BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

March 11, 1975

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Enclosed is a copy of the report of the Staff Committee on Bankers' Acceptances, dated today and entitled "Recommendation for System Operations in Finance Bills."

It is contemplated that this report will be discussed by the Committee at its meeting on March 18, 1975.

Enclosure

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CLASS II - FOMC

March 11, 1975

TO: Federal Open Market Committee

SUBJECT: Recommendation for System Operations in Finance Bills

FROM: Staff Committee on Bankers' Acceptances

FOMC Charge to Staff Committee

This report of the staff committee on bankers' acceptances is made pursuant to the instruction of the Federal Open Market Committee, at its meeting on April 16, 1974, to study further the desirability of System operations in finance bills or non-trade-related acceptances. Our staff committee considered the potential impact of System operations in finance bills on (1) the System's ability to carry out monetary policy, (2) the market for finance bills, (3) the market for traditional trade-related acceptances, and (4) bank asset-liability management policies. In the course of our study, we surveyed the views of about 30 banks and 9 dealers in acceptances.[1/] We have also sought to take account of several significant developments in the market for trade-related acceptances during the period since early 1974, which could have a bearing on the FOMC's decision whether or not to initiate operations in finance bills.

Conclusions and Recommendations

Based on its review, the staff committee recommends that the Federal Open Market Committee act to broaden the scope of System open market operations to include prime finance acceptances as well as trade-related acceptances. This recommendation emerged from a weighing of plus

1/ A summary of this survey is attached to this report.

and minus elements that are summarized in the discussion that follows. The recommendation is consistent with the views expressed by this staff committee in its report of January 29, 1974, which indicated a favorable inclination toward System operations in finance bills but proposed that the question be studied further, particularly in order to elicit and evaluate the views of market participants.[2/]

Our recommendation can be implemented by amending paragraph 1(b) of the authorization for domestic market operations to add, after the references to acceptances that arise out of shipments of goods and storage of goods, a reference to acceptances that arise out of the provision of general financing to the drawer of the accepted draft.

Paragraph 1(b) of the authorization for domestic open market operations would then read:

> (b) To buy or sell in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates, prime bankers' acceptances with maturities of up to nine months at the time of acceptance that (1) arise out of the current shipment of goods between countries or within the United States, (2) arise out of the storage within the United States of goods under contract of sale or

2/ A copy of this earlier report is also attached.

expected to move into the channels of trade within a reasonable time and that are secured throughout their life by a warehouse receipt or similar document conveying title to the underlying goods, or (3) that arise out of the provision of general financing to the drawer of the accepted draft; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed $1 billion.

As a follow-up to the changes in definitions of acceptances eligible for Federal Reserve purchase adopted last April, the staff committee also recommends certain regulatory changes so as to make trade-related acceptances of the types now eligible for System purchase free of reserve requirements, within certain limits, while retaining a reserve requirement on finance bills. This is a matter for the Board of Governors to consider, rather than the Federal Open Market Committee, but as an integral part of the System's involvement with the acceptance market we believe that a recommendation relating to reserve requirements on those instruments is appropriate in this report. Specific language to accomplish the recommended change is provided in Exhibit A.

Finally, the staff committee reaffirms its recommendation of January 1974 that there be a thorough review, by appropriate legal and technical staff, of the Board's rulings on acceptances contained in the "Interpretations of the Board of Governors of the Federal Reserve System". About 75 of these rulings (#1050-1710) appy to bankers' acceptances and reflect the Board's approach--mainly developed in the 1920's--to the trade-related acceptances described in Section 13 of the Federal Reserve Act. In light of the changing System approach to the acceptance market, some of these rulings, which are still used by accepting banks and examiners as a guide to determining eligibility of acceptances for Federal Reserve discount or purchase, are out-of-date. We suggest that such a review of this matter be undertaken by the legal and technical staff of the Board of Governors, assisted by competent staff of the Federal Reserve Bank of New York.

Discussion

A. Desirability of Operations in Finance Bills

The previous report (January 29, 1974) of the staff committee summarized a number of pro and con factors relating to System participation in finance bills. (See pages 4-10 of the Appendix to that report.)

The points made in favor of such participation still generally stand up, although one modification would be that the sharply increased volume of regular trade-related acceptances now outstanding, compared with a year ago, detracts somewhat from the argument that an expansion of System operations to include finance bills would provide a useful enlargement in the supply of acceptances available for System operations. Not only are trade-related acceptances rather plentiful in the market at present, but also the prospect of exceptionally large Federal deficits in months to come would seem to reduce the likelihood of a market shortage of Treasury issues for the time being. Still, the case for or against System operations in finance bills should not rest on temporary ebbs and flows in the availability of securities suitable for System operations; just as circumstances of relative availability have changed considerably over the past year or two they could change again.

Among earlier arguments for not commencing System operations in finance bills are some points that also require modification. Thus, a major reason that the staff committee recommended further study of the question was in order to ascertain and evaluate potential market reaction to System activity in finance bills--both as it might affect the market in finance bills and as it might impact on the market for trade-related bills. The survey of market opinion summarized in the first attachment to this report indicates that most respondents felt that System participations in finance bills would be helpful to that market and neutral or perhaps helpful to the market in regular acceptances as well.

Another problem considered earlier with respect to System operations in finance bills was that development of finance bills would tend to create tiers of "quality" in the acceptance market similar to those in the CD market. Indeed, it was argued that tiering might spread from the finance bill to the regular trade-related acceptance which had enjoyed a relatively homogeneous rate structure among acceptances of banks of quite different size. Events of the past year have made this point largely moot, since rather marked "tiering" has already developed in the market for regular trade-related acceptances. Among the causes of this increased differentiation were the following:

1. The well-publicized troubles of the Franklin National Bank, beginning in about May 1974. It came as something of a shock to the market that a relatively large bank could get into difficulty. This created concern that some other banks might also have become overextended.

2. The withdrawal from the market in mid-1974 of a major acceptance dealer--M. & T. Discount Corporation. This had been one of the most active dealer firms, and one which had been particularly important in making markets for the acceptances of regional banks (outside the top New York-Chicago-West Coast group).

3. The Federal Reserve's move in November 1974 to discontinue guaranteeing acceptances purchased for foreign official accounts. This led to a sharp drop in the Trading Desk's purchases for foreign accounts, which was only partly offset by an increase in purchases for the Federal Reserve's own portfolio.

Since the acceptance market survived these various shocks remarkably well, our staff committee believes there should be no great concern regarding the ability of the market in regular trade-related acceptances to weather whatever additional repercussions might follow from the development of a broader market in finance bills.

