COMMENTS ON A PAPER PREPARED BY DEAN WILLIS J. WINN AND PROFESSOR ARLEIGH HESS, JR., OF THE WHARTON SCHOOL OF FINANCE AND COMMERCE OF THE UNIVERSITY OF PENNSYLVANIA, ENTITLED: "THE VALUE OF THE CALL PRIVILEGE"

by

J. ARNOLD PINES
CHIEF FINANCIAL ANALYST
DIVISION OF CORPORATE REGULATION
SECURITIES AND EXCHANGE COMMISSION

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COMMENTS ON A PAPER ENTITLED:
"THE VALUE OF THE CALL PRIVILEGE"

Chairman Scanlon, officers and members of the American Finance Association, and guests:

I am privileged to participate as a discussant on the paper submitted by Dean Willis J. Winn and Professor Arleigh Hess, Jr., of the Wharton School of Finance and Commerce of the University of Pennsylvania, entitled "The Value of the Call Privilege."*

When I was invited by your Chairman to participate as a discussant on the Winn-Hess paper, I readily accepted, since, as a member of an advisory committee established at the Wharton School under a grant from the Life Insurance Association of America for the purpose of studying redemption characteristics of senior securities, I had come to know these gentlemen and to realize that any paper submitted by them would be a carefully considered document which would contribute significantly to an understanding of the problem of callability of corporate bonds. I have since read and studied their paper and I have not been disappointed in my appraisal of their undertaking. Accordingly, I hope that anything I say today, which differs from certain of the views presented by Messrs. Winn and Hess, will not be taken as any indication of a lack of appreciation on my part of another point of view.

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The subject of the paper prepared by Messrs. Winn and Hess is a most important one and a very timely one. For that matter, I suspect that the subject will continue to compete for attention for quite a long time with the other important issues facing bond investors, the issuing companies, regulatory bodies, and the general public. It is a problem in which past discussion has often been charged with strong feelings and emotions. Perhaps today's discussion will serve to promote a better understanding of the problem of callability without adding to the heat factor.

The Winn-Hess paper contains a number of points or conclusions. Because of limitations of time, I shall discuss only those which I consider to be the more important ones.

Point No. 1 -- The authors state that, in general, privately placed corporate bond issues have greater restrictions on the call privilege than publicly offered issues, perhaps because of the stronger bargaining position of the institutional investor in the private transactions. They state further that privately placed issues also carry higher interest rates, generally, than publicly offered issues.

Comment on Point No. 1 -- It must be obvious to all that privately placed issues will ordinarily contain more stringent call restrictions and higher interest rates than publicly offered issues. Insofar as public utility companies are concerned, the practice of going to public competitive bidding on bond issues is strongly

entrenched as the result of the Securities and Exchange Commission's competitive bidding Rule 50 which was promulgated in 1941 under the Public Utility Holding Company Act of 1935. Accordingly, the fact that the issuer does not sell its bonds at competitive bidding but, rather, seeks to raise the money through a private placement, bespeaks, generally, a weaker bargaining position on the part of the issuer as against the institutional investor.

This relative inferiority in bargaining position exists not only in situations where the particular bond issue may lack the conventional investment appeal or vendibility of a competitive bidding issue, but also where the bond issue is being sold by a fairly strong issuer. In the latter case, the issuer, by selling its bonds privately, has stripped itself of a good deal of its bargaining power on the call provision and leaves itself in a weakened position in the determination of the interest rate. This latter type of situation clearly points up the efficacy and wisdom of the Securities and Exchange Commission's competitive bidding rule.

Point No. 2 -- Messrs. Winn and Hess state that data accumulated on corporate bond issues offered between 1945 and 1958 indicate that there is very little evidence that the value of the call privilege is reflected to any significant extent in the yields on the bonds; i.e., the presence or absence of the call privilege appears to have no significant effect on the interest rate.

