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Proposed Report of the Treasury-Federal
Reserve Committee on Financing Procedures

I. Should rights be eliminated?

Pros

(1) Rights narrow the market for refunding issues. When rights are given to holders of maturing securities, the Treasury cannot sell a refunding issue directly to the whole market, but can operate only through the holders of the rights. This is particularly objectionable when, as is often the case, the rights are held predominantly by commercial banks who desire a short security, while the Treasury wants to offer a long security which is desired principally by non-banking investors.

(2) When rights are given to the refunding portion of a joint cash and refunding issue, it increases the amount of "free riding" on the cash portion. This is because the rights provide a quoted market in the new security while the cash subscription books are still open, thereby practically assuring "free riders" of their sought-for profit. This is particularly objectionable when the refunding is only a small portion of the total issue as in the case of the 2-1/2's of 1967-72.

(3) Rights distort the market by causing short maturities to sell at negative yields. This in practice closes the market for short United States securities to pure investors and leaves it exclusively to those persons and institutions who are willing to speculate in rights values.

(4) The existence of rights makes it necessary to hold new issues open longer than would be necessary for cash subscriptions only. This is a not inconsiderable disadvantage in these days of rapidly changing news.

<u>Cons</u>

(1) The Treasury is able, other things being equal, to reduce the interest rate on new issues somewhat because of the fact that the market may anticipate some rights value from the very beginning of the life of a security. Such savings are probably very small, however, except in the case of securities with an original maturity of five years or less.

(2) The market is thoroughly accustomed to rights and would be upset should they be eliminated. With so many uncertainties over-hanging the market, this is a poor time to rock the boat further.

(3) If rights should be abolished without notice, it would cause severe losses to many holders of short securities. This would be unfair and could be avoided only by giving adequate notice -- at least one year. Such a notice would commit Treasury policy rather far ahead for these troublous times.

(4) Rights are one of the ways in which banks make a living. It would be unfortunate to abolish them in these times when banks are performing a great deal of free service for the Government and are finding it increasingly difficult to make adequate earnings.

(5) Excessive rights values could be avoided if new money and refunding were separated in future financings as hereafter suggested.

Conclusion

If the past twenty years could be retraced, the rights system should probably never have been allowed to develop. At the worst, however, rights are an evil of very limited proportions, and this seems a poor time to eliminate them.

II. Should new money and refunding be separated in future financings?

Pros

(1) If new money and refunding were separated, new securities would not be quoted, in effect, through the medium of rights before the closing of cash subscription books. This would be of substantial help in reducing padding of subscriptions.

(2) If new money and refunding were separated, it would be possible to raise new money by means of long bond issues, while refunding maturing securities (already held predominantly by banks) into long notes or short bonds. This would minimize secondary distribution and (since short securities could be priced more closely) would also hold rights to more moderate values than those recently experienced.

Cons

(1) Separating new money and refunding would somewhat increase the total number of financings and also the total number of outstanding issues.

(2) To the extent that it was desired to refund maturing securities into long-term bonds, the second of the pros set forth above could not be realized.

Conclusion

It is recommended that new money and refunding be separated in future financings.

III. Should the "down payment" be increased on cash subscriptions?

Pros

(1) It would discourage the padding of subscriptions and so reduce the problem of policing new issues.

(2) It would diminish the amount of "distress" selling in the event of the failure of an issue or of unexpectedly large allotments.

Con

(1) The 10 percent cash payment already required really amounts to more than 100 percent when the allotments themselves are less than 10 percent. In the case of the 2-1/2's of 1967-72, where the allotments were 12-1/2 percent, the 10 percent down payment on subscriptions actually amounted to 80 percent of allotments.

Conclusion

It is recommended that the required down payment be raised experimentally to, say, 20 percent.

IV. Should the Secretary announce that he reserves the right to accept oversubscriptions on new issues to a greater amount than the 10 percent limit which has hitherto been customary?

Pros

(1) Such an announcement would tend to make "free riders" more wary, and so reduce the problem of policing.

(2) It would permit the Treasury to obtain needed additional money when the occasion seemed opportune.

Con

(1) It would increase the elements of uncertainty attending each issue and make it more difficult for subscribers to calculate the amount of their probable allotments. This might frighten some otherwise bona fide subscribers out of the market.

Conclusion

It is recommended that the Secretary reserve the right to accept oversubscriptions on new issues to a limited amount, say, not in excess of 25 percent.

V. Should preferential allotment on new money issues be given to special classes of investors?

Pros

(1) Preferential allotment would permit the Treasury to place securities, in the first instance, in the hands of those whom it desired to hold them finally and so reduce secondary distribution.

(2) It would save the ultimate purchasers from paying an unnecessary "underwriting commission" in the form of a premium to persons who had held the securities for only a short period.

(3) Many bona fide investors are unable or unwilling to pad their subscriptions in order to secure a desired allotment. This is particularly true of trustees and places them at a great disadvantage in securing Government securities on original allotment in competition with other investors.

