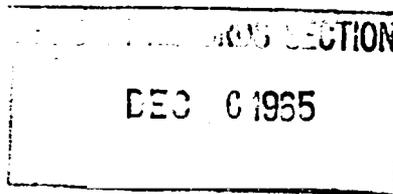




BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON



December 6, 1965

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

There is enclosed a copy of a progress report on dealer financial statements by the Staff Steering Group established to implement some of the recommendations of the 1959 Treasury-Federal Reserve Study of the Government Securities Market. Proposals for obtaining financial statements from nonbank dealers in U.S. Government securities were discussed at the meeting of the Federal Open Market Committee on December 15, 1964.

Ralph A. Young
Ralph A. Young, Secretary,
Federal Open Market Committee.

Enclosure

C O N F I D E N T I A L

DEC 0 1965

December 3, 1965

TO Federal Open Market Committee
and Secretary of the Treasury

FROM Steering Group

SUBJECT Progress report on dealer
financial statements

The statistics program for the Government securities market, which was inaugurated in 1960, was designed to collect two types of information. The first concerns the dealers' daily operations as reflected in position, volume, and borrowings figures, and the second the dealers' general financial condition and earnings. The initial efforts of the Steering Group were directed toward the first of the two tasks, but in early 1964 work began on a program to obtain uniform statements of dealer assets and liabilities and earnings and expenses. The nonbank dealers submitted their first set of the new reports under the financial statement program in the spring of 1965; these showed their financial positions as of December 31, 1964 and their earnings for calendar 1964. The bank dealers will be submitting their first set of reports early next spring covering the year 1965.

Our preliminary discussions with the nonbank dealers indicated that there were two primary obstacles to development of uniform condition statements and to the determination of industry earnings. The first was the proper allocation of expenses in large firms which operate in several different securities markets, and the second the allocation of a portion of net worth to the Government securities operations of such firms. The Group decided that initially each firm would be free to make these two allocations as they saw fit in the hope that the Group could then evaluate the various procedures used and be in a position to ask for uniform procedures of allocation for 1965. Work on the development of such procedures has not been completed.

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For the bank dealers, the allocation of expenses does not present any great difficulty, but the allocation of net worth and the determination of the cost of bank funds used by the dealer departments are both stumbling blocks. Following the same procedure used for the nonbank dealers, for the first go-round each dealer bank will be asked to use its own system for capital allocation and for assignment of interest costs.

Despite all the problems that were and are being encountered in setting up these new sets of reports, the Steering Group is encouraged by the progress made to date. While we do not expect to obtain completely comparable data for all dealers for at least another two or three years, and our analysis of the reports will be handicapped by the lack of an historical framework against which to measure the first few years' figures, the initial data do help to confirm information received from other sources on the status of the industry.

Summaries of the financial condition figures reported by the nonbank dealers of their earnings and expenses for 1964 are shown in Tables I and II.^{1/} Despite the allocation problems and other inherent limitations of the figures, the fact that strikes one is the relatively low level of dealer earnings on their operations in Government and Agency issues and certificates of deposit (which are handled by the Government department in all firms which trade them). A clear-cut, after-tax comparison of earnings with other industries is difficult, because the firms that operate in many markets are not taxed separately on their operations in Government securities. However, in

^{1/} One small dealer, which reports to the Market Statistics Department on a daily basis but does not do business with the Trading Desk at the Federal Reserve Bank of New York, was not asked to participate in the new program. Figures for another dealer who went out of the Government securities business in 1964 were reported but they were omitted from the aggregates shown in the tables.

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Table I

Statement of Financial Condition of Nonbank Dealers
December 31, 1964

(In millions of dollars)

<u>Assets</u>		<u>Liabilities</u>	
Cash assets and receivables	81.9	Loans payable	1,771.0
Securities owned (at market price)		Secured	1,763.1
		Unsecured	7.9
U. S. Government	2,926.1	Repurchase agreements	2,318.9
Due in 1 year or less	2,252.0	U. S. Government securities	
Due in 1-5 years	449.7	15 days or less	1,761.2
Due in 5-10 years	167.5	More than 15 days	536.6
Due after 10 years	57.0	Other securities*	21.1
Federal Agencies	238.7	Securities sold short	519.6
Municipal and State	175.2	U. S. Government	494.0
Corporate stocks and bonds	140.4	Due in 1 year or less	90.3
Other securities	20.1	Due in 1-10 years	203.9
Bankers' acceptances	127.3	Due after 10 years	199.7
Certificates of deposit	318.6	Other securities	25.6
Securities sold but not delivered	1,180.4	Other liabilities	<u>461.1</u>
Less: Securities purchased but not received	859.2	Total liabilities	5,070.8
Net of undelivered securities	321.2		
Other assets	<u>942.7</u>	Net worth	<u>221.6</u>
Total assets	5,292.2	Total liabilities & net worth	5,292.2

Note: The figures may not add to the totals shown because of rounding.

