bonds maturing on April 1, 1960. The terms of the financing contained certain provisions that not only are quite new and experimental so far as Canadian financing is concerned, but they also have particular interest (and may turn out to be rather significant) from the standpoint of debt management procedures in the United States. The new provisions cover the sale at auction, through competitive tenders, of part of a 3-year bond issue and part of a 9-year bond issue being offered in the refunding. While the amounts and techniques employed in Canada are not strictly comparable to the auctioning procedure used in the sale of Treasury bills in the United States, this new approach to the handling of public debt transactions falls in an area that has recently attracted considerable Congressional interest. In Congressional consideration of the 4 1/4 per cent ceiling rate on Treasury bonds and in Joint Economic Committee hearings there has been serious agitation for the extension of the auction technique to the sale of longer term U. S. Treasury securities.

Terms of Canadian Offering

The specific issues offered in the Canadian financing were:

A 3-year (maturity, April 1, 1963) 5 1/2 per cent bond priced at 99.75 to yield 5.95 per cent. This issue is convertible by the holders at any time on three months' notice into 5 1/2 per cent bonds due in 1976. If the conversion option is exercised promptly by holders, the yield to 1976 would be 5.52 per cent. This part of the offering represents an additional amount of an issue that was already outstanding in the amount of \$200 million, as the result of an advance refunding in February of this year of part of the

April 1 maturity. Prior to the financing announcement on March 14, this issue of 3-year 5 1/2 per cent bonds was trading in the market at 100.10.*

Distribution of Canadian Offering

There were three steps involved in the financing:

First: The Bank of Canada agreed to purchase \$129 million of the 3-year 5 1/2 per cent bonds in exchange for part of its holdings of the April 1, 1960 maturity. The Bank's total holdings of the maturing issue amounted to \$161 million.

Second: A total of \$75 million of each of the two new issues was offered to members of the primary distributing group** (approximately 300 dealers, brokers and banks) on a firm basis. A specific amount was offered to each primary distributor subject to acceptance or rejection by 8:00 p.m. Tuesday, March 15.

Third: The remaining part (\$50 million plus any firm offerings not taken up by the primary distributors, and less any bonds taken up by Government accounts) of the total offering of \$329 million was offered at competitive tender. Tenders were invited only from the primary distributors (and not from the public at large as in the case of U. S. Treasury bill auctions) for either or both of the 3-year and 9-year 5 1/2 per cent bonds at not less than the issue price of the bonds, less commission. The issue price of the 3-year bonds on firm offerings was 99.75 and the commission to distributors 0.35, making the minimum price for the submission of tenders 99.40. The issue price on the 9-year bonds was 97.75, the commission was 0.75 making the minimum tender price for that issue 97. Tenders were to be submitted prior to 8:00 p.m. on Tuesday, March 15. Bidders did not know beforehand how much of each issue would be awarded. Nor did they know for sure that \$50 million was the amount to be sold at tender, although they apparently were confident that all of the firm offerings would be taken up by primary distributors.

* Prices mentioned in this paper are in decimals rather than 32nds.

** In Canada, marketable Government security issues are offered only to a group of dealers, brokers and banks (known as primary distributors), and are not open to direct subscription by the general public as in the United States.

Results of the Financing

The financing was very successful. All but \$245,000 of the \$150 million of firm offerings were taken up by the primary distributors. In the auction the Government accepted competitive tenders for \$44,120,000 of the 3-year bonds at an average price of 100.23, and \$5,125,000 of the tenders for the 9-year bonds at an average price of 98.25. These prices were 0.83 and 1.25 higher than the net price received by the Government under the firm offering part of this financing. The aggregate of tenders submitted in the auction portion amounted to many times the amount offered.

Comments

The use of the auction technique may have stemmed from some criticism that the terms of earlier financings were too generous. It is not clear, however, how the restricted auction technique employed (it was described as a "controlled experiment")* can be used as a measure of the Treasury's generosity, since any average price established had, necessarily, under the ground rules, to be higher than the firm offering price, less commission. Two additional factors that might help to explain the success of the auction were the rate level itself--5 1/2 per cent--and the strength underlying the market at the time of the financing. Despite this, the authorities expect that there may arise some criticism of the fact that the cost of financing under the auction was cheaper than under the other parts of this offering. In one report from Canada it was said that the auction part of this financing was "embarrassingly" successful.

The new issues closed on Wednesday, March 16, in when-issued trading at prices of 100.35 for the 3-year bond (compared with the average auction price of 100.22 and the firm offering price of 99.75, less 0.35 commission) and 98.62 bid - 98.75 offered for the 9-year bonds (compared with the average auction price of

* The Bank of Canada was apparently prepared to tender in the auction for an amount up to \$32 million, representing that portion of the Bank's holdings of the April 1 maturity not being converted into new 3-year bonds (part 1 of the financing).

98.25 and the firm offering price of 97.75, less 0.75 commission). By Friday afternoon, the market prices had risen to 100.45 bid - 100.50 offered, and 98.75 bid - 99 offered, respectively.

Some of the investment dealers in Canada were reportedly deeply concerned, at the outset, over this innovation in the distribution of debt but they may have since adopted a more favorable view. There seemed to be some initial resentment on the part of the so-called old line firms that the newer firms were willing to transact business on too fine margins and that the auction technique might strengthen this tendency. The investment fraternity has been pressing the authorities in Canada for answers to the question as to whether this new technique is to become a regular part of financing operations. They are being informed that the debt managers are not yet prepared to answer that question, and that this operation represents just one experimental step that may or may not be repeated.

Further study of the results of this operation will be required. It has been mentioned that the authorities would favor selling a larger amount of bonds at auction in the future if this technique is to be tested again.