

09/24/99 TT&L
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COMMENTS ON
PROPOSED AMENDMENT TO TREASURY TAX & LOAN RATE OF INTEREST

The U.S. Treasury proposes raising the Treasury Tax and Loan rate to equal a weighted-average rate of primary-dealer, general-collateral repurchase agreement transactions. This change will raise the cost of TT&L balances to approximately 2 basis points under the Fed Funds rate.

This pricing level fails to recognize and incorporate the value of the TT&L product's imbedded option and the inherent differences between this product's characteristics and those of the referenced dealer repurchase agreements. Unlike a transaction in which two dealers agree to a repurchase agreement trade with identified amount and term when this action suits them both, with TT&L, the Treasury holds the option of depositing or withdrawing balances at will. Participating banks must stand ready, often with little or no warning, to accept new balances or to lose balances on any day, regardless of their present funding requirements. When last-minute TT&L calls occur, the bank may suffer detriment by "wasting" the resulting excess pledged collateral after balances have been withdrawn that, with more warning, could have been deployed in another manner to obtain favorable-cost funding (such as acquiring local public funds deposits).

The TT&L structure is one in which, practically speaking, banks have "sold" options to the Treasury. Options have value, and banks and other market participants expect to be paid for selling them. The present TT&L pricing at Fed Funds minus .25 incorporates such payment. Banks accept this price as fair compensation for the option, for the associated uncertainty in managing funding and reserve positions, and for the periodic collateral waste and opportunity loss. Moving the TT&L rate up as proposed would eliminate this fair compensation and make TT&L considerably less attractive to banks.

Banking companies that carefully manage funding and collateral use will likely be substantially less inclined to commit securities collateral consistently for uncertain balances at the proposed higher rate. More attractive alternative funding will often exist. This company, for example, is consistently able to buy (unsecured) Fed Funds 7 to 10 basis points below the Fed Effective Fed Funds rate.

CONCLUSION:

If the rate is increased as proposed, this bank will likely amend its TT&L involvement in some combination of the following:

1. Convert to remittance option
2. Remain in note option, but:
 - a. Reduce participation (lower the cap and collateral)
 - b. Increase and decrease the cap and pledged collateral much more frequently
 - c. Release pledged securities and pledge loans instead

The Treasury Tax and Loan concept was created to prevent unduly large sums from leaving the banking system on tax dates. The proposed higher rate would undoubtedly reduce banks' ability to participate in the program, and loss of this stabilizing factor would complicate the Federal Reserve's open market operations to preserve stable reserves and market rates in these periods.

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