The key pro and con arguments to consider in deciding whether to extend System open market operations to finance bills are essentially the following:

<u>In favor of operations in finance bills</u>

1. Since finance bills are legitimate money market instruments, if System operations in acceptances serve a useful policy purpose (as the

System Account Manager has asserted), there is no basis for discriminating against finance bills in these operations, without a clear and strong reason. The fact that currently eligible acceptances are related to specific transactions in specific goods is not an appropriate basis for distinction, but rather is a carryover of the archaic "real bills" doctrine. The quality of a bankers' acceptance rests basically on the credit standing of the business borrower and the accepting bank, not on the documentation linked to particular trade items.

2. System encouragement of a market in finance acceptances could give some useful liquidity to bank loan portfolios without eroding the effectiveness of over-all credit policy since the reserve requirement would continue to operate as a control. As a liquidity instrument, the finance acceptance might be most useful to medium-sized banks. Such banks have only limited access to the CD market, but their names enjoy sufficient market recognition so that when combined on an acceptance with the name of a business borrower, a readily marketable piece of paper is created. (The largest banks might continue to rely mainly on CDs for their liability management.)

3. System participation in the market for finance bills could provide a useful additional vehicle for open market operations. As noted earlier, the rapid growth in the market for trade-related acceptances (the outstanding volume more than doubled in 1974), and the prospect of large Federal deficits in the next year or two weaken the current force of this argument. However, one can readily envisage circumstances--such as sharply increased foreign purchases, and less ample new offerings of

Treasury and regular trade-related acceptances--which would again place a premium on a wide range of security options for System open-market action.

In opposition to operations in finance bills

1. System operations could involve the Trading Desk in some difficult credit judgments about particular banks. This problem already exists to some degree with trade-related acceptances, but if System participation encourages a significantly broader range of banks to enter the acceptance market (beyond the 250 or so that are now active) the problem could be considerably magnified. There is not only the question of the credit judgment itself, but also the very delicate question of how to exercise it, since a decision by the Desk to discontinue purchasing the acceptances of a particular bank could add to the difficulties of that bank. As some measure of protection against becoming the "dumping ground" for less marketable names, the Committee would probably want to set rather modest limits on the proportion of any particular bank's finance acceptances that could be held by the System.

2. Development of the finance bill could accentuate the "tiering" or gradations of marketability among the acceptances of different-sized banks. In turn, this could in some measure be detrimental to the existing market in trade-related bills. As discussed earlier in this report, however, the acceptance market has weathered a noticeable increase in "tiering" over the past year and still managed to grow substantially, with continued active participation by a wide range of different-sized banks. Moreover, the preponderant judgment of respondents to the staff committee's survey

was that the development of a market in finance bills would not be harmful to the market in trade-related acceptances.

3. A natural counterpart of advantage #2--the provision of additional liquidity to commercial bank loan portfolios--is that at certain times this additional flexibility could be a problem for the monetary authorities in seeking to maintain restraint. The same problem also exists with CDs--as banks have found that, for a price, additional liquidity can be purchased and the cost passed on to borrowers. Again, as with CDs, new tools in the hand of the monetary authorities, such as marginal reserve requirements, may prove helpful in retaining the desired degree of control over credit formation through the banking system. But still other tools might be needed--such as some sort of central bank control over loan commitments--if credit creation expansion resulting from the issuance of CD's and finance bills is to be effectively restrained.

After weighing the foregoing pro and con arguments, the staff committee concluded that System operations should be broadened to include finance acceptances. In initiating these operations, the Trading Desk should proceed cautiously, facilitating gradual development of a broader market in finance bills rather than encouraging an upsurge that would only lead to subsequent disruptions in the market. It might be well for the Account Management, at least at the outset, to have a fairly low limit for the purchase of finance bills in relation to the outstanding volume of such bills. For example, the System might wish to hold its purchases of finance bills to no more than 10 per cent of the outstanding volume issued by any one bank. It might also be desirable to purchase only finance bills that have been accepted and marketed by member banks--in order to ensure that a reserve requirement attaches to all finance acceptances bought by the System.

As indicated earlier in this report, the proposed change can be accomplished by amending paragraph 1(b) of the authorization for domestic open market operations to add a reference to finance bills, following the reference to trade-related acceptances.

B. Proposed Changes in Application of Reserve Requirements

Along with its consideration of finance acceptances, the staff committee also reviewed experience in the period since early 1974 when the definition of trade-related acceptances eligible for System purchase was modified and liberalized somewhat. The principal elements of liberalization were to permit the Desk to buy maturities up to 9 months (as against 6 months previously), to eliminate the requirement that documents be attached in the case of acceptances drawn to finance domestic shipments, and to permit the purchase of acceptances financing storage of any goods in the United States (compared with only readily marketable staples previously). Despite these changes, there has been rather little use of the more liberal standards adopted by the FOMC--perhaps because the liberalized definitions do not apply to acceptances eligible for discount under Regulation A, and it is only the acceptances eligible under Regulation A that are exempt from reserve requirements. To give full effect to the modernizations contemplated when the more liberal rules for

System purchase were adopted, the reserve requirement could be removed on those trade-related acceptances that are now eligible for System purchase but not eligible for discount.

On the other side it might be questioned whether there is an urgent need for this class of trade-related acceptances to be free of reserve requirements. If one feels that, ideally, all bank liabilities should be reservable, then there should be clear justification for each exception. The exception applying to the acceptances explicitly described in Section 13 of the Federal Reserve Act, it may be argued, rests on long historical tradition, and accordingly need not carry over automatically to the other trade-related accepances now eligible for Federal Reserve purchase.

On balance, the staff committee favors treating trade-related acceptances uniformly as regards reserve requirements, and accordingly the committee recommends removing the requirement on those trade-related acceptances that are eligible for Federal Reserve purchase. At the same time, however, the staff committee recognizes that the Board might well be reluctant to allow a class of acceptances to develop that would be subject neither to reserve requirements nor to the "100 per cent of capital" limitation which now applies to the acceptances described in the Federal Reserve Act and which are eligible for discount. One way to resolve this difficulty would be for the Board to apply reserve requirements to trade-related acceptances of the type that are now ineligible for discount but only to the extent that such acceptances, plus the acceptances eligible for discount, would exceed 100 per cent of the bank's capital. In this manner, all of the acceptances sold by member banks would be subject either to reserve requirements or to the 100 per cent of capital limitation.

