

REC'D IN RECORDS SECTION

JUN 26 1961



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

June 26, 1961.

To: Federal Open Market Committee

From: Mr. Young

Attached is a memorandum dated June 15, 1961, from the Steering Group of the Government Securities Market Study with respect to dealer financial statements. It will be noted that the Steering Group is asking for authority from the Federal Open Market Committee to talk with nonbank dealers individually about the possibility of setting up a more standardized system of financial reporting.

This matter will be included on the agenda for discussion at the meeting of the Open Market Committee on July 11, 1961.

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

Enclosure.

To Federal Open Market Committee
From Steering Group of the Government
Securities Market Study

June 27 1961
Subject: Dealer Financial
Statements

Now that a specific program for the collection and publication of current statistics on dealer operations in the Government securities market has been launched, the Steering Group has turned its attention to the matter of dealer financial statements. You will recall that a Supplementary Study entitled, "Adequacy of Market Statistics," in Part III of the Treasury-Federal Reserve Study of the Government Securities Market suggested "further detailed exploration by Treasury and Federal Reserve officials with the dealers, both nonbank and bank" of "the possibility of eventual publication of some kind of consolidated balance sheet and income statement for the dealer community as a whole." The Federal Open Market Committee subsequently authorized the Steering Group to undertake such exploration.

The Steering Group has studied the matter of dealer financial statements further and submits the attached memorandum summarizing its tentative conclusions with regard to financial statements of nonbank dealers for the consideration of the Committee. In summary, on the basis of an examination of the statements currently being submitted by dealers annually to the Federal Reserve Bank of New York, we have concluded that these statements have the following inadequacies:

- (1) The absence of any surplus reconciliation of the balance sheet from one year to the next, thus precluding an explanation of year-to-year changes in dealer capital.
- (2) Lack of full disclosure of certain contingent liabilities, principally long-term repurchase contracts.
- (3) Obscurity and lack of uniformity in accounting practices and usage.

The need for more standard and comprehensive dealer financial statements arises mainly from a recognition of the quasi-public responsibility exercised by the Government security dealers in making markets for the Government's own obligations. The Federal Reserve Bank of New York has found the present statements adequate for purposes of establishing the financial status of dealers. Supplemented as they are by dealer explanations of the statement items and by daily reports disclosing individual dealer current trading positions and liabilities on longer term repurchase agreements, the present statements provide sufficient information for the Federal Reserve Bank of New York to establish the financial status of the dealers. More uniform statements would, however, be generally helpful for purposes of credit analysis to the whole market and might contribute in some small way to the maintenance of a sound financial structure among the professionals in the market. But the Government securities business is an activity where risk exposure can and occasionally does change sharply from day to day; therefore, annual or even quarterly financial statements cannot in and of themselves assure credit worthiness or financial soundness.

There is also considerable interest on the part of some members of Congress and some sectors of the general public for periodic, consolidated balance sheet and income statement information on the dealer community in the Government securities market. We feel that satisfying such public interests could contribute to a more orderly functioning Government securities market.

Thus, we are at this time requesting authority to talk with the nonbank dealers more specifically about the possibility of setting up a more standardized system of financial reporting along the lines of the attached memorandum, recognizing that considerable effort by way of negotiation will be required to compose variations arising from the widely different types of business done by the individual dealer firms.

As the financial status of the dealer banks is well established by reports of condition and examinations, there is no need for obtaining special statements to establish their financial status. At some point, it may be desirable to obtain further information from the bank dealers to facilitate assembling consolidated data for all dealers, but this can follow if the need appears and when the problems relating to nonbank dealers have been worked out.

Attachment

REC'D IN RECORDS SECTION

JUN 27 1961

GOVERNMENT SECURITIES DEALER FINANCIAL STATEMENTS

Financial statements presently submitted to the Federal Reserve Bank of New York by the nonbank Government securities dealers lack uniformity of treatment and in some cases do not appear to reflect fully all items of a contingent nature such as repurchase agreements and forward commitments. The diversity of the statements submitted and of the way various items are reported by different firms is shown in the attached comparative table. This memorandum sets forth a tentative approach for securing more satisfactory statements from the dealers based on the following general propositions:

1. For reasons set forth in the covering memorandum of the Study Group, it would be highly desirable to receive audited financial statements from Government securities dealers, on a uniform basis, that would adequately reveal their financial status.
2. In view of the varied activities of the Government securities dealers, the different forms of organization, and the different accounting procedures employed, it may be impractical to attain full uniformity of accounting procedures.
3. Neither the System nor the Treasury has legal authority to require dealers to submit financial statements. For credit purposes, however, the Federal Reserve Bank of New York, in making repurchase agreements with Government securities dealers under authorization of the Federal Open Market Committee, requests dealers to supply such statements to the Securities Department of the New York Bank, and for many years has done so in conjunction with this activity. From time to time, the Securities Department has requested dealers also to supply supplementary explanatory information.

