

SEC POLICY ON CALLABILITY OF CORPORATE BONDS
UNDER THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

by

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It gives me great pleasure to be invited to a group of financial people such as this to discuss a matter which, perhaps as much as any other recent single aspect of corporate finance, has been the subject of a good deal of controversy. I, of course, refer to the question as to whether mortgage bonds (or debentures) issued by public utility companies which are regulated by the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935 should be callable for any purpose at the option of the issuer, including refunding at a lower interest rate. It is a matter which is of particular importance not only to regulatory agencies such as the SEC, to name one, but also to the corporate issuers of the bonds and to the purchasers of the bonds. In addition, there are other parties in interest who are vitally affected by the terms of the contract or indenture securing the bonds. They are the consumers of the service sold or rendered by the utility company, and the general public. I understand, moreover, that, while this audience is not concerned with the regulated electric utility industry, the subject is one which is of lively interest to this group because of the various financing activities undertaken by it.

As you know, the SEC has a policy on callability which was announced in a formal Statement of Policy issued on February 16, 1956. (Holding Company Act Release No. 13105.) The Statement of Policy, which contains a wide variety of protective provisions applicable to mortgage bonds issued by

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public utility companies under the Holding Company Act, provides, among other things, that the bonds shall be redeemable at any time upon reasonable notice upon the payment of a reasonable redemption premium, if any. Although debentures are not specifically referred to in the Statement of Policy, the policy on callability is equally applicable to debentures.

The Statement of Policy contains no formula as to what constitutes a reasonable redemption premium, but 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 five per cent 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, by its very terms, actually has a degree of built-in flexibility in it by reason of its being affected by changes in interest rates --and I think it is safe to assume that the Commission will continue to adhere to it unless it is presented --as it on rare occasion is --with a special or unusual situation which makes its application in the particular circumstances an unreasonable hardship.

The question naturally arises as to why the Commission should be concerned with what may, to a good number of people, appear to be something which ought properly to come within the scope of contractual bargaining between the issuer and the purchaser (or underwriter) of the bonds, or entirely within the discretion of the management of the issuer. The answer is a short one, and it is this. Under the Public Utility Holding Company Act of 1935, the Commission is required to pass upon the specific terms and

provisions of security issuances by public utility holding companies and their public utility subsidiaries. This jurisdiction extends to a substantial segment of the privately-owned electric and gas utility companies in the United States.

Section 1(b) of the Holding Company Act, which lists the evils and abuses which the Congress directed the Commission to eradicate, declares that the national public interest and the interest of consumers of electricity and 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, i.e., unrestricted, callability for refunding purposes is necessary to secure this result. Nor is it proper, in the Commission's view, to dilute or vitiate freedom of callability by imposing such high call premiums as to render unfeasible, or at best speculative, a contemplated refunding operation. The rule-of-thumb formula which we insist upon for companies under our jurisdiction takes care of that contingency.

To effectuate this Congressional policy against unenconomical methods of raising capital, the Commission explicitly set forth its position on redemption restrictions in two cases in 1953. You will note that these two cases antedated the Commission's Statement of Policy adopted in

February 1956 to which I referred a few minutes ago. In one of those cases, 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).

In the excerpt which I have quoted from the Indiana & Michigan case, it is important to note 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. I shall deal shortly with this question as to whether bonds which carry a restriction on callability for refunding purposes --i.e., a call deferment of, say, five or ten years--do actually command a lower interest rate than bonds which may be refunded at any time upon the usual thirty days' redemption notice.

We are all familiar with the fact that, particularly in the 1940's and the early 1950's, and again in 1954 and part of 1955, public utility companies effected very substantial savings in their interest costs

because they were able to refund high-interest rate bonds with new bonds carrying materially lower interest rates. Had they been unable to do this, the higher interest charges in the rate-of-return process would have to be paid for by the consuming public and by the stockholders of the companies. To point up the significance to be attached to free refundability, I should like to refer to a study which I made some time ago of all electric, gas, and telephone utility bond or debenture issues offered publicly during the period of a little more than 5 years from January 1, 1953, to May 15, 1958, where the proceeds were used in whole or in part to refund outstanding bonds or debentures. Most of the refundings actually took place between March 1954 and May 1955.

