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Board of Governors — Issuance of nonmarket Treasury obligations

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As part of the Treasury's program to increase sales of Government securities to the savings groups of the country, Mr. Haas of the Treasury has prepared a memorandum suggesting three types of savings bonds that might be issued. The first type would be the present form of Savings bond with a slight decrease in redemption values prior to maturity. This decrease in redemption values would be designed to deter purchasers of these issues from redeeming the issues before maturity. In view of the demand liability on Savings bonds and the possibility of a rise in interest rates, there seems to be a strong feeling in the Treasury that the present redemption values would subject them to the danger of large redemptions prior to maturity.

Some question may be raised as to the importance of the redemption value, since available information on redemptions of Savings bonds to date indicates that the bulk of the redemptions take place in the first two years after issuance when the penalty on the holder is particularly severe. The type of investor who holds such issues, moreover, tends not to disturb his investments even if a larger return could be obtained by shifting to some other security. There is at least a possibility, therefore, that comparatively little would be accomplished by changing these redemption values and that it would not be necessary for the Treasury to make this change.

The return on the present type of Savings bond if held to maturity would be maintained at 2.9 per cent. Since the small saver would be provided with something of an interest subsidy as compared with purchasing market obligations, Mr. Haas' memorandum recommends that the maximum amount that any individual should purchase of this type of security should be reduced to $3,000 a year. Since the new Savings bonds of this type will be taxable, however, the subsidy will be smaller than has been the case in the past. There might be some advantage, therefore, in continuing the plan with the present limitation on maximum purchases.

Mr. Haas' memorandum also suggests two other types of Savings bonds: (1) a discount issue and (2) a combination interest-bearing and discount issue. Bonds of the first type would be issued at 82 and would be redeemed at the end of 10 years at 100. If held to maturity the interest return would be 2 per cent. The return if redeemed before maturity would increase rather gradually.

The combination issue would be sold at 95 1/2. The redemption value would decline to 92 1/2 at the end of three years and would increase to 100 at the end of 10 years. In addition a coupon of 75 cents per $100

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bond would be paid each six months, giving a current return of about 1 1/2 per cent on the investment. Because of the declining redemption value, however, the yield would remain at a relatively low level if the issue is turned in prior to maturity and would increase to 2 per cent if held to maturity.

It seems likely that the maturity return which the Treasury has placed on these issues, only 2 per cent, is too low in view of the fact that they are to be made taxable. Another criticism of the proposal is that the return to the investor increases very materially in the last year, which would result in a substantial penalty to the investor who because of some emergency condition might have to turn in the securities shortly before maturity. There might be some advantage, therefore, in making the increase in yield more gradual than is shown in these plans. Mr. Haas further suggests that each holder could acquire either or both of these issues in a maximum annual amount of $50,000. The Treasury seemed to favor this limit because of the large demand liability involved if a substantial amount of these issues should be sold.

Another plan which has been considered by the Treasury is based on a 3 per cent return for a 20-year period. These issues would be purchased at 100 and would pay a semi-annual coupon at a 3 per cent rate. The holder could redeem them at prices declining to 91 at the end of six years and gradually increasing thereafter to 100 at the end of 20 years. The general scheme of this plan is quite similar to that proposed in Mr. Haas' memorandum.

Another proposal which has been placed before the Treasury is based on a 2 1/2 per cent return for 10 years, with the redemption value remaining at 98 until maturity. The plan for maintaining the redemption value at 98 has the advantage of greater simplicity as compared with the other plans and would be more easily understood by investors. On the other hand, it has the disadvantage that the return to the holder turning in the issue prior to maturity would be fairly large relative to holding the issue to maturity. Redemptions prior to maturity might for this reason be larger than on the other issues discussed.

The Treasury proposal to issue Savings bonds paying a coupon would probably result in a considerable broadening of the demand for Savings bonds. Mr. Haas proposes that the two types with a $50,000 limit would be salable to any investor other than commercial banks. The demand might be substantial from individuals, trust accounts, retirement funds, and the smaller mutual savings banks and life insurance companies. It would not, however, meet the needs of larger insurance companies and mutual savings banks, since the $50,000 annual limit would take care of only a minor part of the requirements of such institutions. The reason that the Treasury looks with disfavor on raising the maximum beyond $50,000 is the fact that the proposed securities would be redeemable on demand.

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Sales of nonmarket obligations, however, could be considerably broadened by increasing the amount that may be purchased annually by such institutions and by changing the redemption feature. Life insurance companies would probably be willing to purchase a considerable amount of issues irredeemable prior to maturity. In this event the maximum limitation on sales of these issues could be placed at a high point. Some limitation should be placed on sales of such issues in order to prevent life insurance companies from acquiring large amounts of such issues and selling a portion of their present holdings of market issues. If they did this they would exert a depressing influence on the market for outstanding issues. Since a portion of the issues which they sold would go to banks, moreover, this result would tend to defeat the policy of financing the increased debt from the savings groups rather than from commercial banks.

Mutual savings banks and some life insurance companies would not be interested in an issue entirely irredeemable prior to maturity. It is likely, however, that they would be interested in an issue with a redemption feature that did not involve a demand liability on the Treasury. Various possibilities for this type of obligation include: (1) making them redeemable at a discount on 3 months' notice, which would give the Treasury ample time to prepare for meeting the drain; (2) making them redeemable at a discount but only after a period of perhaps 3 years, at which time the financing of the defense program may be completed and the Treasury may be in better condition to meet such a drain; or (3) making them convertible into some selected outstanding market issue, which could then be sold by the holder at the then-current market price and which although subjecting the purchaser to a considerable loss would make it possible to realize on the principal of the issue.

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