Comment on Point No. 2 -- I believe this conclusion of Messrs. Winn and Hess to be entirely valid. I assume the conclusion was reached from the study being conducted at the Wharton School of Finance and Commerce, to which I referred previously. This conclusion, I should like to emphasize, is tremendously important. It should lay to rest the erroneous assumption which apparently has gained currency among certain issuers and underwriters, and even among certain regulatory agencies, that, all other things being equal, a bond which is nonrefundable for, say, five years will carry a measurably lower interest rate than a freely refundable bond. The conclusion reached by Messrs. Winn and Hess will probably startle quite a few people. Because of the transcendent importance of this point, I am quite disappointed that the Winn-Hess paper does not contain details concerning the absence of any significant degree of correlation between interest rate and call provision.

In this connection, I am amused when I recollect that a little over a year ago an official of a very large underwriting house said to me and certain of my associates that the freely callable bonds issued under the Holding Company Act are costing the issuers about 35 basis points more in interest costs than bonds issued outside the Holding Company Act carrying a five-year restriction on refunding. I questioned this individual as to the basis for this statement, and he replied that he really could not prove his point since he had not made any study of the question. It soon became clear that he was simply

echoing what he had heard some other people in the financial community say. It is this kind of statement, made without the benefit of any objective study, that is mischievous and can cause a great deal of confusion in the minds of the managements of the corporate issuers and others concerned with the problem.

Point No. 3 -- Messrs. Winn and Hess state that several Federal and State regulatory agencies have followed a firm policy of requiring immediate callability or a short deferment period, in conjunction with a low premium, in bond issues subject to their regulatory jurisdictions. They further state that these agencies have asserted that such provisions do not raise interest costs and that these agencies have implied that if a utility company could prove the opposite the agencies would modify their policy.

Comment on Point No. 3 -- On the basis of my own studies of interest costs of refundable versus five-year nonrefundable electric and gas utility bonds offered at competitive bidding during approximately the last 18 months, it is my view that the presence or absence of a restriction or freeze on refundability does not necessarily carry with it any advantage to the issuer insofar as the cost of money is concerned. In any event, the difference between the average cost of money on refundable versus nonrefundable issues is so slight as to indicate that a relatively small drop in interest rates during the

period of the call freeze, after making due allowance for the redemption premium, would be prejudicial to the company issuing the nonrefundable bond. Accordingly, the issuer of the nonrefundable bond, and ultimately the electric and gas utility consumers, could suffer real detriment from loss of opportunity to refund.

Since the Winn-Hess paper refers to the policy of Federal agencies on callability, I should like to use this opportunity to discuss the Securities and Exchange Commission's policy thereon. The Securities and Exchange Commission has no jurisdiction to pass upon indenture provisions of industrial corporations or of utility companies which are not subject to the Public Utility Holding Company Act of 1935. With respect to utility companies subject to the Holding Company Act -- and I might point out, in this connection, that at the present time the jurisdiction of the Act extends, in terms of assets, to a little over one-fifth of the privately owned electric and gas utility industries combined -- Section 1(b) of the Act declares that the national public interest and the interest of consumers of electricity or gas are or may be adversely affected by lack of economies in the raising of capital. Other provisions of the Holding Company Act provide the Commission with the necessary means of implementing this Congressional policy. Thus, while the Holding Company Act itself does not give the Securities and Exchange Commission jurisdiction over utility rates charged to consumers, the Act does direct the Commission to protect the consuming public against being required to support

unreasonable interest costs. It is the Commission's position that free callability upon the payment of reasonable redemption premiums is necessary to secure this result.

To effectuate this Congressional policy, the Commission explicitly set forth its position on redemption restrictions in two cases in 1953. In one of them, Indiana & Michigan Electric Company (35 S.E.C. 321, 326), the Commission stated:

> "It is our opinion, however, that non-redeemable features in senior securities, even though the period of non-redeemability is as short as three years, should not be resorted to as a means of reducing the cost of money, and we shall in the future insist that all reasonable efforts be made to keep this undesirable feature out of financing programs."

The other case to which I referred was Arkansas Louisiana Gas Company (35 S.E.C. 313).