There were 49 such refunding operations, and nearly all of the refunded issues had been marketed less than 5 years previously. The total principal amount of the issues refunded was approximately \$871 million. The weighted average interest saving per year, before expenses, resulting from these refundings amounted to one-half of one percent, or an aggregate of over \$4.3 million per year. This is a sizable item in the total annual cost of utility services to the American public.

You are probably aware of the fact that American Telephone & Telegraph Company, which, of course, is not subject to the Holding Company Act, only last month announced that it plans to sell at competitive bidding, on June 6th, \$250 million of new debentures, and to use the proceeds to refund an equal amount of 5-3/8 debentures, due 1986, which had been sold in November 1959. It is surprising to note, however, that in spite of the interest saving made possible by the call provisions of the 1959 issue, the

1961 issue, for some reason, will not be redeemable for a ten-year period. Other A.T.&T. system companies have also announced plans to refund some of their existing high-cost debentures, and one has already effected a refunding. Thus, Southern Bell Telephone and Telegraph Company, on March 21, 1961, sold \$70 million of new debentures, at an interest cost of 4.37%, for the purpose of refunding an equal amount of 5-1/2% debentures due 1994, which had been sold in October 1959. The new issue, however, unlike the refunded issue, will not be redeemable for a five-year period. New England Telephone and Telegraph Company will sell \$45 million of new debentures on April 11th to refund a 5-3/4% issue due 1994, which had been sold in September 1959. Similarly, Bell Telephone Company of Pennsylvania plans to sell \$50 million of new debentures on May 2nd, in part to refund \$30 million of 5-3/8% debentures due 1994, which had been sold in December 1959.

National Fuel Gas Company, which is subject to the Holding Company Act, has filed an application with the SEC for permission to sell, on April 24th, \$27 million of new debentures. The proceeds will be used, in part, to refund \$15 million of 5-1/2% debentures due 1982, which had been marketed in May 1957.

None of the above refundings, of course, could be possible if the issuer had accepted a restriction on refundability.

By way of digression, I might call your attention to the fact that in addition to the SEC, two other Federal agencies, the Federal Power Commission and the Interstate Commerce Commission, also prohibit refunding restrictions

in new debt issues subject to their jurisdiction. The FPC, however, does not necessarily adhere to the same rule-of-thumb formula which the SEC employs: The ICC's policy is a fairly recent one, and I do not know whether it has had occasion to indicate whether it will employ a call price formula similar to that of the SEC. One State commission, the Georgia Public Service Commission, adopted a Statement of Policy about five years ago virtually identical with that of the SEC, but it permitted the issuance of nonrefundable bonds in at least one case after the company introduced testimony which claimed that a materially lower interest rate could be placed on the bonds if they were made nonrefundable for a period of five years.

This latter point now brings me to the important question of whether refunding restrictions of, say, five years--i.e., an absolute bar on redemption where the funds for redemption are provided from other debt carrying a lower interest cost than the old issue--do result in lower interest costs to the issuer, all other things being equal, than where the bonds are freely callable at any time. As you know, the usual argument in favor of a refunding restriction is that the issuer can obtain a lower interest cost on the bonds if he provides call protection to the purchaser of the bonds.

