

FEDERAL RESERVE BANK
OF CHICAGO

MICHAEL H. MOSKOW

President
(312) 322-5001
(312) 322-2141 (Fax)

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Government Securities Regulation Staff
Bureau of the Public Debt
999 E Street NW
Room 315
Washington, DC 20239-0001

To Whom It May Concern:

The Federal Reserve Bank of Chicago appreciates the opportunity to comment on the Treasury Proposal "Marketable Treasury Securities Redemption Operations." Given the prominence of futures exchanges in Chicago, the Federal Reserve Bank of Chicago actively monitors proposed regulations for their potential impact on these exchanges and the financial markets more generally.

The Chicago Board of Trade (CBOT) lists several futures contracts based on Treasury securities. These contracts permit a contract seller (short position) to either settle the contract with a cash payment or to deliver an eligible security. This optional settlement procedure results in the futures contract being priced off "the cheapest-to-deliver" Treasury security; that is, the futures price closely tracks the price of the least costly Treasury security eligible for delivery against that contract.

Due to these institutional features, Treasury decisions affecting the available supply of Treasury securities can have significantly disruptive impacts on these contract markets. An example of the kind of disruptions that can be caused by a limitation on the available supply of the contract item to be delivered occurred several years ago in grain trading at the CBOT. In 1989, a soybean wholesaler held a substantial portion of the available supply of soybeans. Prices for the soybean contract trading at the CBOT were greatly affected when that exchange elected to avert delivery problems by forcing liquidation of a large number of open soybean contracts.

There is the potential for similar problems in futures contract markets delivering Treasury securities. Should Treasury elect to redeem an outstanding issue that is deliverable on a futures contract, the impact on the supply of securities available for delivery may have important price impacts. First, pricing impacts stemming from delivery concerns may reduce the usefulness of these futures contracts as hedging instruments. The record suggests that the ability of dealers to hedge their positions has led to reductions in bid-offer spreads. This is because the ability to

hedge lessens the price risk of inventories held by these dealers. Absent the ability to hedge as effectively, dealers will require compensation for their increased levels of risk.

Second, the very high levels of liquidity in the Treasury futures contracts result in those contracts becoming an important element of the price discovery process. The enhanced transparency provided by this price discovery process is widely viewed as a public good. The public benefit derived from the Treasury's debt redemption decisions might be mitigated by a reduction in the public benefit of price transparency.

Broadly stated, our suggestion is that Treasury's redemption decisions incorporate the potential impact of a redemption on the futures contract markets for Treasury securities. This could be accomplished in a variety of ways. A simple approach might be to not redeem outstanding issues during the weeks prior to their potential delivery. This would provide markets with sufficient time to adjust to changes in the deliverable supply of securities.

Again, we appreciate the opportunity to comment and would be happy to discuss these issues and provide additional information.

Sincerely,

A handwritten signature in cursive script, appearing to read "Michael Moskow".

Michael H. Moskow