No contracts more than 15 days to maturity were reported.

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Table II

Nonbank Dealers' Income and Expenses, 1964

(In millions of dollars)

<u>Item</u>	<u>Government operations</u>	<u>All operations</u>
<u>Income</u>		
Trading and underwriting profit on coupon issues	15.1	74.2
Unrealized appreciation or depreciation	(.5)	(2.6)
Interest and dividend income	102.6	158.2
All income on Treasury bills	(67.9)	-
Other income	<u>-</u>	<u>147.2</u>
Total income	117.7	379.7
<u>Expense</u>		
Interest on borrowed funds	98.0	130.3
All other expenses, excluding Federal and State income taxes	<u>16.6*</u>	<u>189.7</u>
Total expenses	<u>114.6</u>	<u>320.0</u>
Net income	3.1	59.7
Federal and State income taxes#	<u>1.7</u>	<u>28.4</u>
Net income after taxes	1.4	31.3

* Dealers operating in other securities markets used varying methods for allocating their expenses to Government operations. Some of the estimates may be subject to a wide range of error.

Taxes for the two partnership dealers were estimated by applying the corporate tax rates and no allowance was made for capital gains. Three dealers reported a net loss on their Government operations, but the reduction in their tax liabilities on their total operations that resulted from this loss is not reflected in the Government operations totals.

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Table III we have shown each of the nonbank dealer's total return on its net worth and the estimated return on its Government operations, assuming the latter were conducted by a separate corporation. A few firms did relatively well with their Government business, but most of them apparently did not. It should be noted, however, that the firm that earned the most on its Government operations had no allocation problem. This highlights the question of whether the low earnings of the Government operations business of multi-activity firms might not have been due, at least in part, to an over-allocation of either expenses or net worth or both to the Government operations part of the firm.

In Table IV figures on the net return of the nonbank dealers on both their Government and their total operations in 1964 are compared with figures compiled by the Internal Revenue Service on the 1961-62 net return (the latest available) of other types of financial industries, and with the 1961-62 net return on the total operations of the nonbank dealers. The 1961-62 dealer figures are based on information collected by George Benston for the House Banking and Currency Committee. These data, however, have to be interpreted cautiously because the figures are not strictly comparable with the 1964 data. Furthermore, they exclude the operations of the large stock exchange house which purchased one of the Government dealers in 1964. The earnings of that firm on operations other than those in the Government securities market accounted for a large part of the total income of nonbank dealers in 1964.

As the table indicates, on a before-tax basis the dealers' net return on their Government operations in 1964 was in the neighborhood of 4 per cent, while the average return for all types of financial institutions in 1961-62 was over 9 per cent, and none of the other subgroupings shown earned less than 6 per cent. On their total operations the net return before taxes in

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Table III

Nonbank Dealers' Net Income After Taxes as a Per Cent of Net Worth,
All Operations and Government Securities Operations, 1964

(In per cent)

<u>Dealer</u>	<u>Net income on Government operations to allocated net worth</u>	<u>Net income on all operations to total net worth</u>
Blyth	0.84*	7.64
Briggs	0.60*	5.15
Discount	4.76*	5.72
First Boston	1.52*	11.85
Hanseatic	0.79*	3.75
Lanston	8.18	8.18
Merrill Lynch	- 0.67*	18.85
Pollock	0.93*	2.44
Quincey	7.39*	8.91#
Rich Discount	- 12.09	- 6.86
Salomon	0.25*	14.18#
Second District	- 2.08*	8.66
Average of individual ratios	0.87*	7.37
Median of individual ratios	0.82*	7.91
Ratios for industry aggregates	1.76*	14.11

* Allocation of net income and net worth to Government securities operations for firms dealing in other securities were made by each dealer respectively, but may be subject to a wide range of error. State and Federal income tax liabilities for Government securities operations were estimated by the Market Statistics Department and do not include any allowance for capital gains taxes.

Salomon estimated its State and Federal income tax liabilities at corporate rates. Similar estimates for Quincey were prepared by the Market Statistics Department and do not include any allowance for capital gains taxes.