In this connection, you may be aware of the fact that, in the latter part of 1956, the Wharton School of Finance and Commerce of the University of Pennsylvania, acting under a grant from the Life Insurance Association of America, undertook a study of the entire subject of callability of bonds. It is a comprehensive study in which data on corporate bond issues have been collected back to 1926. In addition, the historical pattern of Federal

Government financing, and the current pattern of Federal, State, and Municipal government financing are discussed in some detail. I am here concerned, however, only with so much of the study as relates to corporate bond financing. The actual study, including the collation and evaluation of the relevant data, is under the active supervision of Dean Willis J. Winn and Professor Arleigh F. Hess, Jr. The final report of the task force has not yet been issued, but when it will be issued--and I believe it will be issued some time this year--I am sure you will find it most interesting and informative. I happen to be a member of the Advisory Committee which meets with the task force to discuss techniques to be employed, and the problems encountered, in the study.

It is not inappropriate for me to give you a few high lights of the data assembled by the Wharton School task force, without, however, getting into the area of conclusions and recommendations which the authors of the study may have tentatively reached. Preliminarily, I would point out that the study to date covers 1,265 corporate bond issues offered from 1926 through 1959. The bonds were public utility and industrial issues; were \$5 million or larger in size; were sold privately or publicly for cash, except that, for the last four years, 1956 through 1959, only publicly-offered issues were included; the publicly-offered issues were rated A or better; none of the bonds carried warrant or conversion privileges; and all were term rather than serial issues.

For the period 1926-1943, the sample covered 572 issues, of which 551 were immediately callable, while only 21 had a call deferment. A comparison of the interest costs between the callable and the noncallable issues,

meager though the data for the latter were, does not lend support to the hypothesis that more restrictive call provisions resulted in lower interest costs, all other things being equal. Any market value for the call privilege was not apparent in the offering prices of the bonds.

The 1944-1955 sample covered 332 issues, of which 320 were immediately callable and only 12 had a call deferment. Here, too, a comparison of interest costs provided little, if any, evidence that the call privilege had any market value in this period. However, since yields were relatively low during most of this period, the inducement for the investor to seek call protection was apparently not strong.

During the period 1956-1959, the data require some discussion. The 1956 issues numbered 73, of which 68 were immediately callable and 5 had call deferments. The data for that year make it difficult to establish a strong case that easy callability raised interest costs, although those making the study believe that the data provide some evidence that easy callability did have this effect in 1956.

The 1957 issues, numbering 109, contain 73 which were immediately callable, and 36 which had call deferments. It is the view of the task force that, in spite of the increase in 1957 in the number of call deferments, no clear evidence existed that easy callability caused higher interest costs.

The 1958 issues, which numbered 104, included 64 which had immediate callability, and 40 with call deferments. All of these call deferments were for five-year periods. The task force concluded that in some cases call restrictions were associated with lower interest costs, while in

other instances the reverse was true. Thus again, nothing of any conclusive nature could be attributed to free callability as against call deferment.

The 1959 issues covered in the study presented some evidence for the first time, and then only beginning with the second half of the year, of a change in investor attitudes on the question of callability. The 1959 issues number 75, of which 51 were immediately callable and 24 had call deferments, all for five-year periods. The task force found that, beginning in the second half of 1959, for the first time during the entire 34-year period covered by the study, the market placed a value on the call privilege. The value, however, appears to have been small in most cases, and differences in interest costs attributable to call provisions were found in this latter period to be considerably less than one might assume on the basis of theoretical analysis. By this, I mean that the value of callability to the issuer is equal to the present worth of the saving in interest cost from the time of refunding to the date of maturity of the bonds refunded, less the cost of refunding and any other costs associated with the call.

The differences in interest costs found during the second half of 1959 varied from about 14 to 38 basis points in favor of the call-protected bonds, but, as the task force notes, these are indeed inconsequential differences, having in mind differences in size of issue, industrial classification, or variation in investment merit within a rating group. Moreover, the day of the offering was generally not the same for the immediately callable versus the call-protected issue.

