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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

July 12, 1968

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Mr. Holland

In connection with Item 7 of the agenda for the meeting of the Committee on July 16, there are enclosed for your consideration a copy of a draft letter to Secretary of the Treasury Fowler and an attached memorandum from the Account Manager dated July 10, 1968, and entitled "System Subscriptions in Treasury Cash Refundings." In keeping with instructions received at the last meeting of the Committee, the Account Manager, in consultation with the Board staff, informally reviewed the matter of new System subscription procedures with the Treasury and tentative agreement to move forward to effect these procedures was reached along the lines of the attached draft letter and memorandum.

Robert C. Holland, Secretary
Federal Open Market Committee.

Enclosure

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D R A F T

July 11, 1968.

The Honorable Henry H. Fowler,
Secretary,
U.S. Treasury Department,
15th Street and Pennsylvania Avenue,
Washington, D.C. 20220

Dear Joe:

I am enclosing a memorandum prepared by the Manager of the System Open Market Account regarding the handling of System subscriptions to Treasury refunding offerings in the light of recent innovations in Treasury debt management techniques.

These innovations--which involved combining an exchange offering of new securities with a cash offering--have a number of obvious advantages from the point of view of debt management and System operations. There is, however, a disadvantage in that--for practical reasons--the System's options for exchanging its holdings of maturing issues are limited. As a result, the System's subscriptions tend to be predetermined by the Treasury's choice of a particular debt management technique--a situation that may not be the best for monetary management. This anomalous situation could be avoided if the suggestions contained in the memorandum were adopted by the Treasury and I commend them to you.

I emphasize that what is involved is a technical problem and not a question of basic relationships between the Treasury and the Federal Reserve. I know that we both feel strongly that any Treasury

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offering must meet the test of the market and that the Treasury does not want to look to special System support of its financial operations. I am sure that we would agree also that it is essential for the Federal Reserve to have ample facilities for rolling over its holdings of maturing issues, including the possibility of subscribing to both long- and short-term issues in any optional Treasury refunding operation.

Sincerely yours,

Wm. McC. Martin, Jr.

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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 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 May 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 maturing issue lets the market decide the size of the long-term issue. While it might not always work

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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, thus highlighting a problem which had already arisen in connection with straight cash refundings involving more than one new issue; in such cases the System had felt it could only subscribe to the shorter issue. Given the liquidity of the

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System protfolio and the sizable amount of longer term issues held, no serious problems were created, but it would appear to be wrong in principle for the System to be in a position where it always had to subscribe to either the longer or the shorter 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 faced the problem of establishing the amounts of the issues to be offered. In order to set the amounts properly

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it needs to know something about the System's intent to subscribe to the new issues. Similarly, the market, if it is to assess the attractiveness of the Treasury's offering, needs to know how much of each issue will have to be taken up by the public since public subscriptions will be subject to partial allotment. 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

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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. 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.

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. 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 Governments, foreign Governments and central banks, international financial institutions of which the U. S. is a member, and publicly administered pension funds. This arrangement provided for a smooth exchange of Federal Reserve holdings of maturing issues, but as noted earlier, there were practical problems that limited the System's subscription to the shorter issue in an optional cash refunding.

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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 any other investors 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.

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While there are good technical reasons--as enumerated above--for this rather anomalous situation, it does not seem desirable for the System subscription to be predetermined by the Treasury's choice of a particular debt management technique. 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.

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.

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. For purposes of setting the amount of the issues to be offered to the public, other investors who are now given full

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allotment privileges 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 be in a position to decide on its subscriptions independent of the Treasury. In fact, its flexibility would be increased since it could exercise an option to subscribe to either or both issues without creating problems for the market or for the Treasury. There would be no question of the System subscribing for more of the new issues than 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

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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. 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 issues, appears to be a useful technique for debt management operations. It would appear desirable for the System to retain the same option to subscribe for either issue, whether or not there was a small separation in time between the two offerings. The fact that settlement date for the cash issue would normally come after the maturity date of the issues being refunded would, however, 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.

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The following example illustrates the problem and suggests a possible solution to it. 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

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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.

The System's problem would be solved if the Treasury dated the cash issue offered to the public for payment on May 20 as of May 15. The System would pay for its subscription 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 detract from the success of the Treasury offering. (The System, of course, would not pay the five days interest as its investment would be continued over the five days.) Those subscribers who were allowed full exchange privileges in the cash refunding could also exchange their maturing issues on May 15. Thus there would be no loss of interest and no violation of normal market practices. If the Treasury concurs in the approach, this would appear a satisfactory solution to the System's problem.

Alan R. Holmes
Federal Reserve Bank of New York
July 10, 1968