Frederick R. Dahl (Board staff)
Peter M. Keir (Board staff)
Roy A. Remedios (San Francisco)
Hilbert G. Swanson (Chicago)
Peter D. Sternlight, Chairman
(New York)

Exhibit A

To accomplish the proposed revision in Regulation D, it is suggested that Regulation D, Section 204.1(f)(5) be amended as follows:

> (5) arises from the creation of a bank acceptance of the type described in Section 13 of the Federal Reserve Act and eligible for discount by the Federal Reserve Banks OR A TRADE-RELATED BANK ACCEPTANCE OF THE TYPE DESCRIBED IN THE AUTHORIZATION FOR DOMESTIC OPEN MARKET OPERATIONS OF THE FEDERAL OPEN MARKET COMMITTEE, PARAGRAPH 1(b), NUMBERS (1) and (2), PROVIDED THAT THE TOTAL AMOUNT OF ACCEPTANCES EXEMPT FROM RESERVE REQUIREMENTS DOES NOT EXCEED 100 PER CENT OF THE ACCEPTING BANK'S PAID UP AND UNIMPAIRED CAPITAL STOCK AND SURPLUS.

ATTACHMENT A

FINANCE ACCEPTANCES

A Survey of Commercial Bank Attitudes and Experiences

The Staff Committee on Bankers' Acceptances commenced during May 1974 a survey of commercial bank attitudes and experience regarding finance acceptances. Interviews were held with officials of seven large New York City banks, two Chicago banks and four San Francisco banks. In addition, a questionnaire was mailed to 24 banks, of which 16 replied through August of 1974. In a more informal way, the views of dealers in acceptances were also solicited. Their opinions are summarized in the final section of this report.

I. Commercial Banks

The survey revealed that finance bills were created mainly by large banks in major money centers. Approximately three out of four major money center banks used finance bills but only one of three regional respondents had created finance bills. The most common reasons for creating finance bills were to provide a new source of funds and to offer investors a complete array of short-term investments. Some regional banks noted that they used finance bills to accommodate the credit demands of customers who could not have been serviced on other terms. Many banks, however, were either satisfied with the more common sources of funds or had no need for additional sources of funds.

Finance bills would have gained more widespread usage if reserve requirements had not diminished their economic value.

Reserve requirements sharply curtailed activity, although a number of banks maintain contact with the market to preserve this instrument as an alternative.

Attitudes regarding the future value of finance bills varied. Some banks felt the instrument could have a role in providing liquidity, in that all avenues to liquidity may be necessary in the future, while others believed finance bills had inherent disadvantages limiting their usefulness or their competitive power. Respondents generally felt that Federal Reserve participation would broaden the market by raising the status of finance bills and by providing demand. Many banks thought that an improved market would benefit banks of all sizes but others felt that investor sensitivity to credit risk would place large or well-known banks in a more advantageous position. Most banks believed that trade-related acceptances would hold their own in competition with finance bills but a number of banks felt that a proliferation of finance bills created by large banks would diminish the marketability of trade-bills created by smaller banks.

Respondents generally agreed that open market operations would probably be facilitated by Federal Reserve activity in finance bills, but questions were raised by a few regarding the wisdom of promoting finance bills considering that the System's policy objectives might be better served by open market operations in more traditional instruments.

Responses to the specific questions asked of each bank are summarized below:

Question 1

Has your bank marketed finance bills (also known as working capital acceptances)? What considerations have entered into your decisions to use or not to use this instrument?

Of the 29 banks responding to the survey, 13 had marketed finance bills. Six of the major eight New York City banks had marketed finance bills, as had one Chicago bank and one San Francisco bank. Of the 15 regional banks (including one small New York City bank) only 5 had marketed finance bills.

The major New York City banks marketed finance bills mainly to provide another source of funds and to provide investors with an array of market instruments. Of the two major New York City banks which had not marketed finance bills, one had been about to enter the market but the combination of an imposition of reserve requirements and high clerical costs made their plans uneconomical. The other bank felt that it was not worthwhile to gear up for the effort because their best customers resisted having their names in the marketplace.

The Chicago and San Francisco banks using the market also cited a need for alternate sources of funds. The Chicago bank was particularly enthusiastic, noting that all sources of funds are important in a unit banking state, that finance bills provide a degree of flexibility, and that their management feels there will be an expanded market in the future. The other Chicago and San Francisco banks were considering finance bills but terminated plans with the imposition of reserve requirements although one San Francisco bank is still considering testing the market, particularly since the supply of trade acceptances they generate is not sufficient to meet investor demand. Another San Francisco bank noted that, although they were considering using the market, the pending decision might have been affected by customer reluctance to have their names in the market as well as the rate differential between trade acceptances and finance bills.

The five regional banks that had marketed finance bills offered similar reasons for using the instrument. The issuer of the largest volume of this type of paper said that the marketability of finance bills was an important factor. This bank also said that although the lack of reserve requirements was originally a dominant factor, they still continue to use finance bills when relative rates make it advisable to do so. Two banks noted that they use finance bills when customers did not maintain sufficient compensating balances.

Four regional banks appeared to have been favorably disposed to using finance bills eventually, but plans were deferred when this paper was subjected to reserve requirements.

Three regional banks felt their sources of funds were adequate and, consequently, there was no need for introducing a new instrument. Among other reasons for not creating finance bills were diverse considerations such as the lack of a stable secondary market, the problem of educating customers and lending officers, concern over legal lending limits, uncertainty over the regulatory position of bank supervisors, the circumstances of having created eligible acceptances to the maximum permitted by regulation, and preference for other sources of funds such as

CD's or self-liquidating real bills of exchange. One bank noted that it regarded finance bills, "as a definite threat to liquidity and an invitation to a liquidity squeeze for the simple reason that their use involves reliance upon a money market in which we would be disadvantaged in the event of an acute credit squeeze".

Question 2

If you have marketed finance bills, what was the maximum outstanding amount and on what date was it reached? What is the current dollar volume of your outstanding finance bills?

Among the banks surveyed, the major creator of finance bills was a New York City bank which had approximately $500 million outstanding when reserve requirements were imposed in mid-1973. The bank's outstanding volume declined since and is now insignificant. Other New York City banks peaked around the time reserves were imposed with outstandings mainly in a range of $100 to $300 million. Only two of the banks maintain a significant outstanding volume.

A Chicago bank has maintained a level of $200 million since 1971. A San Francisco bank had approximately $20 to $25 million outstanding in years past but was not a market factor in recent years.

One regional bank reached a peak of $121 million on June 15, 1973 and reported $54 million still outstanding. Other regional banks also reached peaks near that time ranging from $5 to $20 million. One regional bank began creating finance bills this past spring and reported about $7 million outstanding.