4. The foregoing imply

- (a) that efforts should be made to have dealers submit uniform financial statements to the Federal Reserve Bank;
- (b) that if uniform reporting should prove impractical, dealers should be requested to supply information necessary to adjust the individual statements to a common basis that would meet a predetermined standard of adequacy;
- (c) that if uniformity of statement forms can be attained, dealers could be encouraged to use this form in supplying information to lenders and customers, and
- (d) that it may be appropriate at some future time, after experience with the data internally, for either the Treasury or the Federal Reserve to issue aggregate financial statements periodically for the dealers considered as a group, having in mind that the public may have an interest in such composite figures.

* * * * *

There is set forth below a suggested "uniform" balance sheet prepared by the Credit and the Securities Departments of the New York Federal Reserve Bank which in the view of the Study Group would appear to provide adequate information on the financial status of dealer firms. The suggested balance sheet is broad enough to cover all of the major elements of dealers' activities, and to make allowance for the fact that some of the dealer firms are corporations while others are partnerships. It should be noted that not all of the items will apply to each dealer firm because of the different types of business conducted by them.

It is obvious that there may be numerous problems of interpretation and of adapting individual dealer accounting methods to fit the form suggested.

In some cases dealers, and their auditors, may be required to perform a significant volume of extra work because the form here suggested differs in various aspects from the reports required by supervisory agencies, such as the New York Stock Exchange or the SEC and from the figures that can be supplied by their present accounting systems and controls. Proposals for a standard form of dealer financial statement could be adopted by the Federal Open Market Committee, subject to coordination with the forms adopted by other supervisory agencies. The Study Group has not felt it desirable to explore such possibilities at this stage of consideration of the subject.

It is also obvious that it is impossible to foresee and make provision for every type of item on which information might be useful. Therefore, once a decision has been made as to the usefulness of the general line of approach suggested here, the uniform statement should be discussed with the individual dealer firms and with accounting firms that are expert in this specialized field. If in these subsequent negotiations the problems of uniform reporting by firms with various interests, accounting procedures, and forms of organization should prove to be serious, there would be no insurmountable problems created by permitting dealers to submit financial statements in the form they normally use, providing that they also submit supplementary information that would permit the statements to be reconciled in a meaningful manner. Since there are only thirteen nonbank dealer firms presently involved in the reporting, the technical aspects of adjusting individual statements to a common basis would not be too great.

The manner in which we suggest that repurchase and resale agreements be treated requires some explanation, particularly since the different methods of treating these items in the statements previously submitted to the Securities Department have raised the most serious problems of interpretation. Recognizing that it is possible to treat repurchase and resale agreements differently in

financial statements, and that any uniform system of reporting is to a certain extent arbitrary (and subject to disputation by dealer firms who have various philosophies regarding such agreements), we make the following suggestions:

1. Repurchase agreements maturing within 15 days would be treated in the balance sheet in a manner similar to loans collateralized by Government securities. That is, they would be included among "Securities owned" on the asset side of the balance sheet, and in an item "Liability on repurchase agreements" on the liability side. In order to measure the exposure of dealers to possible market risk on such agreements, the "Liability under repurchase agreements" would be valued at the repurchase price agreed on, while dealers would be asked to supply supplementary information on the market value of the securities covered by these agreements as well as the maturities of the securities as related to the maturities of the contracts. Resale agreements maturing within 15 days can be treated in a similar fashion, although they are somewhat more complex and further consultations with accountants and dealers will probably be required before their final treatment can be decided. One approach would be to ask the dealers to report the amount receivable on such agreements, at the resale price, as an asset. The offsetting liability would be "Liability for securities held under resale agreements". In most cases, presumably, the resale agreements would be offset by a matching repurchase agreement and would drop out of the balance sheet although it would be reported as a memorandum item as in (3) below.

