Techniques of Member Bank Borrowing at the Federal Reserve

When the Federal Reserve System was founded fifty years ago, one of the primary objectives was to provide the United States with an elastic supply of money and credit that would expand and contract with the legitimate needs of business and agriculture. The System's founders envisaged that these objectives could be attained largely through the discount mechanism, with member banks obtaining short-term credit accommodation at the "discount window" of the Federal Reserve Bank—in times of stress, to meet seasonal needs, and in other times of rising credit demands.

With the far-reaching changes in the economy and in the financial structure of the country that have taken place since 1913, the System's basic objectives have become considerably broader. For many years these have been to promote sustainable economic growth, a high level of employment, and reasonable price stability. More recently, the defense of the international position of the dollar has also become a major consideration. The instruments and techniques used to seek these goals have also undergone a significant evolution; most notably, open market operations have become a major instrument for implementing monetary policy.

This article does not attempt to discuss in any detail these changes in objectives and instruments, but merely seeks to focus attention on certain technical aspects of member bank borrowing at the Federal Reserve—that is, on the potential use, in today's financial environment, of customer paper as collateral with the Federal Reserve. To provide some perspective, however, it should perhaps be briefly noted that the discount mechanism nowadays continues to fulfill a key function. In particular, the availability of Federal Reserve credit enables member banks to maintain their reserves at the levels required by law in the face of sudden withdrawals of deposits, of seasonal demands for credit beyond those which can reasonably be met by the use of the bank's own resources, or of other unusual situations and exceptional circumstances. By lessening greatly the risk to member banks of having to liquidate assets precipitately, the smooth day-to-day functioning of the credit and capital markets is facilitated. Furthermore, shifts in monetary policy are likely—in the first instance—to have an uneven effect on different individual banks or groups of banks. By enabling member banks to effect orderly adjustments in their asset positions in response to changes in over-all reserve availability, the discount mechanism enables the System to change the direction of policy more readily than might be the case in the absence of the discount window.[1]

GOVERNMENT SECURITIES AS COLLATERAL

Under the original Federal Reserve Act of 1913, member banks could obtain credit accommodation from the Federal Reserve only through the rediscount of "eligible" paper—in effect, the member banks endorsed and sold to the Reserve Banks short-term commercial, industrial, or agricultural paper. It soon became apparent, however, that the detail involved in rediscounting large numbers of individual notes and other kinds of paper was burdensome to all concerned. For administrative convenience and to effect economies in operation—and presumably also to aid in the financing of World War I—Congress in 1916 amended the Federal Reserve Act to permit the Federal Reserve Banks to make short-term advances to member banks against their own notes secured by eligible paper or by bonds or notes of the United States. As a result, the mechanics of the use of the discount window were simplified considerably, and in due course rediscounting was supplanted very largely by advances.

Advances against Government securities proved to be particularly convenient. It is not surprising, therefore,

[1] The System's discount objectives, and the conditions under which banks may properly borrow from their Federal Reserve Banks, are discussed in "Borrowing from the Fed", this Bank's *Monthly Review*, September 1959, pp. 138-42.

that by the early 1920's such advances accounted for a substantial proportion of member bank borrowings at the discount window. Nevertheless, with a relatively small Federal Government debt—only $24 billion in 1920 and declining to $17 billion by the end of the decade—many banks did not hold sufficient Government securities to cover all their borrowing needs. During this era, moreover, banking practices still cast much customer borrowing in the form of eligible paper. Partly for these reasons, and also because the custom was firmly ingrained, commercial banks throughout the 1920's did not hesitate to use eligible customer paper in large amounts to obtain credit accommodation from the Reserve Banks. For example, total member bank borrowings came to about $687 million (month-end averages) during the 1925-29 period. Of this amount, some $396 million was on average secured by Government obligations, while the balance of $291 million was obtained through the rediscount of eligible paper or advances collateralized by such paper.

Member bank borrowing fell off sharply during the Great Depression and generally remained negligible thereafter through the immediate postwar years. In the middle and late 1930's, the volume of bank reserves was substantially in excess of legal requirements. During World War II member banks could obtain reserves readily by selling their holdings of short-term Government obligations to the Federal Reserve. Since 1951, however, when the System ceased relatively rigid support of Government securities, member banks once again have placed greater reliance on the discount window for temporary accommodation.

In sharp contrast to the 1920's, when member banks continued to use large amounts of eligible paper to borrow from the Federal Reserve, borrowings since World War II have been almost entirely in the form of advances secured by obligations of the United States. This situation reflects no reluctance on the part of the Reserve Banks to accept eligible paper as collateral for advances, but results from the preference of the borrowing banks themselves. Commercial banks had acquired large amounts of Government securities during World War II and, as long as such securities were readily available in their portfolios, banks naturally chose this convenient method of borrowing. The composition of bank portfolios, however, has changed gradually but markedly over the postwar period. There has been a substantial decline in the aggregate amount of member bank holdings of Government securities. Between the end of 1945 and the end of 1963, member bank loans and investments other than in Goverment securities expanded by approximately $132 billion to a level of $160 billion; over the same period, their holdings of Government securities fell by about $29 billion to a level of $49 billion. The decline, moreover, has been concentrated at banks in the financial centers. Holdings of Governments at the New York City banks declined by $12 billion to about $6 billion between the year ends of 1945 and 1963, while holdings at other reserve city banks fell by $15 billion to a total of $18 billion; the decrease at "country" banks, on the other hand, was only $2 billion to $25 billion.

