BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

August 2, 1965

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Mr. Young

At Chairman Martin's request there is attached for the consideration of the Committee a prospectus for a new study of the Government securities market that might be initiated under the joint sponsorship of the FOMC and the Treasury. Board staff serving the FOMC and the staff of the Trading Desk of the New York Bank collaborated in preparing the prospectus.

As the memorandum makes clear, the study would focus on the functional, structural, and behavioral changes in the market over recent years affecting System open market operations and Treasury debt management operations, and vice versa. The specific aim would be to facilitate judgment as to whether System or Treasury operations or relations to the market ought to be adapted or modified in any way with a view to strengthening the market's efficiency and functioning. It is intended that this study would complement the proposed study of the System's discount procedures.

It is expected that the prospectus will be discussed at the meeting of the Committee to be held on August 10, 1965.

Ralph A. Young

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

Attachment

CONFIDENTIAL (FR)

July 9, 1965

Prospectus for
Proposed Study of the Dealer Market
for Government Securities

The Federal Reserve System and the Treasury have a continuing direct interest in a smoothly functioning secondary market in Government securities. The System relies on the dealer market to enable it to buy and sell Government securities on a large scale without sizable price movements as it enables the banking system to respond flexibly to the changing financial needs of the economy. The Treasury depends on the dealer community to provide good trading markets for investors in Government securities, to reflect accurately the balance being continually struck between supply and demand for its issues so that new issues may be properly priced, and to facilitate the distribution of these issues. Over time the quality of the market's performance, in turn, depends upon the ability of the dealer community to attract and hold skilled personnel and capital in a changing economic and institutional environment.

The market environment of the 1960's has changed considerably from that within which the System and Treasury operated first during World War II and the early postwar years and then in the post-Accord market of the 1950's. Experiences during these two periods were studied by official groups in the early 1950's and then again at the end of the decade. At this time, a further study of changes in market performance and structure, their relationship to changing official policies, and the significance of these developments for future market performance would seem to be of value.

The 1960's have been a period of relatively moderate interest rate movements in all bond markets, at least as compared with the previous decade. The period has also been one in which a number of new short-term instruments competitive with short-dated Treasury securities have been developed--for example, CD's. In addition, official policies were aimed at shoring up short-term rates for a good part of the time, and long-term rates have at least been relatively more conditioned by official policy than in the 1950's. System open market operations have embraced all maturities rather than being confined to near-term issues. The Treasury has made extensive use of advance refundings to restructure its debt, while adding heavily to the supply of Treasury bills.

For their part, the dealers feel that this environment has made it more difficult to operate profitably. They have become more sensitively attuned to interest rate objectives presumed to be associated with official policies and operations. The market for Government securities has also become increasingly competitive, with the entry of new bank and nonbank dealers at a time when relatively high financing costs--implicit in an effort to raise short- relative to long-term rates--have added to the difficulties of profitable operations. Moreover, a number of other banks have expanded their Government securities business, and some are contemplating dealer operations. The present group of primary dealers feel that the changing industry structure and the erosion of profitability has already diluted the willingness of the market to take risks.

For the System and the Treasury the key question is whether the developments of the 1960's have reduced the capacity of the market in the future to undertake transactions efficiently, across a broad maturity spectrum, and in depth and thereby to facilitate liquidity adjustments of corporations, financial institutions, and individuals. An investigation of the genesis, likely duration, and meaning for the future of these changes would be of value to the Federal Reserve because the System's operations require a market that is able to absorb a sizable volume of operations with minimum risk of sharp price movements. Dealers must be willing at times to absorb securities in a falling market and to supply them in a rising market. Whether the changing structure of the U. S. Government securities market has tended to cause the dealer market to back away in any degree from this prime dealer function in any sector of the market is thus a basic, though at present a moot, point.

From the System's point of view the behavior of interest rates has also helped it to gauge the direction and extent of credit market pressures. It would be helpful to try to assess the degree to which this function is still served under conditions as they have developed in the current decade.