Question 3

Has there been any change in your willingness to market finance bills since they were subjected to reserve requirements in July 1973?

The imposition of reserve requirements clearly had a negative effect on the willingness of banks to market finance bills. Many banks ceased or curtailed their activity when the cost of issuance was raised by reserve requirements and several banks which were contemplating the creation of finance bills cancelled their plans.

Reserve requirements did not completely terminate willingness to create finance bills, however. While reserve requirements removed a significant cost advantage and severely limited the market's growth potential, several banks noted that they remained anxious to maintain contact with the market in order to preserve an alternate source of funds or to offer investors an array of money-market instruments. One bank noted that finance bills aid customers which otherwise could not be accommodated. Apparently some banks still intermittently find the cost of finance bills to be reasonable.

Question 4

What possible role, if any, do you see for finance bills in helping to provide liquidity for your bank during periods of general credit stringency? Do you see a similar role for finance bills at other banks of different sizes?

Nearly all the banks surveyed believed that finance bills could provide liquidity for their banks. Only a few banks provided an unqualified response to this question, however. In general, banks felt that the significance of the role of finance bills would depend on the cost of funds and the marketability of the instrument.

The banks which foresaw a relatively strong role for finance bills noted such factors as the flexibility inherent in having a variety of sources of funds available including a source of funds due within 30 days, the need to avoid reliance on the Federal funds or CD market, investor demand for acceptances which cannot be met solely with trade-related paper, and the self-funding aspect of extending credit to customers through the use of finance bills. Two banks also noted the need for an instrument which increases the liquidity of bank assets.

Banks which were more cautious regarding the liquidity potential of finance bills cited a variety of reasons. A major New York City bank noted that finance bills were not uncovering new sources of funds but were only competing with other instruments in raising funds. Some banks felt they could continue to rely on traditional liquidity sources including the discount window, trade-acceptances, CD's and Federal funds, and a doubt was raised over whether finance bills would significantly increase the availability of funds during tight money periods. It was also noted, apparently because of a misconception, that capital ratio limitations could diminish the role of finance bills. A major New York City bank commented that in creating finance bills it tries to hold the uses of the instrument to the sort of working capital needs that are appropriate to this form of financing.

Customer attitudes were also cited in several responses. A number of banks noted that some customers expressed reluctance over having their paper sold in the marketplace although some banks did not meet such resistance and one bank felt that the education of customers and lending officers would overcome this problem. A major New York City bank mentioned that some customers resented the use of finance bills by banks since this method of credit extension competed with commercial paper; to the extent that competition weakened the commercial paper market, customers would have a less effective alternative to bank financing. Customers were also said to find the procedures involved in issuing finance bills to be time consuming, inconvenient, and possibly a distinctly less advantageous way of obtaining credit. Some banks also suggested that it is difficult to handle finance bills on an operational basis and apparently clerical costs were significant.

Opinion was divided on the question of whether finance bills would be an effective liquidity source for banks of various sizes. Many banks believed that an improved market for finance bills would necessarily benefit banks of all sizes. Smaller banks which cannot readily sell CD's in the national market would have more success with finance bills if they were designated "eligible paper". A strong secondary market for finance bills would be especially beneficial to all banks since investors would find finance bills in general to be more attractive than CD's in general. Finance bills might also be readily marketable because they are two name instruments and if the borrowing corporations were top-grade, nationally known firms, their credit strength would strengthen the bank's endorsement of the paper.

Others felt that the investor sensitivity generated by the Franklin National Bank difficulties would place medium or small banks at a definite disadvantage in selling paper they created since investors often associate size with safety. A regional bank, as an illustration, stated that on July 1, 1974 it was unable to sell an ineligible acceptance in the New York market; they were told by the acceptance brokers that the demand had vanished and dealers were only soliciting acceptances from the banks ranked within the top ten. Questions were also raised over whether the modest-sized denominations created by smaller banks would trade well or be as efficiently handled by the market, although it was also said that smaller banks could offer sizable pieces which would be more readily marketed than the small trade acceptances they create. Also, some wondered whether the Federal Reserve would quickly reach the limit of bills it would hold of smaller banks and thereby make dealers reluctant to purchase more finance bills from those banks. In this respect a regional bank as well as a major New York City bank believed finance bills would be a trap for many banks outside money centers, especially since dealer willingness to buy paper is a function of the Federal Reserve's holdings of the paper.

<u>Question 5</u>

Would the development of a market for finance bills be aided signficantly if Federal Reserve open market operations were broadened to include such bills?

Virtually all the banks surveyed responded positively to this question. Federal Reserve operations would be expected to legitimize the instrument, help eliminate investor reluctance to purchase a lesser-known instrument, blur the distinction between trade-acceptances and finance bills, and provide significant demand which would increase the marketability of the instrument. A major New York City bank, however, felt that the market was near its potential growth limits before reserve requirements were imposed and did not think Federal Reserve operations would lead to dramatic growth nor result in a much greater role for finance bills than has existed.

Question 6

Do you believe that such a broadening of Federal Reserve open market operations would facilitate the conduct of those operations?

The surveyed banks generally agreed that open market operations would be facilitated by Federal Reserve activity in finance bills as it would provide another vehicle for operations; this extension of System activity to another market sector would help disperse Federal Reserve demand, thus alleviating shortages resulting from concentrated buying of Government securities or trade acceptances. But, a Chicago bank felt that such operations would help only if the System's portfolio limitation is raised from $500 million and others raised the question of whether reserve requirements or a System policy of stemming the growth of credit through finance bills would limit the supply of finance bills and therefore eliminate the market as a useful area for open market operations.

Procedural and policy questions were also raised. Several New York banks suggested that the Federal Reserve would have a problem in defining prime bank names eligible for purchase. It was indicated that trade acceptances are created mainly by larger and better regarded banks but finance bills may be created by a more diverse group of banks. A money center bank as well as a regional bank felt that the System would lure regional banks into the national market and then potentially hurt them if for some reason the System stopped buying their paper.

A major bank presented a view that finance bills were something of a step in the wrong direction. The bank felt that because the finance bill had such a large potential for unlimited expansion, its very appearance and promotion by a few banks had brought on the reserve requirements which in turn severely limited its potential use in the future. The bank preferred to see the banking system develop a commercial bill that would be related to working capital needs of the borrower, that would be free of a reserve requirement, and that would be more easily limited in volume through examination procedures. In the same vein a few banks mentioned that the Federal Reserve may want to consider purchasing CD's or dealing in Federal funds rather than finance bills, and one bank stated that too many types of paper are being developed. A bank expressed fear that the Federal Reserve may encourage banks to overextend themselves because many would consider finance bills only a contingent liability and forget that they are also a real liability. Another bank stated that every encouragement which the Federal Reserve provides to the development of non-deposit sources of funds by banks will only complicate money management operations and stimulate recklessness on the part of bank management. In a somewhat contrasting view a large bank expressed the view that the Federal Reserve may want to encourage finance bills in order to concentrate more of the credit expansion within the banking system and thus keep it within the surveillance of the banking authorities.