2. Repurchase and resale agreements maturing in more than 15 days would be reported as contingent items and would not appear in the body of the statement. The use of the 15-day dividing line is to a certain extent arbitrary, but parallels the system adopted

for the daily reports that dealers submit to the Market Statistics Department. Including all repurchase agreements in the body of the financial statement would tend to blow up the balance sheet, and, if published in composite form, would risk misinterpretation of the relationship of dealers' activity to capital and other resources. At the same time, it is vital to have full information on dealer exposure on these longer term repurchase agreements, and one approach would be to have dealers report securities covered by long-term repurchase and resale agreements both at market price and at the contractual price and also furnish details as to the relationship between the maturities of the securities and the maturities of the contracts.

3. Matched repurchase agreements--which we define as repurchase agreements offset by resale agreements maturing on the same day and covering the same amount of the same issue of securities--should also be reported as a contingent item. They differ from other repurchase agreements in that the dealers are not exposed to market risk but are exposed to the risk that one of the other parties to the contract will be unable to perform. The maturity of the securities and the relationship to the maturity of the contracts has a bearing on the risk in the event that either of the two other parties default on their part of the agreement.

4. It can be argued that the credit risk arising from repurchase and resale agreements justifies the inclusion of all agreements regardless of maturity in the body of the balance sheet on a gross basis. This alternative approach suggests that, rather than include the securities under the heading "Securities owned", a separate balance sheet item be called "Securities sold under repurchase agreements" be set up on the asset side. Subheadings would segregate agreements

maturing in 15 days or less from those maturing in 16 days or more. A similar subdivision in the case of resale agreements would appear under the liability item "Liability for securities held under resale agreements". Supplementary information relating the maturities of the securities to the maturities of the contracts would be required for all agreements.

The principal bases of valuation for securities in financial statements of securities dealers and brokerage houses are "market" or "cost or market whichever is lower". The latter is the more conservative and would be recommended if credit risk were our primary interest. However, our concern is primarily with the adequacy of capital to maintain a going business in order to fix our lines for repurchase agreements and for the acceptance of dealer tenders to the bill auctions. For this purpose we believe valuation at "market" is preferable in that when a dealer borrows, the margin against his loan is measured against the market valuation of the collateral. Valuation at market could result in the reflection in surplus of unearned income, but in a conservatively run business there should be partially offsetting reserves. If it appears that net worth is significantly distorted by the inclusion of unearned income, dealers could be asked to report appreciation or depreciation on securities separately. On the other hand, valuation at cost or market whichever is lower would result in some understatement of working capital.

The detail in which the breakdown of securities owned by type of security and maturity is largely a matter of the use to which the statement is put. The composition of a dealer's statement is basically simple, consisting almost solely of securities owned and in borrowing to carry such securities. The liquidity shown by the statement is a function of the quality and marketability of the securities owned, and the type of security and the maturity throw some light on the measure of market risk. The classifications in the attached suggested balance sheet have been set up possibly in greater detail

than is necessary in view of the reports received on a daily basis by our Market Statistics Department.

With respect to repurchase and resale agreements a breakdown by class of securities might be in order, for example, U. S. Governments, Federal Agency issues, municipals, etc. The collateral against borrowings might also be subdivided in like manner although this would not necessarily add much to information already available in the breakdown of securities owned.

The treatment of commitments in the financial statement will also require additional attention to ensure uniformity and completeness of reporting. The balance sheet items "Securities sold, not delivered" (asset) and "Securities purchased, but not received" (liability) would include sales and purchases for future delivery as well as failures. Transactions for "regular" (next day) delivery would be included, but it might prove desirable to have some segregation of other future transactions. Transactions in "when issued" securities could be handled as a balance sheet item, but might be more satisfactorily handled as a memorandum item.

