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

April 9, 1974

CONFIDENTIAL

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Enclosed is a memorandum from the System Account Manager, dated April 8, 1974, and entitled "Proposal to bid for Treasury bills on a non-competitive basis."

This memorandum, and the attachment thereto by Shiela Tschinkel, were prepared in response to the Committee's request at its March meeting, and will be considered at the April meeting.

Enclosure

CONFIDENTIAL (FR)

April 8, 1974

TO: Federal Open Market Committee

FROM: Alan R. Holmes

SUBJECT: Proposal to bid for Treasury bills on a non-competitive basis

At the March meeting of the Federal Open Market Committee, the Committee deferred action on a proposal to bid for Treasury bills for official accounts (System, Treasury, Foreign) on a noncompetitive rather than a competitive basis, pending receipt of additional information on which a decision could be based. The attached memorandum, I believe, provides that information.

Based on an analysis of Treasury bill auctions taking place in December 1973 through February 1974, the memorandum finds that awards to those accounts for which the Desk submits bids were made very close to the average. On three-month bills awards were received at a rate about 1/3 of a basis point below the average; on six-month bills awards were almost exactly on the average. While the implications are that shifting to a noncompetitive basis would increase Treasury costs somewhat, the amounts are so small as to be insignificant. There is also the possility that--should there be an increase in those cases where System bids fall on the "stop-out price"--the costs to the Treasury of noncompetitive official bidding would be lower than if we bid competitively. The memorandum finds that the "stop-out" in the auction would be unaffected by shifting to a noncompetitive bidding basis, except in those infrequent cases where System bids fall on the "stop-out". The memorandum also finds that shifting to noncompetitive bidding would not increase the liklihood that a dealer, or a small number of dealers, could "corner the market".

There remains a possibility that the announcement of the size of official holdings of maturing bills will affect private competitive bidding. For example, if official holdings are unusually large, private bidders may step up their bids in order to be sure to acquire bills out of the reduced availability to the public. Similarly, bids may be weaker if official holdings are unusually small. The effects on Treasury financing costs should, however, about balance out over time. This possibility of somewhat greater volatility of bidding depending on the size of official holdings, of course, has nothing to do with competitive or noncompetitive official bidding. The proposal to announce official maturing holdings appears to have market benefits that justify it on its own merit.

I therefore recommend that the Committee approve the proposals contained in my memorandum of March 15, 1974, entitled, "Proposal to bid for Treasury bills on a noncompetitive basis".

Att.

MISC. 3B.2—3-72

FEDERAL RESERVE BANK
OF NEW YORK

OFFICE CORRESPONDENCE

DATE April 8, 1974

TO Mr. Holmes

FROM Sheila Tschinkel

SUBJECT: Review of the Proposal to Bid for Treasury Bills on a Noncompetitive Basis

This memorandum describes the present method of Desk tendering in Treasury bill auctions and reviews the potential impact of shifting to a noncompetitive tender basis by examining a series of auction results. The analysis finds that (1) shifting the System's bid to a noncompetitive basis would have no effect on the absolute level of the "stop-out price", except in the relatively infrequent instances when the Desk's tender is at that price, (2) shifting might result in a very small (about 1/3 of a basis point on three-month bills, and close to zero on six-month bills) rise in the average rate paid by the Treasury, and (3) shifting would tend to shorten the spread between the average issuing price and the "stop-out". The memorandum also finds that there would be no difference in a dealer's ability to corner the market supply. Finally, while the evidence suggests that there would be a very small rise in cost to the Treasury, this might be offset should there be an increase in unintended bidding misses, as these tend to raise the rates paid by the Treasury.

Auction Method and Desk Tendering

The Treasury auctions new bills by first allocating the amount requested by all noncompetitive bidders and then distributing the remainder of the issue to competitive bidders according to price until the total amount of the issue is awarded. The average price is derived by weighting the prices of the accepted competitive tenders by the quantity of bills awarded at each price. Noncompetitive bidders pay the average price. The difference between the average price and the lowest price accepted (or the average issuing rate and the highest rate accepted) is the "tail" in the auction. A long tail is often thought to indicate limited market demand for bills and is generally, although not always, associated with a weaker market atmosphere and upward pressure on bill rates.

The Federal Reserve Bank of New York enters bids on a competitive basis for the System account and also on behalf of various customer accounts. In determining its bid, officers at the Desk rely upon information provided by the primary dealers. The dealers are generally inclined to give the Desk accurate information about their own intentions and their assessment of the market. Most times, they would want the Desk to bid at a relatively high price, for, if the Desk bids at a low price, the System and customers receive partial allotments. Given the quantity of bills that the Desk generally tenders for, a partial allotment means a substantial and often unexpected increase in the amounts awarded to the dealers. However, demands for bills can change substantially in the final minutes before the bidding deadline and the extent of these late shifts are often difficult to assess. At times, the System has unintentionally bid at the lowest accepted price--the "stop out"--when the market has unexpectedly strengthened.