Question 7

In your view, what might be the impact on the existing market for trade-related acceptances if Federal Reserve operations were extended to include finance bills? Might such participation affect the ability of medium-sized banks to discount their trade-related acceptances in the market at the same rate as large banks?

The banks surveyed did not, in general, have strong opinions regarding the probable impact of potential Federal Reserve operations. Seventeen of the banks tended to express the view that Federal Reserve operations in finance bills would have a neutral to positive impact on trade-related acceptances, eight tended to have a negative view, while four had no clear opinion.

Positive opinions reflected the view that a stronger market for finance bills would improve the climate for all types of acceptances. One bank noted that there is a scarcity of well-known names in the market and finance bills would fill a need rather than create an oversupply. Sales of finance bills might enhance the ability of smaller banks to sell trade-related acceptances since their names would thereby become more widely known. It was felt that trade-acceptances could hold their own, particularly since they are not reservable and banks would prefer to create the cheapest paper. A narrow rate differential might reduce investor attraction to finance bills. Trade-acceptances have a unique and traditional role in the market and finance bills would provide competition mainly to the CD market. In addition, it was felt that reserve requirements would limit the growth of the supply of finance bills and so limit their impact on trade acceptances.

Negative opinion reflected the possiblity that investors would favor finance bills, particularly if they are created in large, easily handled denominations, and if their rates remain attractive. While the market for trade-acceptances of large banks would *not* be impacted, the finance bills of large banks could drive out the trade acceptances of smaller banks. Some banks feared that if finance bills become eligible they may proliferate and create oversupply problems to the detriment of trade bills. A large bank noted that investors often do not ask if a trade transaction underlies an acceptance suggesting that many investors are concerned only by rate and bank name and not by the instrument itself.

II. Acceptance Dealers

The views of the nine acceptance dealers with which the New York Bank transacts business have been solicited intermittently, most recently in late November after the market had some time to react to the termination of the Federal Reserve's guarantee of acceptances purchased for foreign accounts. One of the nine dealers is opposed to System open market operations in finance acceptances as a matter of principle. The other eight dealers favor System participation but many express this sentiment without strong conviction.

Federal Reserve participation in the market for finance bills is expected to broaden the market. The prospect for increased trading volume is obviously appealing to a dealer, and most dealers freely admit that this is their primary reason for favoring open market operations in finance bills. Dealers note, however, that the acceptance market needs more depth, breadth and resiliency--traits which can be improved through growth in market activity. The stronger performance of the acceptance market which could result from expanded Federal Reserve open market operations would benefit all participants according to several dealers.

Only two dealers thought that an expansion of the finance bill market would be detrimental for the market for trade-related acceptances. One dealer commented that the simplicity of finance bills as an instrument might eventually lead to a decline of the complex trade acceptance. Another dealer thought that an expanding supply of finance bills would reduce the role of trade acceptances. The remaining dealers felt that trade acceptances would compete effectively with finance bills but no dealer predicted that Federal Reserve operations in the new instrument would be decidedly beneficial for the traditional instrument.

Most dealers noted the sizable premiums investors are willing to pay for acceptances of the largest banks and the corresponding reluctance of many investors to purchase acceptances of other banks except at progressively higher rates. The tiered rate structure is expected to make it difficult for regional banks to use finance bills for liquidity purposes with the same facility as the largest banks but the dealers did not emphasize this as a major problem.

One dealer considers finance acceptances to be a devious type of money market instrument which should not be encouraged by the Federal Reserve System. Another dealer said that the supply of trade-related acceptances is ample and consequently there is no need for wider market activity on the part of the Federal Reserve.

If the System decides to extend open market operations to finance bills, one dealer recommends that the System commence its operations during a period of monetary ease rather than during a period of restraint since joining the market under tight conditions could interfere with the effectiveness of the restrictive policy. Another dealer recommended deferring any possible Federal Reserve plans to enter the market in the near future. The dealer explained that the market requires time to adjust to developments such as a tiered rate structure and the termination of the Federal Reserve's guarantee of acceptances purchased for foreign accounts. A change in the Federal Reserve's policy regarding acceptances would only provide another confusing factor to unsettle the market.

Edward J. Ozog
Federal Reserve Bank of New York
December 12, 1974

CONFIDENTIAL (FR)

ATTACHMENT B

TO: Federal Open Market Committee

January 29, 1974

FROM: Staff Committee on Bankers' Acceptances

SUBJECT: Recommendations on Desk Operations in Bankers' Acceptances.

FOMC Charge to Staff Committee

At its meeting on September 18, 1973, the FOMC concurred in two proposals that had been made in a memorandum from the Secretariat dated August 14, 1973.[1/] These proposals recommended essentially:

1. That the Committee agree in principle to amend Section 270.4 of its Regulation on the conduct of open market operations as it applies to transactions in bankers' acceptances, but that the effective date of this change be deferred until the Committee is also prepared to make related amendments in the language of paragraph 1 of its authorization for domestic open market operations regarding the kinds of bankers' acceptances in which the Federal Reserve Bank of New York may operate.

2. That a staff committee be appointed to develop recommendations regarding the substance of these needed amendments and whether they should be made a part of paragraph 1 or incorporated as separate guidelines.

On September 19 Chairman Burns designated the undersigned as members of the staff committee to develop the indicated recommendations.

Why Further FOMC Action is Needed

Until the above noted FOMC agreement to amend its Regulation actually becomes effective, Section 270.4 continues to rely on the Board's Regulation B ("Open Market Purchases of Bills of

1/ A copy of the Secretariat's memorandum, entitled "Proposed actions with respect to bankers' acceptances," is appended as Attachment B.

Exchange, Trade Acceptances, Bankers' Acceptances") for a description of the kinds of bankers' acceptances in which open market operations are authorized. Once finalized, however, the amendment will delete the Regulation B reference entirely as shown below:

Section 270.4 Conduct of Open Market Operations.

