Economic Commentary

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Savings Bonds

When I was growing up during the 1950s, one of the gifts frequently given by aunts, uncles, grandparents and family friends for graduation or other important life events was a $25 U.S. Savings Bond. The smallest Savings Bond denomination was $25 and it cost $18.75, paid a 4% interest rate, and grew to its face value within 7 years. It came in paper form and I remember cashing in several of them, always before they reached face value.

While in the Army and on my first post military job in the 1970s, I was expected to opt for some portion of my pay to be used to purchase more U.S. Savings Bonds. The Army and my employer deducted $6.25 per month and at the end of three months I received a Savings Bond which I promptly cashed. The purchase of U.S. Savings Bonds at the time was seen as a patriotic duty.

Recently I inherited some Savings Bonds so I decided to investigate the current rules and regulations. I was amazed at how the Treasury Department had changed the rules governing Savings Bonds since the 1970s, and not to the advantage of the small denomination saver.

Historically I recalled that by the 1980s, Savings Bonds were no longer a symbol of patriotic duty and most companies no longer expected employees to purchase them. The interest rate on a five year Treasury Note was much higher than the 4% that still prevailed on Savings Bonds, which caused the Treasury Department to update and modernize the offering.

Beginning in the mid-1980s, Savings Bonds were priced at one-half their face value. The interest rate was tied by formula at 85% of the yield on the five year U.S. Treasury Note, with a reset every six months. There was also a floor, or a minimum guaranteed rate, set at 6%. Savings Bonds were then designated as “EE” which contrasted with the “E” bonds of the 1950s. They had a 30 year maturity and at any time the Savings Bonds could be converted into “HH” designated bonds, which paid interest every six months. At the end of 40 years the Savings Bonds stopped paying interest. Holders were not compelled to turn in the Savings Bonds, as that would immediately trigger a tax liability for the accumulated interest.

That system worked reasonably well until 2004 when the Treasury Department notified holders of Savings Bonds that henceforth the minimum interest rate was being reduced from 6% to 4%. Also, the ability to convert “EE” Savings Bonds to “HH” Savings Bonds was no longer an option. At the end of 30 years, the bond was deemed to be matured and the proceeds and the tax liability associated with it were sent to the Savings Bond holder.

As computer technology advanced the Treasury Department created Treasury Direct, an on-line method of selling and redeeming Savings Bonds. This function was consolidated at the Federal Reserve Bank of Minneapolis. Beginning in 2013 Treasury Direct would only sell or transfer Savings Bonds electronically, thus ending the opportunity for aunts and uncles everywhere to provide a paper certificate to a deserving niece or nephew.

At present, Savings Bonds are issued at full face value, but only into a Treasury Direct account and they carry an interest rate of 0.1% with a reset every six months. As one might suspect, Savings Bond sales have plummeted.

The intriguing aspect of this historical recapitulation is how the Treasury Department unilaterally changed the terms of its contracts with small savers. When the Treasury Department saw sales decline in the late 1970s and early 1980s, they came up with “EE” Savings Bonds, leaving holders of “E” Savings Bonds locked in at 4% interest in a double-digit interest rate environment.

When interest rates declined in the early 2000s, the Treasury Department unilaterally changed the rules on the Savings Bonds purchased over the previous 20 years by lowering the minimum rate from 6% to 4% and taking away its convertibility feature. Instead of creating “EEE” Savings Bonds with these new attributes, the Treasury effectively abrogated its contract with existing Savings Bond holders, many of long duration. It is unimaginable that the Treasury would have ever sought to do the same thing with its publicly issued debt instruments to institutional investors.

Also, if the Treasury Department had kept to its market based approach based on the 5 year U. S. Treasury Note, current interest rates on Savings Bonds would be 1.2% instead of the 0.1% that Savings Bonds currently carry.

By its actions the Treasury Department has shown contempt for small savers and an arrogance about the importance of bond contracts between itself and individuals.

Raymond A. Beplat
President