In recent years, moreover, public deposits—including Treasury Tax and Loan Accounts—which generally must be secured by a pledge of collateral have risen substantially. This factor, in turn, has tended to immobilize large amounts of Government securities, since banks have widely used such securities as collateral for public deposits for much the same reasons that apply in the case of securing advances at the Federal Reserve.

The decline in bank holdings of Government securities and the rise in public deposits have combined in recent years to reduce the amount of Government securities banks have available as collateral for borrowing at the discount window to the point where some banks on occasion have actually felt an acute shortage of Government securities for this purpose. Although the shortage so far has been limited to individual banks, principally in the money centers, the situation could become more general.

POTENTIAL USE OF ELIGIBLE PAPER AS COLLATERAL

Member banks could of course use eligible paper rather than Government securities to secure advances and, with minor exceptions, Treasury Tax and Loan Accounts as well.[2] With respect to advances, legal eligibility requirements have remained virtually unchanged since the System's early days, and these confine eligible paper to types of credits which nowadays account for a much smaller proportion of commercial bank assets than in the 1920's. To avoid a possible shortage of collateral—and to bring requirements as to collateral in line with modern banking practices—a proposed amendment to the Federal Reserve Act, now pending in Congress (S.2076, H.R.8505, 88th Congress), would eliminate the obsolete eligibility rules. The legislation would remove existing requirements and authorize the Reserve Banks to make advances to member banks secured by any asset satisfactory to the Reserve Banks, subject to such regulations as the Board of Gov-

[2] In the case of Treasury Tax and Loan Accounts, other collateral may also be used—see United States Treasury Department Circular No. 92 (revised).

ernors of the Federal Reserve System might prescribe. The enactment of this legislation would minimize the possibility that banks might not be able, for want of collateral, to borrow at the regular discount rate to meet legitimate needs.[3]

There is a risk, however, that another obstacle to the use of customer paper as collateral might arise from the reluctance of many banks to use such paper. This attitude was highlighted on occasions in the recent past when certain Second District banks, short of Government securities but holding eligible paper, reportedly refrained from using such paper—either to obtain accommodation at the discount window in times of legitimate reserve needs, or to serve as collateral for Tax and Loan Accounts.

The reluctance appears to have been caused by some concern on the part of the banks that their customers might react unfavorably to the use of their paper as collateral. Customer paper is usually made payable to the order of the lender; and to be effectively pledged in negotiable form, either as collateral for an advance or for a Treasury Tax and Loan Account, "order paper" must be endorsed. This endorsement, in turn, eventually indicates to the bank's customer that his paper has been used as collateral. Some bank customers reportedly have indicated that they would tend to question the managerial capacity of a bank that might find itself in a position of being required to use their paper as collateral.

In actual fact, such a conclusion is entirely unwarranted. If the use of the discount window is appropriate by Federal Reserve standards, it is immaterial whether the advance is secured by Government securities or by eligible paper. Similarly, the securing of Treasury Tax and Loan Accounts by commercial and agricultural paper does not in any way reflect unfavorably on the management or financial position of a bank which thus employs it. For convenience, the bank is merely using customers' notes in lieu of some other form of collateral.

Prior to accepting a given piece of customer paper as collateral for an advance, Federal Reserve Banks also consider the financial condition of the original borrower. As a result, in earlier years, when it was common for a customer's paper to be discounted or used as collateral, the acceptance of such paper by the Federal Reserve was traditionally regarded as indicative of that customer's favorable credit standing. This implication is apparently overlooked by the borrowing bank's customer who today objects to the transfer of his paper.

The discount mechanism plays an important role in facilitating member bank operations and in the smooth implementation of monetary policy. Possible misconceptions on the part of banks and their customers regarding the implications of using eligible paper as collateral should not interfere with the proper functioning of this mechanism.

[3] Actually, under Section 10 (b) of the Federal Reserve Act, any Federal Reserve Bank may make advances to any member bank on that bank's note secured to the satisfaction of the Federal Reserve Bank, but at a rate not less than ½ of 1 per cent per annum higher than the discount rate in effect.

The Business Situation

Economic activity was continuing to expand as the first quarter drew to a close, and business sentiment remained confident of substantial further gains in the months ahead. Industrial production inched ahead in February, payroll employment rose considerably, and average hours worked recovered to the advanced December level. Although still high, the unemployment rate edged down in February to its lowest point in over a year and was maintained at that rate in March. Retail sales appear to have fallen off somewhat from their record February level, while preliminary production data for March are somewhat mixed.

One key factor in the current strong business outlook is the prospect for capital spending. Expanded capital spending programs have recently been announced by several large firms, and—according to the latest Government survey—businessmen as a group plan to increase their outlays for plant and equipment by 10 per cent in 1964. This figure confirms (indeed, slightly exceeds) the year-to-year increase in planned spending reported by McGraw-Hill following a special survey taken in January.

Manufacturers' inventory plans for the second quarter call for a rate of accumulation higher than in the first quar-