Tendering on a Noncompetitive Basis

In order to obtain an estimate of the potential impact of noncompetitive tendering, a series of weekly auctions conducted over the past December, January and February was examined. The results of these auctions were compared with the rates that would have been established if the bids for System, Foreign and Treasury investment accounts had been submitted on a noncompetitive basis. The data, which are summarized in Tables II through V, indicate that Desk tenders are more often submitted at a very slightly higher price in comparison to other bids. (Table I summarizes the proportion of bids submitted by the Desk.) Due to the large quantities involved the Desk tenders exert a small upward influence on the average issuing price of the bills (a downward effect on yields). The influence on the average price is very small, however, and generally amounts to less than one hundreth of a percentage point or one "basis point". Over the thirteen auctions that were surveyed the rate would have increased by an average of three tenths of one basis point for the three-month bills and close to zero for the six-month issues.

The slight upward bias to average issue prices exerted by Desk tenders tends to lengthen the "tail" slightly. Since in most cases the quantity awarded to other bidders would have remained the same, the stop out price would not have changed.

Treasury Costs

The large size of the Desk's competitive tenders and the resultant influence on average issuing prices would ordinarily be expected to lower to a very small extent the rate paid by the Treasury. Thus, if the Desk were to tender on a noncompetitive basis, the Treasury would pay a slightly higher rate, on balance, to foreign and Treasury investment accounts and also to other noncompetitive private bidders. The change in method would have no net impact on joint System and Treasury revenues, however. The increased receipts by the System would increase the earnings it returns to the Treasury by like amounts.

At those times when the Desk inadvertently missed and pushed the average and stop out price down, the Treasury has awarded a larger volume of bills to other bidders at lower prices than the System would have been willing to pay, and would have paid, if a noncompetitive tender had been submitted.

As a consequence, the costs arising from infrequent partial allotments has been an offset to the Treasury's slight gains derived from the Desk's submitting successful competitive tenders. Should there be an increase in these partial allotments, shifting official bids to a noncompetitive basis might even save the Treasury money.

Other Considerations

The consequences of unintentional Desk misses on competitive tenders have increased in recent years. The proportion of System and customer account participation in Treasury bill auctions has grown steadily over time, rising from less than 25 percent in 1962 to over 50 percent in the past year. (See Table I.) The trend accelerated after 1967, when participation was just under one third, as dollar outflows from this country resulted in substantial additions to official foreign account bill holdings. Now, the inadvertent misses can be more costly to offset and may potentially prove disruptive to the implementation of System policy, foreign account investment demands, and to market conditions. The proposal for bidding on a noncompetitive basis would eliminate these difficulties since roll over objectives would be assured. The Desk would expect to bid on a competitive basis in order to schedule redemptions and its bids at those times would also help assure coverage of the issues. If foreign or other customers accounts wished to increase holdings above the amount maturing the Desk would bid competitively for the additional issues. Such participation could be expected to be fairly small so that the chance and cost of unintentional misses would be minor.

Under current procedures, no one public bidder is generally permitted to obtain more than 25 percent of the total amount of an issue. While this provision is intended to prevent a dealer from cornering the market, the increase in Desk participation in recent years and in the share awarded to noncompetitive bidders increases the probability that a single buyer can obtain a significant portion of secondary market supplies. If the Desk were to bid on a noncompetitive basis it would not change matters because the volume of each issue left to be sold to others would remain the same as if competitive tenders were accepted. In any event, the Treasury could reassess its current procedures and consider defining the limit of awards to one bidder as a percentage of the issue excluding the amount of maturing bills exchanged by the System or other official accounts. This could be done in a way that would reduce the chance that one, or a few dealers could corner the market.

It has been argued that the Treasury loses some of the benefits of its current auction procedures, which are a form of discriminatory pricing, by awarding issues on a noncompetitive basis. The theoretical argument rests on the assumption that such purchasers, to be sure of obtaining issues, would be willing to buy bills at an even higher price than the average established in the auction. In practice, however, it is unlikely that the Treasury would derive more funds at auctions if it stopped accepting noncompetitive bids. Even if the bidders are willing to purchase and hold issues at somewhat lower rates it is unlikely that many of them would begin to submit competitive tenders. It is time consuming to determine an appropriate bid and many may feel that dealers or banks have more experience in determining a good price. In other words, if denied the noncompetitive option many of the present noncompetitive bidders would probably purchase issues in the secondary market rather than submit competitive tenders (if they continued to buy bills at all). And if they buy in the secondary market, the dealers would probably capture most of the increased price investors are willing to pay.