You will note from the foregoing quotation in the Indiana & Michigan case that one of the things the Securities and Exchange Commission was emphasizing is that, to put it colloquially, there should be no trading off of the right to call for a consideration in the interest rate, or, to state it otherwise, the Commission will not sanction shaving the interest rate in exchange for accepting a restriction on the right to refund. I take this to mean that the issuer should have complete freedom to refund and that it should pay the going rate of interest consistent with its credit position. This point needs emphasis in view of the statement by Messrs. Winn and Hess

that the agencies whose policy on callability was referred to previously have implied that if a company could prove that free callability to refund is reflected in an increased interest rate on the bonds, the agency or agencies in question would modify their policy against call restrictions. So far as I am aware, no spokesman for the Securities and Exchange Commission has ever implied this, and, indeed, any such implication would appear to be contrary to the import of the Indiana & Michigan decision.

Even if it could be shown by objective data that the issuer could secure a lower interest rate by agreeing to accept a restriction on the right to refund, that merely marks the beginning of the consideration of the problem, for who is so prescient that he can foretell, at the time of the issuance of a nonrefundable bond, that the issuer will save money over the life of the issue? With all due respect to the suggestions of Messrs. Winn and Hess that reference can be had to historical trends of interest rates in order to estimate the statistical probabilities of a reduction in interest rates during a future 5-or 10-or 30-year period, neither the issuer nor the regulatory agency concerned should gamble on the likelihood and timing of such future possibilities.

The Securities and Exchange Commission's position on callability was officially adopted in a Statement of Policy issued as Holding

Company Act Release No. 13105, dated February 16, 1956. One of the provisions included in that document is that bonds issued by public utility companies under the Holding Company Act shall be redeemable at any time upon reasonable notice upon the payment of a reasonable redemption premium, if any. While the Statement of Policy contains no formula as what constitutes a reasonable redemption premium, the Commission's working policy has been that the initial redemption price should not exceed the sum of the initial public offering price plus the interest rate. For example, if the bonds are offered to the public at 102 and bear a 5% coupon, the initial redemption price may not exceed 107, and the 7 point premium must thereafter be reduced pro rata to maturity. The Commission has adhered to this policy -- which, it is worth noting, actually has a certain amount of built-in flexibility in it by reason of changes in interest rates -- and it may reasonably be assumed that the Commission will continue to adhere to it unless it is presented with a special or unusual situation which makes its application in the particular circumstances an unreasonable hardship.

It is my understanding that the Federal Power Commission also has a policy of free callability on electric utility bonds issued under its jurisdiction, although I am not certain that it adheres to the same rule-of-thumb formula which the Securities and Exchange Commission employs. It is also interesting to note that as recently as July 31, 1958, the Interstate Commerce Commission stated, in an

order involving The Southern Railway Company, that it would not look with favor upon the inclusion of provisions in bonds which restrict the issuer's right to redeem them at any time upon the payment of a reasonable premium. It added that its policy in the future, in the absence of clear justification for contrary action, would be to refuse approval of the issuance of bonds which are not freely redeemable at any time.

You might be interested in certain data which I have developed from a study which I have made of all electric, gas, and telephone utility bond and debenture issues offered publicly during the 5-1/3 years from January 1, 1953, to May 15, 1958, the proceeds of which were used in whole or in part to refund outstanding bond issues. The study covered 49 offerings. Nearly all of the bond issues refunded had been outstanding for less than five years. The total principal amount of the issues refunded aggregated in excess of $871,000,000. A large number of the 49 new issues were sold in 1954 and 1955, at a time when interest rates were at a fairly reasonable level. From August 18, 1955, when money costs began to rise, until April 14, 1958, by which time money costs had already clearly declined, there were no refundings, except for one special situation. The average interest savings per year, before deducting expenses, resulting from these refundings amounted to one-half of one per cent, or an aggregate of $4,357,000. This, I am sure you will agree, is a very measurable savings in interest costs and should have a beneficial effect on the total annual cost of utility services to the American public.

Point No. 4 -- Messrs. Winn and Hess state that although free callability may have been a factor in driving some large institutional investors out of the market for utility bonds, it has not prevented utility companies from selling new issues.