Finally, a major advantage to the System from a study of the Government securities market would be the light it might shed on problems that may arise in the market if the System were to modify its posture with respect to the discount mechanism. Thus, a study of the Government securities market and the role of official participation in it could usefully complement a parallel study of the System's discount procedures and possible adaptations in them, as the System attempts to work out for the period ahead the best relationship among the major instruments of monetary policy.

The Treasury's interest in the market stems quite naturally, of course, from its need to sell a very large volume of securities in any given year and the consequent desirability of assuring investors of a broad, continuous market. The current market environment has apparently not made it more difficult to price new note and bond issues, but problems in marketing issues remain. The secondary distribution of new issues out of dealer inventory has not always proceeded smoothly, and it should be helpful to the Treasury to explore to what extent this has been related to changes in the structure of the Government securities industry, to the nature of its own operations, or to general conditions and expectations. In addition, it would be important for the Treasury to be able to evaluate the impact of its own extensive use of advance refundings and other debt operations on the market's willingness and capacity to absorb further debt lengthening operations.

At some stage a new study of the Government securities market should include conferences between high level System and Treasury officials and the dealers themselves. It seems clear that the dealers would benefit, at least psychologically, from a relatively frank discussion of the market environment of the 1960's. While each of them may have special knowledge that will deepen our understanding of the market, an interchange of views will also add to their knowledge of other factors that affected the market during this period. Specifically, such a discussion may help in their evaluation of the degree to which the economy itself, as compared with official operating policies, worked toward stability of interest rates.

Such a discussion, while it may put the role of official policies in proper perspective, will not necessarily alleviate the pressure from many dealers for changes in policies that would tend to increase the potential profitability of dealer operations. This is especially true of nonbank dealers, who feel at a competitive disadvantage. Many nonbank dealers feel that the tax and loan privilege accorded banks on some new issues as well as banks' over-all borrowing power, including access on their own initiative to the discount window, give dealer departments of banks an unfair advantage. On the other hand, bank dealer departments feel that they too face certain disadvantages--for example their ineligibility for System repurchase agreements. Thus, in any program of dealer conferences that might be undertaken, dealers will inevitably be concerned with the System's, and also the Treasury's, fundamental policy posture and operating methods.

In undertaking a study of themarket, however, it would be important to avoid any implication that easy rectification of dealer problems, to the extent that they are found to exist, may be at hand.

Still, there may be some public relation gain in exploring problems with the dealer community, which is now co-operating in a program for obtaining uniform balance sheet information.

If it is found desirable to undertake a study of the Government securities market involving the Federal Reserve, the Treasury, and the dealers, the subjects noted below would appear to be most relevant at present. A number of questions are also included under each subject as a means of illustrating the scope of the proposed study. The organization of the study--including the research assignments to be made, the nature and timing of dealer conferences, and the scope and form of the end product--remains a problem for future consideration.

Responses to many of these questions might be obtained from all participants. Some, however, are especially pertinent to dealers. Others are more in the nature of background or statistical studies that might require the development of staff papers within the Federal Reserve System or the Treasury. And some questions might be addressed directly to the System Account Management or Treasury officials most directly concerned with debt management.

A. Economic and Financial Environment

1. Is the reduced fluctuation in interest rates in the 1960's more marked in the Government securities market than in the corporate and municipal bond markets?

2. To what extent do the relatively moderate interest rate movements in recent years reflect the continuation of an expansionary monetary policy and the orderly pace of the economic advance? To what extent have official efforts to hold up short-term rates and hold down long-term rates contributed to this result? How important a factor has been the enlarged role of commercial banks in competing for short-term funds and channeling them into longer-term loans and investments?

3. Has the increased importance of commercial banks as financial intermediaries contributed to an increased flow of funds between the Government securities, municipal bond and mortgage markets in response to changing yield differentials? Has the broadening of investment authorizations for public pension funds led to a closer interconnection between the Government securities, corporate bond, and mortgage markets?