TABLE I

Desk Tenders* as Percent of Bills Sold

	1962	1967	1970	1973
Q I	24.52	29.77	32.31	52.87
Q II	21.68	34.99	29.28	51.58
Q III	21.68	32.33	34.73	50.71
Q IV	23.13	34.32	35.11	50.63

* For System, foreign official and Treasury trust accounts

TABLE II

Comparison of Average Issuing Rates Set in Treasury Bill Auctions Including and Excluding Desk Tenders

THREE MONTH TREASURY BILLS

Bills Issued On	Average Rate	Rate if Desk Tenders Were Noncompetitive	Difference
Dec. 6	7.358	7.369	+.011
13	7.386	7.397	+.011
20	7.366	7.366	--
27	7.346	7.366	+.020
Jan. 3	7.406	7.413	+.007
10	7.615	7.609	-.006
17	7.983	7.991	+.008
24	7.995	7.989	-.006
31	7.778	7.758	-.020
Feb. 7	6.951	6.951	--
14	7.081	7.081	--
21	7.018	7.026	+.008
28	7.188	7.200	+.012
Arithmetic Average for all Auctions			+.0035

TABLE III

Comparison of Average Issuing Rates Set in Treasury Bill Auctions Including and Excluding Desk Tenders

SIX MONTH TREASURY BILLS

Bills Issued On	Average Rate	Rate if Desk Tenders Were Noncompetitve	Difference
Dec. 6	7.766	7.768	+.002
13	7.530	7.538	+.008
20	7.164	7.176	+.012
27	7.315	7.315	--
Jan. 3	7.371	7.375	+.004
10	7.560	7.546	-.014
17	7.867	7.847	-.020
24	7.819	7.819	--
31	7.516	7.508	-.008
Feb. 7	6.747	6.749	+.002
14	6.882	6.893	+.011
21	6.787	6.791	+.004
28	7.081	7.081	--
Arithmetic Average for all Auctions			.0001

TABLE IV

Comparison of Treasury Bill Auction Results Including and Excluding Desk Tenders

THREE MONTH TREASURY ISSUE

	Actual Results			Desk Tenders Treated Noncompetitively		
Bills Issued 1973	Average Issuing Rate	Highest Rate Accepted	Difference or "Tail"	Average Issuing Rate	Highest Rate Accepted	Difference or "Tail"
Dec. 6	7.358	7.429	.071	7.369	7.429	.060
13	7.386	7.425	.039	7.397	7.425	.028
20	7.366	7.382	.026	7.366	7.382	.016
27	7.346	7.441	.095	7.366	7.441	.075
Jan. 3	7.406	7.453	.047	7.413	7.453	.040
10	7.615	7.647	.032	7.609	7.647	.038
17	7.983	8.019	.036	7.991	8.019	.028
24	7.995	8.003	.008	7.989	8.003	.014
31	7.778	7.793	.015	7.758	7.762	.004
Feb. 7	6.951	6.975	.024	6.951	6.975	.024
14	7.081	7.109	.028	7.081	7.109	.028
21	7.018	7.046	.028	7.026	7.046	.020
28	7.188	7.240	.052	7.200	7.240	.040
Average for all Auctions			.039			.032

TABLE V

Comparison of Treasury Bill Auction Results Including and Excluding Desk Tenders

SIX MONTH TREASURY ISSUE

Bills Issued 1973	Actual Results: Average Issuing Rate	Actual Results: Highest Rate Accepted	Actual Results: Difference or "Tail"	Desk Tenders Treated Noncompetitively: Average Issuing Rate	Desk Tenders Treated Noncompetitively: Highest Rate Accepted	Desk Tenders Treated Noncompetitively: Difference or "Tail"
Dec. 6	7.766	7.801	.035	7.768	7.801	.033
13	7.530	7.548	.018	7.538	7.548	.010
20	7.164	7.198	.034	7.176	7.198	.022
27	7.315	7.350	.035	7.315	7.350	.035
Jan. 3	7.371	7.399	.028	7.375	7.399	.024
10	7.560	7.568	.008	7.546	7.568	.022
17	7.867	7.880	.013	7.847	7.867	.020
24	7.819	7.825	.006	7.819	7.825	.006
31	7.516	7.526	.010	7.508	7.526	.018
Feb. 7	6.747	6.791	.044	6.749	6.791	.042
14	6.882	6.919	.037	6.893	6.919	.026
21	6.787	6.808	.021	6.791	6.808	.021
28	7.081	7.095	.014	7.081	7.095	.014
Average for all Auctions			.023			.023