I have made my own observations of the correlation or lack of correlation between interest costs and callability. These observations, which have been limited to public offerings at competitive bidding from about the middle of 1957 to the end of 1960, are in general accord with the findings made by the Wharton School task force. While one must, of course, make allowance for differences within Aaa-rated or Aa-rated or A-rated bonds--for example an electric utility bond is generally considered to be qualitatively superior to a telephone or a gas utility bond carrying the same rating--nevertheless, with all appropriate allowances for individual variations, it would appear that, in 1960, electric, gas, and telephone utility bonds offered at public competitive bidding, which had call deferments of approximately five years, enjoyed a somewhat lower interest cost, on the average, than utility bonds which were immediately callable. I did not attempt a bond-by-bond comparison, which should make proper allowance for individual qualitative differences between one issuer's credit and another's, as well as differences in day of offering. I simply compared the average interest cost of immediately callable bonds with the average interest cost of bonds having call deferments, by Aaa-rated, Aa-rated, and A-rated bonds. I computed average interest costs, separately for the three rating classifications, for the entire year 1960, except that as to the A-rated issues my comparison covered only the four-month period, July through October, since utility bonds with call deferments were not offered publicly at competitive bidding during the other months of that year.

For the Aaa-rated utility bonds in 1960, those with call deferments had an arithmetic average interest cost of 8 basis points lower than the immediately callable issues, and a median cost of 15-1/2 basis points lower. For the Aa-rated bonds, the differential, again in favor of those with call deferments, was 18 basis points on the basis of arithmetic averages, and 20 basis points on the basis of medians. For the A-rated issues, the differential, also in favor of those with call deferments, was 15 basis points on the basis of arithmetic averages and 16 basis points on the basis of medians. These differences do not strike me as being substantial. Standing by themselves, they certainly do not appear to me to be persuasive that regulatory policies against refunding restrictions are costly to the issuer. It does not require much financial analysis to recognize that, where the interest cost differential in favor of the bond having a call deferment is so small, it can be overcome by an advantageous refunding during the first few years after issuance of the bonds.

Nevertheless, assuming, arguendo, that it can be shown by objective data that the issuer can obtain a substantially lower, not merely a slightly lower, interest rate by agreeing to 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 non-refundable bond, that the issuer will save money over the life of the issue? While one may, on the basis of historical trends of interest rates, indulge in speculation--and even quite sophisticated speculation at that--as to the statistical probabilities of a reduction in interest rates during a future five- or ten- or thirty-year period, neither the issuer nor the regulatory agency concerned should, in my opinion, gamble on the likelihood and timing of such future possibilities.

A little while ago, I expressed the value of callability to the issuer in mathematical terms, as being equal to the present worth of the saving in interest cost from the time of refunding to maturity, less all costs associated with the call. If one could be certain, at the time the original bonds are sold, of the timing and extent of a future decline in interest rates, it would be an obviously simple matter to make the present worth computation and to state categorically that the value of the call privilege is a specific number of dollars. But since the timing and extent of a decline in interest rates are a matter of uncertainty at the time the original bonds are sold, the true value of the call privilege, in the view of those conducting the Wharton School study, is one which also takes into account the probability that the interest rate will decline. Thus, the lower the probability, the lower will be the true value of the call privilege.

The probability that a given decline in interest rates will occur within a given time depends essentially on (1) the size of the decline; (2) the magnitude of the original rate from which the decline is to be measured; and (3) the amount of time which elapses until the decline takes place. It is their view that data which they have collected of yields from 1926 through 1959 of newly issued corporate bonds, including computations of the number of years elapsed before the yields declined by, say, 2%, or 1%, or 1/2 of 1%, can be utilized to estimate the probability distribution of changes in interest rates from any initial level. Indeed, a rigorous mathematical formula of the value of the call privilege under various assumptions of probabilities has been developed by the task force, designed to point up the area within which the issuer and the buyer of the bonds can negotiate the call provision.