4. Have changes in patterns of corporate (non-financial) management of liquid assets, including increased investments in CD's and repurchase agreements, contributed significantly to a dampening of fluctuations in short-term interest rates and to reduced interest in Treasury securities?

5. How have commercial bank activities in the U. S. Government securities market been affected by the further development of the Federal funds market and the rapid growth of CD's?

6. What have been the shifts in the net acquisition of Government securities by different investor groups in recent years, especially since the introduction of the advance refunding technique?

B. Structure of the Government Securities Market

1. Has there been any tendency toward increased concentration of activity in the larger primary dealers--either in the aggregate or in different sectors of the market?

2. Have the growing number of bank dealers been accounting for an increasing share of activity--either in the aggregate or in different sectors of the market?

3. Have the nonbank dealers become increasingly active in the Federal agency and corporate bond markets as well as entered the C/D market? If so, does this mean that the Government securities market has become less important to these dealers?

4. Has the capital of the nonbank dealers tended to decline in recent years--either in total or in relation to their new positions?

Have the net positions of these dealers--and the bank dealers--grown since interest rates have been less volatile?

5. Do bank dealer departments or dealer departments of large securities firms tend to do business at a loss with customers whose total business with the bank or securities house is profitable?

6. Have large banks and other corporate customers of the primary dealers reduced their recourse to the secondary market for securities--depending to a greater extent on acquiring securities from the Treasury directly in the weekly bill auctions and in other debt offerings? On the other hand, have these customers increased the amount of in-and-out trading they do, competing with the primary dealers in arbitraging without assuming any responsibilities to make markets?

7. To what extent has the growth of trading by regional banks with their customers tended to reduce the flow of business to the primary dealers?

C. The Performance of the Dealer Market

1. What have been the trends in the volume of trading activity in Government securities and in dealer positions by maturity category? Has the regularization of Treasury financing operations in coupon securities and the use of advance refundings tended to reduce activity--or to increase the concentration of activity around financing periods?

2. Has the size of transactions dealers are willing to undertake on their quoted markets in different maturity sectors of the market tended to increase during the 1960's? If so, is it the product of greater competition and thereby likely to add to size of quoted markets under all conditions? Or is it primarily a concomitant of reduced interest rate fluctuations and likely to disappear in less prospitious circumstances?

3. To what extent is the narrowing of spreads in the markets dealers quote to customers attributable to increased competition and to what extent to the interest rate environment? In a different environment would dealer spreads widen to the same extent as in the late 1950's?

4. In the past the nonbank dealers have tended to be more willing than the bank dealers to undertake the risks, and reap the rewards, of dealing in intermediate- and longer-term securities. Have high financing costs or other factors affected their willingness to do so in recent years? Have the bank dealers become more active and assumed larger positions in such issues in recent years? If so, would bank dealers maintain

their relatively larger role if interest rate fluctuations increased or tend to reduce their exposure more rapidly than nonbank dealers as risks increased?

5. Have dealers become increasingly less willing to establish short positions in various maturity categories and more willing to carry long positions? If so, are major causes of this development System open market operations in all maturities and the Treasury's willingness to sell Treasury bills when bill rates fall or to buy Government securities for the trust funds at times of Treasury financing? Or is the changed pattern of dealer behavior largely a response to the relative absence of sizable interest rate swings or to such technical factors as the increasing difficulty of borrowing securities to make short sales?

6. Has the Government securities market become so responsive to official operations and pronouncements that interest rates on Government securities move only sluggishly as the balance between supply and demand in the credit markets changes? Has the Government securities market become more isolated from other markets as a result of official policies or are the relative movements in yields on longer-term Government securities, corporate and municipal bonds, and mortgages in recent years explainable chiefly in terms of the net demands placed on the different markets and the response of supply?

