

FEDERAL RESERVE BANK OF DALLAS
DALLAS, TEXAS 75222

Circular No. 68-164
July 30, 1968

To the Chief Executive Officer of the State Member Bank Addressed
in the Eleventh Federal Reserve District:

Recently we have learned that some banks, with the cooperation of brokers, are engaging in bond transactions the circumstances of which are not properly disclosed on the bank's books. Under this procedure, a bank owning bonds carried on its books at cost but having a current market value below cost sells such bonds at a price above the market, usually at a price equivalent to book value of the bonds. The bank then purchases from the same broker other bonds (often of longer maturity and with a higher yield) at a price sufficiently above market value to reimburse the broker for (1) loss sustained on the bonds sold to him by the bank and (2) a broker's fee. The bonds are then recorded at the new "cost" (above market value). Such transaction has the effect of (1) deferring the recognition of loss on bonds sold by the bank and (2) placing new bonds on the bank's books at a price above their true market value when purchased.

EXAMPLE

Bank A - holds \$100,000 of City PHA 3% bonds due May 1, 1973.

Book Value	-	\$100,000
Market Value	-	90,000
Dealer purchases bonds at \$100,000		

Dealer sells Bank A \$100,000 of County 4-1/2% bonds due May 1, 1983.

Market value	-	\$100,000
Dealer sells @ 3.50 basis	-	\$111,590

Resume

Bank A - sells a 3% yield and purchases a 3.50% yield.
Covers up a market loss; fails to book and take
advantage of a portfolio tax loss.

Sales Advantage - Improves current yield 50 basis points.

Dealer - Loss on purchase	-	\$10,000
Dealer - Profit on sale	-	\$11,590
Dealer's Net Profit	-	\$ 1,590

Deferring losses incurred on the sale of bonds by recording bonds purchased at inflated prices is an unsound banking practice. When selling bonds the bank should record any gain or loss realized based on the actual market price prevailing at that time. Moreover, bonds purchased should be recorded on a bank's books at actual market value.

Yours very truly,

P. E. Coldwell

President