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Client Group

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October 4, 1999

Ms Lori Santamorena
Director
Government Securities Regulation Staff
Bureau of Public Debt
Department of the Treasury
999 E Street N.W., Room 515
Washington DC, 20239-0001

Re: Proposed Rule Regarding Marketable Treasury Securities Operations

Dear Ms. Santamorena,

Merrill Lynch Government Securities Inc. welcomes the opportunity to comment on the Treasury's proposed rule on buybacks. Just as the role of primary dealers is critical in underwriting the Treasury's debt issuance, the dealers' role in the reverse auctions will be as important, if not more so. Merrill worked closely with the other primary dealers in drafting the BMA's response and agrees with most of the recommendations in their comment letter. Based upon Merrill's extensive experience with Canadian reverse auctions, however, we would like to stress a few additional points.

Accounting Treatment: We recommend that the Treasury work with Congress to direct that the Congressional Budget Office (CBO) or the General Accounting Office (GAO) study and recommend to Congress the proper accounting treatment for market premium/discount bonds. From both an accounting and economic perspective, we believe that the premium should be amortized over the life of the bond rather than expensed in the year of purchase, as called for under Office of Management and Budget (OMB) rules. By working closely with the Congress, the Treasury may better facilitate the adoption of amortization accounting. In the interim, the buyback program should not be held up waiting for this accounting rule change.

Our concern with the current accounting treatment is that the size of the buyback program could be severely limited, primarily due to the accounting effect on the budget surplus. This is especially important, given that we believe that the Treasury initially will concentrate on repurchasing the premium bonds in the 2015-2025 T-bond sector. We doubt that the Treasury will consider repurchasing the par/discount bonds in the 2026-2029 sector because most of these T-bonds/T-notes are trading with a liquidity premium, having been issued over the past few years.

If the Treasury cannot obtain favorable (i.e., amortization) accounting treatment, we recommend that Treasury consider the following alternative - synthetic par securities - for a certain percentage of the buyback program:

1) Repurchasing a combination of high coupon bonds and the associated P-STRIP; and/or
2) Repurchasing a combination of one P-STRIP and a series of C-STRIPS.

The total price of these packages tendered must equal that of a par bond (100-00). Offers must then be based on yield, not price. This would eliminate any accounting bias and enhance liquidity in the STRIP sector. The risk is that only dealers with active STRIP desks could effectively repackage these securities, thereby limiting the overall participation of the investor base.

Auction Schedule: To build customer interest, we recommend that the reverse auctions be held on a regular schedule, preferably in conjunction with the quarterly refundings. To minimize interest rate risk, the reverse auctions should be held on the day following the last security issued in the quarterly refunding (i.e., Thursday in the May and November cycle and Friday in the February and August cycle). This schedule would help build greater interest and liquidity for the buybacks.

Eligible Securities: We respectfully disagree with the BMA's recommendation that the Treasury identify targeted *sectors*, as opposed to specific bonds, as eligible for repurchase. The rationale for the BMA's recommendation is that the sector approach would minimize the "announcement" effect, whereby the price of the bonds to be repurchased would increase due to the anticipated repurchase by the Treasury.

For the following reasons, we *strongly recommend* that the Treasury identify *specific securities* as eligible for the buyback:

1) If the Treasury were to target sectors, the reverse auctions would appear more like coupon passes. Potentially, this could limit both dealer and customer interest, as the maturity spectrum and eligible securities could be quite large.
2) By identifying specific Treasury securities, dealers may then canvass their client base for these securities and propose bond swaps with their clients, allowing the dealers to inventory the eligible securities. Based upon Merrill's experience in the Canadian reverse auctions, most customers do not want to incur the auction risk. Instead, they prefer to sell the eligible securities to the dealers. The result is that the dealers submit the vast majority of offers for their own accounts, not those of their customers. If dealers are going to incur the reverse auction risk, they must know which securities the Treasury plans to repurchase, so that such securities could be inventoried. If the Treasury were to target sectors, there would be a risk that dealers would not make the effort to inventory the eligible securities. This could adversely affect the viability of the reverse auction program, as there would be a risk that an insufficient amount of securities would be offered to the Treasury.
3) Unless the size of the reverse auctions is quite large, we do not anticipate a major richening of the eligible securities. Please find enclosed a recent copy of a research article entitled

"Potential Effects of a Treasury Buyback on the Curve—The Canadian Experience." As evidenced in the article, the amount of richening for the eligible securities is minor, only 1-3 basis points. Further, a little richening due to the announcement effect will help build customer interest in participating in the auctions. In the more recent Canadian reverse auctions, Merrill has already noticed a falloff in customer participation, primarily because the "announcement" effect is minimal. The prevailing customer attitude is: "Why bother selling the bonds if they have not richened up?"