For the present, however, it seems to me that, as long as differences in interest costs between immediately callable bonds and bonds with a call deferment are insubstantial, regulatory agencies which favor free callability are not likely to change their views thereon. Moreover, even assuming, for the sake of discussion, that substantial and consistent differences in interest rates should develop in the future in favor of bonds with a call deferment, I have serious doubt that these regulatory agencies will change their views unless other adverse factors not now present in the picture should develop. I shall now deal with such other factors:

Our inquiry into the problem at the SEC has not been limited to a consideration of comparative interest costs as between bonds which are callable and those which have call deferments for refunding purposes or, as we often refer to them, refundable versus nonrefundable bonds. We have also been concerned with the question of whether our policy on free callability has had any adverse effect on the ability of the utility companies subject to the Holding Company Act to sell their bonds. This is an important point, because the SEC obviously would not want to have a policy which could result in drying up the 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 continuous review which the Commission has directed be made of its policy of free callability, I have studied all the electric and gas utility bond issues (including debentures) offered at competitive bidding between May 14, 1957, and December 31, 1960, covering a little over 3-1/2 years. The study was not limited to debt issues which are subject

to the Holding Company Act, but rather covered all competitive offerings of electric and gas utility debt issues, whether or not subject to the Holding Company Act. The date of May 14, 1957, was selected as the starting point because on that day 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 5-year restriction, and in some cases a longer-term restriction, on refunding. In this study, I compared the number of bids received from underwriters on the refundable versus the 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 in selling the bonds to the ultimate purchaser will have a profound bearing on whether or not underwriters will continue to compete for refundable issues.

During the period from May 14, 1957, to December 31, 1960, a total of 273 electric and gas utility bond issues, aggregating \$5.9 billion principal amount, was offered at competitive bidding. The refundable issues numbered 208 and accounted for a total of \$3.9 billion, while the nonrefundable issues--all except one being nonrefundable for a period of five years, and one being nonrefundable for a period of seven years--numbered 65 and totaled \$2.0 billion. The number of refundable issues thus represented 76.2% of the

total number of issues, while, in terms of principal amount, the refundable issues accounted for 66.1%. You may be interested to note that for the calendar year 1960 alone, the number of refundable issues constituted 72.1% of all the issues in that year, while in terms of principal amount they constituted 61.5% of the total. Parenthetically, I might point out that for the first three months of 1961, there have been no electric or gas utility bonds or debentures sold at competitive bidding which carried a call deferment. All of the 9 electric or gas debt issues, aggregating \$115 million principal amount, which were sold at competitive bidding during the first quarter of 1961, are freely refundable. However, on April 4, 1961, an electric utility company offered at competitive bidding \$30 million of bonds carrying a 5-year call deferment.

The weighted average number of bids received on the refundable issues for the same period, May 14, 1957, to December 31, 1960, was 4.58, while on the nonrefundable issues it was 4.22. The median number of bids was 5 on the refundables and 4 on the nonrefundables. In this connection, however, it should be noted that the size of the refundable issues was, on the average, somewhat smaller than that of the nonrefundables--a fact which may account for the difference in the average number of bids received on each group.

With respect to the success of the marketing of the bond issues, I have considered an issue as having been successfully marketed if at least 95% of the issue was sold at the syndicate price up to the date of termination of the syndicate. On this basis, 73.1% of the refundable issues during the approximately 3-1/2 year period were successful, while 72.9% of the non-refundables were successful. In terms of principal amount, 63.8% of the

refundable issues were successful, while 69.5% of the nonrefundables were successful. Extension of the comparison to include the aggregate principal amounts of all issues which were sold at the applicable syndicate prices up to the termination of the respective syndicates, regardless of whether a particular issue met the definition of a successful marketing, indicates that 87.1% of the combined principal amount of all the refundable issues throughout the 3-1/2 year period were sold successfully, as compared with 84.9% for the nonrefundable issues.

The foregoing statistics, I submit, which have been developed in respect of the two groups of bond issues, together with the comparative interest cost data discussed previously, fully support the SEC's policy of requiring free callability of utility bond issues subject to the Holding Company Act.

Thank you.