****

(c) In accordance with such limitations, terms and conditions as are prescribed by law and in authorizations and directives issued by the Committee, the Reserve Bank selected by the Committee is authorized and directed--

****

(2) To buy and sell bankers' acceptances ~~of-the kinds-made-eligible-for-purchase-under-Part-202-of-this Chapter--(Regulation-B)~~ in the open market for its own account.

The FOMC approved this deletion in principle because, on July 3, 1973, the Board of Governors had decided to revoke the now obsolete Regulation B, contingent upon necessary action by the Committee to amend its own Regulation.[1/] Further action by the Committee is now needed to amend its authorization for Domestic Open Market Operations, because paragraph 1 of the latter authorizes

1/ At the same time the Board agreed to revoke Regulation C, "Acceptance by member Banks of Drafts or Bills of Exchange," but this action has no direct bearing on the regulations of the Open Market Committee.

operations in acceptances--"of the kinds designated in the Regulation of the Federal Open Market Committee"--and the amended Regulation (reproduced above) no longer designates any particular kinds of acceptances. Moreover, as the charge to the staff committee indicates, the need to introduce requisite technical changes in the authorization offers a useful opportunity for the FOMC to consider substantive changes as well, directed at liberalizing and modernizing its rules governing the kinds of acceptances in which the Desk is allowed to operate.

In discharging its assignment, the staff committee began by reviewing the history and background of System participation in the bankers' acceptance market, including earlier recommendations for action by various System-wide committees. We then considered recent changes in acceptance practices with a view to determining what, if any, additions or modifications should be made in these earlier recommendations, and arrived at the following conclusions and recommendations. The considerations shaping our conclusions are provided in greater detail in the appendix.

Conclusions and Recommendations

1. Although it was not specifically a part of our charge, the staff committee considered the question whether the System should continue to engage in open market operations in bankers' acceptances. It seemed appropriate to explore this question because one of the major justifications for the System's reentry into the acceptance market in 1955--to encourage the postwar development of that market--no longer exists; the acceptance market has long been sufficiently well-established to obviate the need for special support or encouragement from the System.

We were advised by the System Account Manager that authority to operate in bankers' acceptances improves his operating flexibility, particularly in the area of repurchase agreements, and is needed to help carry out the policy directives of the Committee with maximum effectiveness. On the basis of that opinion, we concluded that a continuation of operations in acceptances was desirable.

2. Under present rules and regulations, System operations in bankers' acceptances are limited to trade-related instruments and dollar exchange bills--essentially to the kinds of acceptances that are eligible for discount by the Reserve Banks under the Board's Regulation A and paragraphs 7 and 12 of Section 13 of the Federal Reserve Act. The staff committee considered the question whether, as would be permissible under the law, it would be desirable to authorize operations in all "prime" bankers' acceptances, including ineligible acceptances commonly referred to as "finance bills" or "working capital acceptances". As noted in section B of the appendix, there is considerable sympathy within the committee for authorizing operations in all "prime" acceptances, particularly since the recent application of reserve requirements to finance bills has eliminated much of the basis for earlier concern about the risk of uncontrolled expansion in these instruments.

While the staff committee believed that such a broadening would potentially increase the flexibility of open market operations, it also felt that in view of the newness and still limited use of finance bills--and in fact their reduced use since reserve requirements were imposed in mid-1973--further study would be desirable to determine how Desk operations in this type of instrument might affect the general performance of the acceptance market and bank asset and liability management. Accordingly, we recommend that we be authorized to undertake the suggested study, conducting interviews with a small group of representative firms and perhaps also sending a written questionnaire to a broader group of industry participants.

3. The staff committee discussed several more limited types of changes in the rules governing System operations in bankers' acceptances that might be considered appropriate and desirable at this time. We concluded that until a final decision can be made on the broader question of finance bills, the most appropriate interim action would be to adopt essentially the modest reforms recommended by the preceding staff committee on bankers' acceptances. These changes are spelled out in Section D of the appendix.

4. On the question whether the needed rules relating to operations in acceptances would be better included in the Committee's authorization itself or in separate guidelines, we concluded that the rules could be formulated with sufficient brevity to warrant inclusion directly in the authorization. The specific language changes we recommend affect paragraphs 1(b), dealing with outright purchases and sales, and 1(c), dealing with repurchase agreements. These recommended changes are shown in Attachment A, following the appendix.

5. It should be noted that a change in the System's approach to operations in bankers' acceptances would call for a thorough review of the Board's rulings on acceptances contained in "Interpretations of the Board of Governors of the Federal Reserve System". About 75 of these rulings (#1050-1710) apply to bankers' acceptances and reflect the Board's approach, mainly in the 1920's,

to the trade-related acceptance described in Section 13 of the Federal Reserve Act. The rulings are still used extensively by accepting banks and by Federal Reserve Examiners as a guide to determining the eligibility of acceptances created by the banks for discount or purchase by the Federal Reserve. A change in the System's approach could make some of these rulings obsolete or incorrect. However, FOMC action on our recommendations, spelled out in Section D of the appendix, need not await review of these rulings and any resultant revisions therein.

Peter D. Sternlight, Chairman
(New York)
Frederick R. Dahl
(Board of Governors staff)
Peter M. Keir
(Board of Governors staff)
Roy A. Remedios
(San Francisco)
Hilbert G. Swanson
(Chicago)

(The staff committee acknowledges the valuable assistance of Mr. Robert L. Cooper, Federal Reserve Bank of New York, in the preparation of this report.)

APPENDIX

CONSIDERATIONS SHAPING STAFF COMMITTEE CONCLUSIONS

A. Historical Background

The Federal Reserve Bank of New York buys and sells bankers' acceptances outright and under repurchase agreement as part of the open market operations authorized by and conducted for the FOMC. Rules governing these operations are set forth in a chain of references involving the Committee's Authorization for Domestic Open Market Operations, the Committee's Regulation, the Board's Regulation B and ultimately, the Board's Regulation A and Section 13, paragraphs 7 and 12 of the Federal Reserve Act. Both of the last two sources, it might be noted, are directly concerned with acceptances eligible for discount and became involved in determining those eligible for purchase through cross reference.

The net effect of this chain of references has been to limit System purchases of bankers' acceptances to trade-related and dollar exchange instruments; specifically:

1. Acceptances having not more than six months to run, which grow out of: (a) transactions involving the importation or exportation of goods; or (b) transactions involving the domestic shipment of goods, provided shipping documents are attached at the time of acceptance;

2. Acceptances (with same maturity as in (1)) which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples.

3. Acceptances having not more than three months to run, drawn by banks or bankers in foreign countries or dependencies for the purpose of furnishing dollar exchange.