Comment on Point No. 4 -- Firstly, I should like to observe that while some of the large life insurance companies have not purchased freely callable public utility bonds in recent years, a substantial number of the smaller life insurance companies have purchased them. The large life insurance companies, I believe, are not very greatly interested even in bonds carrying a five-year restriction on refunding. Perhaps they prefer a much longer freeze period. In this connection, I might point out that every electric or gas utility bond offered at competitive bidding during the last 18 months which carried a freeze on refunding limited the freeze to a five-year period.

Secondly, I should like to address myself to the very important point as to whether or not issuers of refundable utility bonds have been able to sell their issues. The answer, you will shortly see, is a vigorous yes! I say this point is very important, because the Securities and Exchange Commission would not want to have a policy which could result in drying up available sources and supply of capital to such dynamic industries as the electric and gas utility industries. Any impediments to the free flow of capital to a public utility company would be a matter of serious concern to the Commission.

In connection with a review which the Commission directed be made of its policy on free callability, I studied all the electric and gas utility bond issues offered at competitive bidding between May 14, 1957, and November 30, 1958, covering some 18-1/2 months. The date of May 14, 1957, was sèlected because on that day New York State Electric and Gas Corporation, a public utility company not subject to the Holding Company Act, instituted a practice which has been followed by a number of other public utility companies, none of which is subject to the Holding Company Act, of accepting a five-year restriction on refunding. In this study, I compared the number of bids received from underwriters on the refundable versus the five-year nonrefundable issues, and also the degree of marketing success which the winning bidder had in disposing of the bond issue.

A comparison of the number of bids received is relevant because underwriters, who are in business to make a profit, will not be interested in bidding for refundable bonds unless they believe the bonds can be marketed at a profit. Similarly, a comparison of the success or failure of the winning bidder to sell the bonds to the ultimate purchasers will have a profound bearing on whether or not underwriters will continue to compete for refundable issues.

For the period May 14, 1957, to November 30, 1958, there was a total of 137 electric and gas utility bond issues (including debentures) offered at competitive bidding, aggregating $2,956,000,000. These included companies subject to the Holding Company Act as well as

those not subject to the Act. The refundable issues numbered 109 and accounted for a total of $2,005,000,000, while the nonrefundable issues -- each one nonrefundable for a period of five years -- numbered 28 and totaled $951,000,000 principal amount. The number of refundable issues thus represented approximately 80% of the total number of issues, while in terms of principal amount the refundable issues accounted for approximately 68%.

It must be recognized, of course, that the number of bids is affected by such factors as the quality of the issue; its size; its timing in terms of such considerations as the current market conditions, the number of issues expected to appear in the near future, the current inventory of the underwriters, and the appeal which a particular issue has to investors; and many other factors. Notwithstanding these variables, it seems reasonable to assume that their presence or absence will tend to cancel out if there is a sufficient sample. While one may contend that the sample is not large enough because it included only 28 nonrefundables as against 109 refundables, it must be remembered that the sample comprised the entire universe of electric and gas issues sold at competitive bidding, and it would therefore seem incumbent on one who favors a call restriction to present proof of its necessity.

The bidding data for the issues included in my study are presented below:

	Number of Bond Issues	
	Refundables	Nonrefundables
One bid	2	-
Two bids	7	2
Three bids	21	10
Four bids	28	5
Five bids	22	8
Six bids	20	1
Seven bids	7	1
Eight bids	2	1
Totals	109	28

The weighted average number of bids received on the refundables was 4.46, while on the nonrefundables it was 4.11. The median number of bids on both groups was the same, i.e., 4.

As to the relative degrees of marketing success of refundables versus nonrefundables, we must first define our terms. I have assumed that a successful marketing by an underwriting syndicate is one in which, at the termination of the syndicate, at least 95 per cent of the bond issue has been sold at the syndicate price, or, conversely, not more than 5 per cent of the issue remains unsold. Of the 109 refundable issues, 75.2 per cent were successful according to this definition. Of the 28 nonrefundable issues 75.0 per cent were successful. In terms of principal amount, 72.3 per cent of the refundable issues were successful, while 73.9% of the nonrefundable issues were successful. Extending the comparison to the aggregate principal amounts which were sold at the applicable syndicate prices up to the termination of the respective syndicates, we find that 90.0% of all the refundables and 89.5% of all the nonrefundables were so sold.