Net Returns on Capital of Nonbank Government Securities Dealers
Compared with Finance, Insurance, and Real Estate Corporations*

<u>Industry</u>	<u>(In thousands of dollars)</u>			<u>(In per cent)</u>		<u>Number of reporting firms</u>
	<u>Total net worth</u>	<u>Net income before taxes</u>	<u>Net income after taxes</u>	<u>Net income before taxes/ net worth</u>	<u>Net income after taxes/ net worth</u>	
Nonbank dealers in U. S. Government securities						
<u>1964</u>						
All operations	221,572	59,687	31,274	26.94	14.11	12
Government securities operations	76,774	3,076	1,348†	4.01	1.76	12
<u>1961-62</u>						
All operations#	102,899	20,119	8,000†	19.55	7.77	11
Total finance, insurance, and real estate industries--1961-62						
Banking	27,375,778	3,500,280	2,207,070*	12.79	8.06	14,901
Credit agencies other than banks	13,675,553	896,390	503,485*	6.55	3.68	48,866
Holding and other investment companies	23,699,730	1,979,152	1,878,802*	8.35	7.93	12,638
Security and commodity brokers, dealers, exchanges, and services	846,208	204,919	109,418*	24.22	12.93	3,854
Insurance carriers	24,733,245	2,248,566	1,502,460*	9.09	6.07	4,019
Insurance agents, brokers, and services	974,516	144,234	94,337*	14.80	9.68	21,060
Real estate, except lessors of real property other than buildings	15,237,892	985,946	566,752*	6.47	3.72	227,984
Lessor of real property, except buildings	1,441,333	91,629	51,174*	6.36	3.55	6,888

* 1964 data for Government securities dealers were taken from the statements of financial condition for the calendar year 1964 which were submitted to the Market Statistics Department. 1961-62 data are averages of the figures for 1961 and 1962 which were collected by Dr. Benston for the House Banking and Currency Committee. Corresponding data for the Government securities operations of the nonbank dealers are not available because they did not report allocated net worth and in addition several did not report allocable expenses. Data for other industry categories were obtained from Federal income tax returns for fiscal years ended July 1961-June 1962, as published in Statistics of Income...1961-62, U. S. Business Tax Returns (U. S. Treasury Department, Internal Revenue Service, 1964).

Excludes Blyth and Rich because these firms did not report equity. Also, in 1964 a substantial part of total income from all operations represented the earnings of Merrill Lynch; these are not included in the 1961-62 data.

† Estimated by the Market Statistics Department at corporate rates without allowance for capital gains taxes.

* Includes tax liability for a few small corporations which elected to be taxed at the shareholder level.

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1964 was 27 per cent and in 1961-62, 20 per cent. The difference reflects the greater profitability of other types of security operations but it also again raises a question about the dealers' allocations of expenses and capital to their Government functions.

The tentative nature of many of the figures, especially those on dealer expenses and on the amount of capital which was either in use by the Government operation or available to it, precludes any firm analysis of the reason for the dealers' apparent poor performance, but a review of the available data does provide some clues. On the income side, not all the dealers were able to break down their Treasury bill income in a fashion which would permit an accurate distinction between profit or loss from trading operations as such and those derived from "carry"--that is, the differences between the interest earned on the bill and the interest cost involved in holding it--but apparently none of the firms were able to make much on their trading operations; they either about broke even or experienced a moderate loss. For all dealers combined, aggregate interest (including all income from Treasury bills) received exceeded aggregate interest paid by about 3 per cent. Expenses were generally fairly closely related to gross dollar volume of operations, although some marked differences among firms were noticeable.

The dealers used a number of different systems to allocate capital. Some related it to average or year-end positions or borrowings; some calculated the amount generally needed to provide margins; and some simply made an arbitrary allocation. The aggregate amount allocated increased by \$12 million between the end of 1963 and 1964 to a total last December of \$77 million. This increase does not reflect any significant new investment of funds by any of the firms involved, but rather the fact that two of the large firms based their allocation on the ratio of their year-end positions in Government

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securities to total positions, and the 1964 ratio happened to be above 1963; and one firm, which was acquired by another during the year, was arbitrarily assigned a larger amount of capital than had been available before. The arbitrary increase in the capital of the latter firm probably resulted in an "over capitalization" of that particular operation and thus tended to bias downward the net return on invested capital figures, but the amount of capital allocated in 1964 by one or two other large firms appeared to be low relative to the amount of capital needed to provide margins for their average inventories, or in comparison with firms that did not have an allocation problem. Even if 1964 net earnings are compared with the 1963 capital base, the net return before taxes would still be less than 5 per cent.

As performance data for the dealers become available over a longer period of years, and some of the inconsistencies in the reports are cleared up, the Steering Group expects that further light will be shed on the reasons why, or even definitely whether, the earnings of Government securities dealers in recent years have been low relative to either (1) alternative fields of investment and (2) to past years in the Government securities industry. Hopefully also, the type of market developments or action on the part of the System or the Treasury which might improve the industry's earnings prospects may also become clearer.

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Franklin R. Saul,
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