STATEMENT OF FINANCIAL CONDITION

ASSETS

Cash		\$	_____
Cash pledged against securities borrowed			_____
Due from brokers and dealers			_____
Bankers' Acceptances			_____
Receivable on Resale Agreements (maturing within 15 days, at selling prices)			_____
Securities owned (at market prices)			
United States Government Securities (total)			_____
Treasury Bills	\$		_____
Certificates of Indebtedness			_____
Notes and Bonds			_____
Due in 1 year or less	\$		_____
Due after 1 year but within 5 years.			_____
Due after 5 years but within 10 years			_____
Due after 10 years			_____
Securities of Federal Agencies (total)			_____
Due in 1 year or less	\$		_____
Due after 1 year			_____
Municipal and State Bonds			_____
Corporate Bonds			_____
Corporate Stocks			_____
Other Securities			_____
Securities carried for participants in joint accounts			_____
Securities sold, but not delivered (at selling prices)			_____
Accrued interest on securities owned			_____
Cash surrender value of life insurance on partners or officers			_____
Furniture and fixtures (net) and other assets			_____
Total		\$	_____

No assets or liabilities are to be stated net of other liabilities or assets, unless specified.

LIABILITIES

Loans payable - Banks (Unsecured _____; Secured _____)	}	\$ _____
- Other (Unsecured _____; Secured _____)		
Liability on Repurchase Agreements (maturing within 15 days at purchase price)		_____
Liability for securities held under resale agreement		_____
Deposits on securities loaned		_____
Due to customers		_____
Securities sold but not yet purchased (at market prices)		
United States Government Securities (total)		_____
Treasury Bills	\$ _____	
Certificates of Indebtedness	_____	
Notes and Bonds	_____	
Due in 1 year or less	\$ _____	
Due after 1 year but within 5 years	_____	
Due after 5 years but within 10 years	_____	
Due after 10 years	_____	
Securities of Federal Agencies (total)		_____
Due in 1 year or less	\$ _____	
Due after 1 year	_____	
Municipal and State Bonds		_____
Corporate Bonds		_____
Corporate Stocks		_____
Other Securities		_____
Securities purchased but not received (at purchase price)		_____
Accrued interest on securities sold but not yet purchased		_____
Reserve for Income Taxes		_____
Reserve for other expense items		_____
Other liabilities		_____
Long-Term Debt		_____
Reserve for contingencies		_____
Net worth		
Capital stock (_____ shares outstanding, net of Treasury stock)		_____
Earned surplus		_____
Capital surplus		_____
Partners' capital		_____
Partners' individual credit balances		_____
Total		\$ _____

Supplementary Information

1. Market value of collateral securing bank and other loans payable.
2. Market value of securities covered by repurchase and resale agreements and relationship of maturities of securities to maturities of contracts maturing within 15 days.
3. Securities covered by repurchase agreements maturing in more than 15 days at purchase price and at market price and relationship of maturities of securities to maturities of contracts.
4. Securities covered by resale agreements maturing in more than 15 days at selling price and at market price.
5. Matched repurchase agreements.
6. Contingent liability as endorser on bankers' acceptances.
7. Nature and amount of other contingent liabilities not otherwise itemized.
8. Nature and amount of commitments not reflected in balance sheet.
9. Special provisions of long-term debt, including maturity and terms of subordination agreements, if any.

In addition to the financial statement, we suggest that dealers also submit a reconciliation of surplus statement, enabling the System and the Treasury to measure net operational income of the dealer firms. A suggested form follows:

RECONCILIATION OF SURPLUS

EARNED SURPLUS

Balance at beginning of the year	_____
Net income for the year.	_____
Adjustments - Detail	_____
Dividends.	_____
Partners' withdrawals.	_____
Earned surplus end of period (included unrealized profits of)	=====

CAPITAL SURPLUS

Balance at beginning of period	_____
Adjustments - Detail	_____
Capital surplus at end of period	=====

In view of the "department store" activities of several dealer firms, no effort has been made to segregate profits attributable to activities in Government securities above. Such an attempt would be difficult, if not completely impracticable, in the case of several dealer firms. A rough rule of thumb measurement might be achieved, however, by asking dealers to assign an appropriate percentage of total profits attributable to trading in Government securities.

While the foregoing approach is designed to provide reasonably uniform data and adequate disclosure of significant financial details, it does not provide for reporting as of the same date. Simultaneous reports would be useful mainly in disclosing total dealer capital employed in the market at one date and

the earnings or losses for a given uniform period. However, it is believed that a reasonably accurate picture could be provided by furnishing an estimate of total net worth and earnings for a given date on the basis of the reports of different dates, presumably for the end of each dealer's fiscal year. Estimates in broad terms such as these are frequently used in other fields and would certainly meet the requirements of policy makers since net worth and earnings are not likely to change sharply over short periods and the estimates presumably would be used only as background for broad policy decisions.