Effect on CTD: The Treasury must clarify that the buybacks should not affect the price of the cheapest-to-deliver (CTD) into the CBOT T-Bond futures contract. If the buybacks do affect the CTD price, this could give the impression that the Treasury is "manipulating" the contract (even if it is not). If futures' liquidity were to decline due to this perception, this would adversely affect liquidity in the cash markets. Unfortunately, this problem may be hard to avoid. With the upcoming adoption of the 6% notional coupon for the March 2000 contract, the CTD falls within the 2021 sector (at current yields). The 2021 sector is also close to the "peak" yield sector in the Treasury curve (based on Oct. 1 close, the peak yield sector is 2019-2020). We anticipate that the Treasury may concentrate the buybacks in these sectors due to their cheapness. We recommend that the Treasury avoid purchasing any bonds with maturities that fall within plus or minus one year of the CTD.

Liquidity Considerations for Remaining Securities Outstanding:
The Treasury has expressly stated that it reserves the right to repurchase 100% of the outstanding amount of a particular issue. Consistent with the BMA's recommendation, we recommend that Treasury initially limit buybacks to 10% of outstanding supply (as the amount outstanding decreases, this 10% limit should increase). At the end of any reverse buyback, at a minimum, $1 billion face amount of any particular issue should be left outstanding. If this recommendation is not adopted, dealers would run the risk that the size of an issue would be so small after a reverse auction that shorts in the issue could not be covered. Dealers would then be hesitant to short the issue, with the result that the number of offers submitted would decline. This would adversely affect the viability of the reverse auctions. Once the size of an issue approaches $1 billion, the Treasury might engage in conversions, similar to the procedure used by the U.K. Debt Management Office (DMO). There, the DMO offers terms for converting the remaining balance of this old issue into the then "Current." If the terms were reasonable, most participants would accept the conversion. If not accepted, investors would most probably be left with an issue that trades cheap due to its small size and illiquidity.

Amount Repurchased: We understand the Treasury's desire to retain the right buy back less than the announced amount due to insufficient or too rich offers. However, we believe that the Treasury should make every effort to repurchase 100% of the amount announced. We further believe that, to guarantee that enough fair priced offers would be submitted, the Treasury should specify one or two fallback bonds (i.e., deep liquid bonds) as eligible for repurchase at each auction. Moreover, the Treasury should try to avoid partial fills at each single price submitted (not for multiple offers), especially for customer accounts. Customers would be hesitant to participate in the program if the Treasury could potentially leave them with an "odd lot" after a reverse auction.

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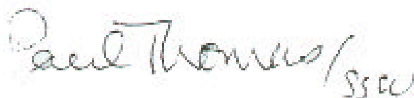
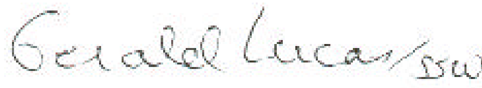
If the Treasury has any further questions regarding the issues raised in this letter, we would be pleased to meet with you at your convenience. In addition, you may reach the undersigned at the following telephone numbers: Paul Thomas at (212) 449-4917 or Gerald Lucas at (212) 449-0251. Merrill Lynch has worked closely with the Bank of Canada in developing the procedures for its reverse auctions and has been an active participant in the five reverse auctions so far conducted by the BOC. We have learned much and believe our experience to be valuable.

Sincerely yours,

Paul Thomas
President, GSI

Gerald Lucas
Senior Government Strategist, Research

cc: Lee Sachs, Assistant Secretary, *Department of the Treasury*
Gary Gensler, Under Secretary, Office of Finance, *Department. of the Treasury*
Paul Malvey, Director, Office of Finance, *Department. of the Treasury*
Walter Eccard, Chief Counsel, *Bureau of the Public Debt*

Attachment