In view of the virtually equal results of number of bids and

of marketing success which the two groups showed, I believe we must conclude that the presence or absence of a freeze on refundability has no especial significance, let alone a controlling influence, on the ability of a public utility company to raise bond money.

Point No. 5 -- Messrs. Winn and Hess state that institutional investors criticize the policies of certain regulatory agencies on callability on the ground that they favor the utility consumer at the expense of the investor, thus providing a "one-way street" of protection for the former as against the latter.

Comment on Point No. 5 -- I vigorously disagree with this contention. I referred earlier to the fact that the Statement of Policy promulgated by the Securities and Exchange Commission includes a provision requiring free callability. But it includes more. It contains a whole galaxy of protective provisions which the Commission requires to be included in first mortgage bond indentures of public utility companies. These provisions, which are of very material benefit to the bondholder and which are designed to make the bond a sound security, relate to such matters as the issuance of additional bonds, sinking and improvement fund, renewal and replacement fund, limitation on common stock dividends, limitation on prior lien obligations, and various other matters.

When the Securities and Exchange Commission had under consideration the adoption of a Statement of Policy, it received very

strong objections from the issuing companies who complained, among other things, that these protective provisions would injure the issuing companies and their common stockholders and would be unduly beneficial to the bondholders who could look after themselves. They argued, in effect, that the bondholders were receiving a "one-way street" of protection at the expense of the issuer. Notwithstanding these and other objections, the Commission adopted the Statement of Policy.

It must always be borne in mind that the Holding Company Act is a regulatory statute which Congress deemed necessary to protect the national public interest and the interests of investors and consumers in respect of public utility holding companies and their public utility subsidiaries which have a monopoly within a given area or region. The Securities and Exchange Commission has sought to do justice to all those whose interests are affected by this statute, and to reconcile, so far as practicable, their competing views.

<u>Point No. 6</u> -- The Winn-Hess paper states that the only way the bondholder can protect himself against loss from a refunding call, other than to prohibit the call outright or to impose an extremely high call premium, is to require the issuer to pay over to the bondholder all the interest savings resulting from the refunding for the remaining life of the refunded issue, together with an amount equal to the expense incurred by the bondholder in reinvesting the proceeds of the redemption.

Comment on Point No. 6 -- A provision in the indenture such as that suggested by Messrs. Winn and Hess would be tantamount to an absolute noncall provision for the remaining life of the bond issue insofar as a refunding is concerned. Obviously, no issuer would undertake a refunding if the only result would be to pay over the fruits of the refunding to the bondholder, plus an amount assumed to represent the bondholder's reinvestment expenses to boot. The reasons which I have set forth above, which justify the position of the Securities and Exchange Commission in not permitting a noncall provision for up to five years, would *a fortiori* compel the Commission, in my opinion, to reject a provision the effect of which would be to make the bonds nonrefundable for their entire life.

I should like to make one further point on the Commission's formula regarding the initial call price. While the initial call price adds one year's interest requirement to the initial public offering price, this increment will actually extend the bondholder's interest income at the equivalent of his old contractual rate for several years beyond the call date. Assume, for example, that just about one year after issuing a 25-year 5 per cent bond at par, the issuer calls the issue at the call price of 105, and refunds it with a new 3-1/2 per cent issue. The present worth of the interest savings of 1-1/2 points for the remaining 24 years of life of the bond, discounted at the rate of 3-1/2 per cent per annum compounded semi-annually, amounts to

$24.22 per $100 principal amount. The call premium of 5 points thus gives the bondholder 20.6 per cent of the present worth of the interest savings. To state it another way, the call premium, if invested by the bondholder at a rate of 3-1/2 per cent per annum in the new bond or in an equal-risk security, will extend the bondholder's interest income of 5 per cent per annum for a little over 3-1/2 additional years beyond the call date. Thus, under the Securities and Exchange Commission's policy, the bondholder actually shares in a substantial portion of the refunding savings.

Thank you.

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