(4) Commercial banks, on the other hand, are the only real market for short-term securities, yet they are forced by the present system to pay a premium to individual "free riders" on a substantial portion of their purchases of such securities.

Con

Any preference given one class of investors implies discrimination against other classes. Preferential allotments, therefore, constitute an abandonment of the principle of public offerings of Government securities with equal privileges to all.

Conclusion

It is recommended that preferred allotment be given individuals, trustees, insurance companies, and mutual savings banks on new-money offerings of long-term securities. Any securities so allotted should be non-negotiable for a limited period, perhaps one year. It is suggested in this connection that 100 percent allotment might be made to individuals and trustees on subscriptions up to $1 million, upon affidavit that no money had been borrowed, directly or indirectly, to finance the subscription. Insurance companies might be given 100 percent allotment up to 50 percent of their cash and mutual savings banks up to 20 percent of their cash. Commercial banks might occasionally be given preferential allotment for limited amounts of short-term securities. There seems to be no need in this case that the securities should be non-negotiable for an initial period.

VI. Should one or more securities be sold "on tap" by the Treasury?

Pros

(1) A tap issue would provide a continuous outlet for savings not absorbed under the present Defense Savings Bond Program. It would permit all classes of investors with access to it to fill their demands at the offering price without the necessity of paying a premium to others.

(2) A tap security would not depend for its success upon market conditions of a few days, as is the case with regular offerings.

(3) British experience with tap securities has been favorable.

Cons

(1) A tap security, if offered to all comers, would set a minimum interest rate for all Treasury obligations of approximately the same maturity class. It would not set a maximum rate, however, and sales would dry up in the event of an increase in interest rates.

(2) It is difficult to maintain a market in an issue currently available on tap. The issue would be so much easier to obtain from the tap than anywhere else that a seller would be hard put to it to find a buyer except at a discount. Sales at a discount, however, would reflect unfavorably on the tap.

(3) A tap security would immediately satiate the accumulated demand of all classes of investors who had access to it. There is considerable merit, however, in the view that investors should be kept "hungry" as long as possible.

(4) If a tap security, available only to a limited class of investors, were substantially more attractive than open market securities, it would be purchased, in large part, by liquidation of such securities rather than with new money.

(5) The British market for Government securities is so closely controlled that their experience with tap issues is not applicable to our own.

Conclusion

A negotiable tap security is more suited for a controlled market such as that in England than a free market such as our own. A tap security non-negotiable for a limited time, perhaps one year, would be more suited to American conditions. The time does not yet seem ripe for a tap security even of this type, however, as long as the regular issues continue to be oversubscribed many times. The objectives of a tap security are, in part, the same as those of preferential allotment, and it would seem best to defer further consideration of a tap security until some experience is gained with preferential allotments.

VII. Should a special type of Government security be issued to tap idle corporate and municipal funds?

Pros

(1) There is a considerable volume of idle corporate and municipal funds seeking short-term employment. This is true even after giving effect to sales of tax notes. These funds could be borrowed without increasing bank deposits.

(2) A more effective appeal might be made to States and municipalities to reduce their expenditures if a suitable medium were provided for the investment of funds thereby made idle.

Cons

(1) Every special issue tends to reduce the general market for Government securities. Special issues, therefore, should be avoided as far as possible.

(2) The rate of interest on the proposed securities would have to be higher than on securities of corresponding maturity eligible for purchase by banks.

(3) While sales of the proposed securities would not increase bank deposits, they would increase total spending and so would be almost as inflationary in the current period as if sold to banks.

Conclusion

It is recommended that a special type of security be issued to tap idle corporate and municipal funds. A non-negotiable registered two-year security, such as that suggested by Chairman Eccles, bearing interest at the rate of one-quarter percent per annum for the first 6 months, one-half percent during the second 6 months, three-quarters percent during the third 6 months, and one percent during the fourth 6 months (an average of five-eighths percent for the entire period), redeemable on any interest date on thirty days notice, would seem to be suitable for this purpose.

VIII. Should the limit on purchases of Series F and G savings bonds be increased?

Pros

(1) A substantial addition to savings bond sales could probably be secured in this way. The likely magnitude of such an increase may be inferred from the fact that 55 percent of the total sales of Series F and G bonds in the months May to August, inclusive, were in the highest ($10,000) denomination.

Cons

(1) A very small proportion of the increased sales due to raising of the limit on purchases by individuals would be from current savings. Very liberal assumptions with respect to the amounts of such savings indicate that the maximum which might be secured from this source would be, perhaps, $15 millions a year.

(2) A large proportion of the increased sales due to the raising of the limit would come from the liquidation of outstanding securities.

(3) The demand sought to be met by raising the limit on Series F and G savings bonds could be largely met by a system of preferential allotments such as that previously suggested, and could be met without paying a premium rate of interest or increasing the outstanding volume of demand obligations.

Conclusion

It is recommended that the existing limit on sales of Series F and G savings bonds should be retained.