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A Practitioner's Perspective: Comments on "Analysis of U.S. Savings Bonds"

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In this issue, Potts and Reichenstein describe features of U.S. savings bonds and discuss their evaluation. The article can serve as a reference for busy practitioners who may not follow changes in the savings bond market closely, especially those who tend to rely on product-related education for updates on financial instruments.

Savings bonds remain an important investment for individuals; on March 31, 1994, individuals held $174.9 million in U.S. savings bonds, a 7% increase from one year prior (Williams, 1994). Further, as Table 1, "Demographic Characteristics of Individual Savings Bond Holders," indicates, the holding of savings bonds is not exclusive to any particular age group or income level (*Federal Reserve Bulletin*, 1994).

I. Potential Changes

The recently (November 1994) passed General Agreement on Tariffs and Trade (GATT) included provisions that gave the Treasury Department full authority over interest rate setting on U.S. savings bonds. The Agreement removes the 4% guarantee previously set by Congress for bonds held for less than five years and enables the Treasury to index the savings bond rate to that of the six-month T-bill.

Peter Hollenbach, a spokesman for the Bureau of Public Debt, indicated in December 1994 that changes will not be retroactive and "an announcement of any change is some months away" (Lazzareschi, 1994b). While details are not finalized, changes expected are:

- Pegging the rate for savings bonds held for less than five years to 85% of the six-month T-bill rate, eliminating the 4% rate guarantee. Bonds held for 5 years or more will continue to earn 85% of the average rate paid by Treasury notes with five years left to maturity, with a minimum of 4%.
- Changing interest accrual from a monthly to a semiannual basis. Those individuals who sell just before the six-month or one-year anniversary will forego the partial period of interest.

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To those unfamiliar with legislative customs, inclusion of these changes in the apparently unrelated GATT seems unusual. But because new legislation passed by Congress must be "deficit neutral," GATT needed a revenue enhancer. The Congressional Budget Office's projection of $120 million in savings over five years as a result of the interest changes provided that revenue source needed for GATT's passage (Lazzareschi, 1994a).

The Treasury has wanted to make these changes since the early 1990s, when the 4% fixed rate was so favorable that investors, as the Potts and Reichenstein article suggests, used the bonds as short-term investments. According to Hollenbach, the Treasury wanted to return bonds "to their original purpose: to buy and hold for the longer term, instead of using them as money market mutual funds whenever [the] fixed rate looks more attractive." (*Boston Herald*, 1994) The removal of the interest rate minimum, as well as the change in interest accrual from monthly to semiannually, will limit these opportunities.

However, realizing the savings from the removal of the 4% rate floor would require an extended period of low interest rates. Even with the low interest rates during the early 1990s, the variable rate never fell below the 4% floor and "temporary dips would be moderated in any event since the return you get at redemption is an average of the six month variable rates" (Smith & Wiener, 1995).

The $120 million savings estimate was based on the April 1994 assumption that Treasury bill rates would be 4.3% for 1995 and 4.6% thereafter. In early 1995, when six-month T-bills paid 6.81%, an immediate implementation of the changes would have obligated the Treasury to pay 5.79% rather than 4% on savings bonds cashed in early. With revised interest rate assumptions, the changes are estimated to cost the Treasury about $360 million over five years in additional interest payments (Kristof, 1995).

II. IMPLICATIONS AND STRATEGIES FOR THE INDIVIDUAL

Since changes are expected in spring 1995, those individuals who are concerned about long periods of low interest rates should lock in the minimum rate guarantee by buying before the changes are implemented. Likewise, liquidity-minded individuals who want the option to redeem the bond in less than six months should purchase before the change eliminates monthly interest crediting.

Several other features of the bond are worth noting. First, the tax deferral differs from the deferral associated with qualified pension plans where individuals must take a required minimum distribution by the April 1 following the year of attaining age 70½. In contrast, savings bonds' interest can be deferred for up to 30 years or until redemption, regardless of the holder's age. This could be helpful for older individuals looking for tax deferral; additionally, compared to the qualified plan, savings bonds afford individuals more liquidity and more control over when they choose to redeem the bonds and pay tax on interest.

Planners also should not neglect the estate planning benefits of savings bond investments. A bond purchaser can request that the bonds include an inscription naming a beneficiary "POD," to be paid on death. Then, at the owner's death, the bonds are excluded from the probate process; the named beneficiary can redeem them or have the bonds reissued in the beneficiary's own name (Doyle, 1995). When the owner dies and there is no beneficiary listed, the survivor must forward appropriate forms, along with a death certificate, to the Federal Reserve Bank (Doyle, 1994).

There are reports that the 1993 tax law set thresholds lower than Congress intended for tax exemptions on savings bonds used for educational funding; there is speculation that Congress may pass a technical corrections bill to make changes to the law. This could be good news for high income couples because when bonds are used for educational funding, the 1995 full tax exemption on interest applies to couples with adjusted gross incomes (AGI) up to $63,450, and a partial exemption is available for couples with AGIs up to $93,450 (Klott, 1995).

While impending changes may limit the savings bonds' appeal as a short-term vehicle, their tax and estate treatment, along with safety and freedom from transactions costs, continues to make savings bonds a reasonable conservative investment vehicle. Potts' and Reichenstein's work contributes to our understanding of these bonds' valuation.

APPENDIX

Percentage of Families Holding U.S. Savings Bonds in the Year 1992

All Families	22.7
Income *(in 1992 dollars)*	
Less than $10,000	6.6
$10,000–24,999	13.3
$25,000–49,999	27.9
$50,000–99,999	39.5
$100,000 and over	32.1
Age of head of household (in years)	
Less than 35	22.8
35–44	29.4
45–54	25.4
55–64	21.4
65–74	14.1
75 and over	14.5

Source: *Federal Reserve Bulletin* (October, 1994).

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