The System is not legally required to limit its acceptance purchases to the bills described above. The Federal Reserve Act, as interpreted by the Board in the past, provides broad authority for the Federal Reserve Banks to purchase and sell bankers' acceptances under the direction of the Federal Open Market Committee.

Some banks have recently issued "ineligible" acceptances--also known as finance bills, marketable time drafts, or working capital acceptances. Under Section 13 of the Federal Reserve Act, these acceptances are not eligible for discount by the Federal Reserve Banks--hence the term "ineligible". Under present rules--but not law--they also are not eligible for purchase by the Desk.

Because of the rather rapid growth in bank finance bills during 1972 and early 1973, and the potential for still greater expansion in future periods of monetary restraint, the Board of Governors acted in July 1973 to apply time deposit reserve requirements to these instruments. Specifically, the regulation applies to bank liabilities in the form of bankers' acceptances

> "issued or undertaken by a member bank as a means of obtaining funds to be used in its bank business, except any such obligation that .... arises from the creation of a bank acceptance of the type described in Section 13 of the Federal Reserve Act and eligible for discount by the Federal Reserve Banks".

This amendment to Regulation D has had the effect of putting finance bills on a similar basis to CD's, as far as reserve requirements are concerned.

B. Desirability of Continuing System Operations in Bankers' Acceptances

One of the major objectives of the FOMC when it authorized a reentry of the System into the acceptance market in 1955 was to encourage the postwar redevelopment of this market. Since that time the acceptance market has become self-sustaining, and no longer requires support or encouragement from the System.

The Account Manager has stated, however, that System operations in acceptances do provide an important marginal assist to the day-to-day implementation of monetary policy. These operations have centered largely in repurchase agreements, although small variations are also undertaken in outright holdings. When the Desk seeks to provide reserves to meet temporary needs, it frequently offers RP's against acceptances as well as Treasury and Agency securities. The acceptance portion, while relatively small, generally provides a significant share of the total--either permitting the Desk to meet its objectives more completely or to meet them in a way that encourages keener competition in the market for the System's repurchase money. The acceptance RP's are particularly helpful at times when market scarcities of Government securities tend to impede the Desk's ability to extend temporary RP assistance.

During 1973 repurchase agreements against acceptances totaled $5.6 billion, or about 6.1 percent of the System's total repurchase agreements against all collateral. This ratio probably understates the contribution of acceptance RP's to total RP's, since agreements secured by acceptances are less susceptible to early termination by dealers than those secured by Treasury and Agency securities.

In view of this positive contribution of acceptance RP's to open market policy, the staff committee concluded that it would be counter productive for the FOMC simply to abandon such operations. Such a move would seem to be particularly inconsistent with the successful initiative of recent years in extending System transactions to Federal Agency securities as a means of broadening Desk operating flexibility.

C. Should Operations be Extended to All "Prime" Acceptances?

Once it is agreed that Desk operations in bankers' acceptances are beneficial to open market policy, logic suggests that this benefit would be maximized if such operations were permitted to encompass the widest possible range of "prime" acceptances. The staff committee spent considerable time evaluating the arguments for and against this approach.

Arguments advanced in favor of the expansion of Desk operations to encompass all types of "prime" acceptances were essentially as follows:

(1) Existing System regulations that restrict Desk operations to trade-related acceptances of the types eligible for discount are a carryover from the discredited "real bills" doctrine in vogue during the early 1920's when most of the relevant regulations were adopted. The underlying quality of a bankers' acceptance depends essentially on the credit standing of the business borrower and of the accepting bank or banks whose names it carries, rather than on the documentation related to the trade items it is financing. Consequently, the System would seem to be amply justified in broadening Desk operations in acceptances to encompass any acceptance of "prime" quality, whether a trade-related instrument or a more generalized finance bill. Such an approach would not only enhance the flexibility of open market operations; in the longer run it could provide some additional assurance that as economic growth generates the need for an expanded reserve base, there will be an ample supply of instruments in which the Desk can operate.

(2) Earlier staff concern that System buying might encourage an uncontrollable growth in finance bills has been substantially eliminated by last summer's Board action making them subject to reserve requirements. Much of the earlier concern about undue expansion was fed by the evidence that large banks were focusing on finance bills as a means of avoiding reserve requirements on large CD's. Now that finance bills are reservable, there is no reason to continue stigmatizing them by refraining from System purchases and sales. (If the System decides, at some future date, to purchase finance bills, it may be advisable to purchase only the acceptances of member banks, thus ensuring that a reserve requirement is applicable to such bills, and providing a modest additional benefit to membership.)

(3) While the System might find it somewhat more difficult to identify finance bills appropriate for purchase than is now the case with trade-related acceptances, any resulting increase in administrative burdens could be reasonably handled. Examination reports and indications of marketability would continue to be the primary basis for making such judgments. As an additional protection, the FOMC could, if it wished, set quantitative limits on System acquisitions of the outstanding finance bills of any particular bank.

(4) The extension of System operations to any prime quality bankers' acceptance would encourage the development of a broader acceptance market and, to that extent, add liquidity to a part of bank loan portfolios. This could be particularly helpful to small- and medium-sized banks that do not have ready access to the CD market. In effect, the finance acceptances would be similar

to a more liquid form of CD. Realization of this full potential for finance bills might take a while to evolve, even with the System as a regular market participant. In time, however, regional markets could very well develop in which acceptances of medium-sized banks, located in that area, were readily traded. For the finance bills of small- and medium-sized banks to trade effectively in the national market they might, of course, have to be bought, endorsed, and resold by large bank correspondents, at some additional cost to the accepting bank. But this process would be encouraged if the System were a regular market participant.

(5) Expansion of Desk operations in finance bills could also lead to the development of a flexible means--alternative to the discount window--for the System to provide emergency assistance to individual banks in periods of severe general credit stringency. At such times, System acquisitions of acceptances could provide banks under particular pressure with added liquidity, without aggravating pressures on the secondary market. (Operations of this type would, of course, be different from the usual Desk practice of purchasing through the dealer market; the operations contemplated here would presumably be closely coordinated with discount window operations to assist banks under particular pressure.)

(6) By encouraging a broader and more flexible range of instruments in the acceptance market, System support of the finance bill would help to avoid some of the problems with United States letters of credit of the type that developed in the case of the United States National Bank of San Diego. Foreign banks apparently assumed that letters of credit issued by United States National Bank had the same binding effect as an acceptance--an assumption that

is now in question. Since there is no question about the liability status of a finance bill, System encouragement of this instrument might offer a more viable alternative than certain types of letters of credit, hence avoiding future difficulties of this type.