D. Health of the Dealer Market

1. What are the major factors that contribute to dealer profits and their willingness to make markets? How have the primary dealers as a group fared in recent years, and how does the return on their capital compare with that of dealers in corporate and municipal bonds? Is there any significant difference in the experience of the bank and the nonbank dealers in Government securities? Have the relative positions of firms in the industry changed in recent years?

2. How has diversification of dealer operations into C/D's, Federal agency securities, corporate and municipal bonds and the like contributed to over-all financial results and in the case of the nonbank dealers, to the financial strength of the firms?

3. In the less volatile interest rate environment of the 1960's has the relative profitability of operations in Treasury bills and coupon securities changed? Has the participation of some dealers in the intermediate- and longer-term market declined? Have the operations in this area of the market of those most active in it continued profitable?

4. How important a factor have Federal Reserve operations in all maturities been in reducing interest rate fluctuations? Have such operations tended to add to the uncertainties market participants must live with and to reduce their willingness to maintain long positions? Or since such operations and Treasury investment operations have been largely on the buy side, have they tended to reduce the risk of loss involved in holding long positions and stimulated dealers, trading banks, and others to take larger positions at times when the potential for profit appears, as at times of Treasury financing?

5. Have the Treasury's advance refundings and the regularization of other offerings tended to reduce activity in the secondary market, or at least to concentrate it at times when trading margins are narrowest?

6. Have nonbank dealer financing costs been higher in this economic expansion because of official action to shore up short-term interest rates? If this were true in the earlier stages of the expansion, is it still the case or are rate relationships similar to those that have prevailed at comparable stages of previous economic expansions?

7. Have the nonbank dealers been able to increase the share of their financing provided by banks, corporations and public funds outside New York City? Do the New York City banks reliably provide residual financing at reasonable rates? Has the Federal Reserve been more, or less, important as a source of financing than in comparable past periods? How wide is the spread between average financing costs among the dealer firms and how important is this factor in the differential success of such firms?

8. To what extent has increased activity by dealer departments of banks and non-dealer banks in making repurchase agreements with corporations and others reduced the availability of such funds to nonbank dealers?

9. A few nonbank dealer firms have been active in buying longer-term Treasury bills in the auction and selling them to corporations under repurchase agreements maturing in several weeks--thereby assuming the risk of market fluctuations. What has been the impact of such operations on the profitability of such firms, including periods in which Federal Reserve discount rates have increased?

10. Do bank dealers, current or prospective, intend their operations to contribute directly to bank profits in proportion to bank funds employed or are such operations expected only to cover the out-of-pocket costs of providing a service to bank customers?

11. Is the continuation of recent market developments likely to lead to a withdrawal of capital from the nonbank sector of the dealer market? What would be the impact on market performance under all types of conditions of such a development?

E. Official Policies

1. In the light of answers to the foregoing questions, and recognizing that other issues may be equally or more important factors, should the Federal Reserve: Revert to a "bills only" instruction to the Desk? Sell coupon securities regularly on a moderate scale as well as buy them? Lend securities to dealers?

2. Should the Federal Reserve do repurchase agreements on tap at attractive rates to the nonbank dealers up to guaranteed minimum levels, going beyond such levels only on the initiative of the System? Should dealer departments of banks be treated in the same way as nonbank dealers? Should the System rely less on repurchase agreements and more on outright transactions? Should the maturity limitation on securities held under repurchase agreements be eliminated?

3. Given its interest in a viable dealer market, as well as its other debt-management responsibilities, should the Treasury be more sparing in its use of the advance refunding technique? Should investment operations of the trust funds be placed on a more regular and routing basis?

4. Should the Treasury waive the costs of CPD transfers on the bulk of transactions by primary dealers as a means of encouraging a strong dealer market, and of discouraging trading with customers by those banks who undertake no responsibility to make markets to others?

5. Are there any practices in the dealer market that suggest the desirability of supervising it more closely? If so, whose responsibility should this be?