(7) There is no good reason to continue fostering what appears to be a specially protected area for trade-related acceptances, which in practice are primarily linked to international trade. One may ask why credit for this type of transaction should enjoy what might be construed as a priority over other types of credit transactions. The activity of financing international trade is now well able to stand on its own feet; if public policy calls for special support for some types of international trade financing that support might best be provided through such vehicles as the Eximbank.

Arguments advanced against the extension of Desk operations to all types of "prime" acceptances were essentially as follows:

(1) While analysts may scoff at the allegation that investors have good reason to rate trade-related acceptances more favorably than finance bills--independent of the credit standing of the accepting bank--in practice investors do seem to view the trade-related instruments more highly. To some extent this may simply reflect the fact that the volume of trade transactions suitable for financing with acceptance credit has not grown on a scale comparable with, say, bank CD's or various types of commercial paper. This limited dollar growth has helped the acceptance market to avoid some of the pitfalls of overly rapid expansion that have sometimes affected other types of instruments adversely. The excellent credit record in the acceptance market has inspired a high degree of confidence among investors, including some major foreign central

bank investors that have placed part of their dollar reserves in acceptances. In this way, the acceptance market has been able to serve to maximum advantage the specialized borrower needs on which it has concentrated.

There is some risk--difficult to evaluate but nonetheless a source of concern to some market participants--that an extension of System operations to finance bills would make it difficult for investors to distinguish between trade-related and other acceptances with the result that the needs now so well served by trade-related acceptances would be less well served than before. The concept of a fairly homogeneous "prime" bankers' acceptance--in which, say, export or import bills accepted by any of 200 or so large- and medium-sized accepting banks are regarded about the same by the market--might well disappear. Instead one would be likely to have the much greater distinctions now drawn by the market between CD's of the top handful of major money market banks and those of second and third echelons of less prestigious institutions. While the result might be some greater liquidity for the general loan portfolios of large- and medium-sized banks, there might also be a diluted and hence reduced ability of medium-sized institutions to finance the types of transactions now covered by trade-related acceptances.

(2) The current System approach to the trade-related acceptance should not be viewed as a special program designed to favor the financing of international trade. The trade-related acceptance is simply a credit instrument particularly well adapted to financing international trade. It goes beyond the mere extension of credit since the banks involved perform other functions on behalf of both the exporters and the importers of the goods. This helps

to explain why acceptance credit has never developed to any great extent in the financing of domestic shipments of goods, where the collateral services of the banks, beyond the extension of credit, are not really needed.

(3) By extending its participation in the acceptance market to include finance bills, the Federal Reserve would give encouragement to an area of credit formation that might prove difficult to control or limit in the future. Formation of traditional trade-related acceptances is limited both by the need to tie the credits to specific transactions and by the legal ceilings on individual banks' acceptance liabilities in relation to their capital. Other acceptances are not similarly constrained. To be sure, these other acceptances, if sold by the accepting bank, generate reserve requirements, and indeed the volume of finance bills has shrunk precipitately since such requirements were imposed. Still, it remains to be seen whether the reserve requirement would prove to be an effective constraint if the prestige of finance bills were enhanced by initiating Federal Reserve purchases.

(4) Under broadened criteria to buy acceptances, the Federal Reserve would have to give greater care to credit judgments on the accepting banks and in some cases on the drawers and endorsers of the paper as well. To some degree the System faces this responsibility even now, but it would be considerably expanded under the proposed extension of Desk authority to include transactions in finance bills. Other investors in the acceptance market would face similar complications. Some important investor groups, such as foreign investors in our acceptance market, might well respond by cutting back--and perhaps even abandoning--their participation in the market.

The lauguage of Regulation D imposes reserve requirements only on finance acceptances sold by the accepting bank. If the bank returned the accepted draft to the drawer to be sold by him, presumably there would be no reserve requirement imposed. There is no evidence that this is being done, since it has not been the usual practice in this country for the drawer of an acceptance to market the instrument himself, but it could provide a means of lessening the restrictive effects of System policy.

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After reviewing these various pro and con arguments, the staff committee developed considerable sympathy for the view that System operations should be broadened to include finance bills. The recent application of reserve requirements to finance bills was a key consideration, because it eliminated much of the basis for earlier concern about the risks of uncontrolled expansion in these instruments.

However, no systematic review of market judgments regarding the possible effects of System operations in finance bills has been made since the application of reserve requirements. Previously, some of the largest issuers of finance bills had strongly opposed such an extension, on the grounds that it would be preferable not to blur the distinction between finance bills and trade-related acceptances. In view of the rather limited use now being made of finance bills and the still open question how System operations in these instruments might affect trade-related acceptances, the staff committee concluded that it would be prudent for the FOMC to proceed cautiously. We recommend, therefore, that the FOMC take no action with respect to System operations in finance bills until participants in the acceptance market can be questioned to gain better insights on the likely ramifications of System operations in finance bills. This further study could be undertaken by the present staff committee, on the basis of interviews with selected representative firms and perhaps also a questionnaire sent to a wider cross-section of participants in the industry.

D. Recommended Changes in the Substance of Rules on Acceptances

Although our staff committee is not prepared to propose an immediate extension of Desk operations to finance bills, we do recommend some modernization in the technical language defining acceptances eligible for purchase. These language revisions, by increasing the usefulness of trade-related acceptances to merchants and other borrowers and to the banking system, are designed to improve the performance of the bankers' acceptance market and thus enhance the usefulness of this market to System open market operations.

Specifically, the suggested language modifications would:

(a) Eliminate the present requirement that banks be in possession of shipping documents conveying or securing title at the time they accept drafts covering the shipment of goods within the United States. This would remove the distinction, for which there seems to be little, if any, rationale, between international and domestic shipments of goods in this respect.

(b) Broaden the use of acceptances to finance the storage of any goods rather than just "readily marketable staples". But the modification would confine such financing to goods stored in the United States and would continue to require that the accepting bank be secured by documents conveying title to the goods. The reason for not purchasing foreign storage bills is that verification on the documertation of these bills presents undue administrative difficulties. In any event, few such bills have appeared in the United States market.

(c) Remove dollar exchange bills from the list of acceptances suitable for System purchase, since these instruments are seldom used and have become essentially an anachronism.

(d) Increase the maximum maturity of "trade-related" acceptances from six months to nine months. This would permit the inclusion of transactions that require somewhat longer-term financing--thus covering a lengthier process of shipping and marketing. It was considered preferable not to go beyond nine months, however, since longer maturities might jeopardize the status of such acceptances as money market paper--not to mention the possibility of becoming subject to SEC registration requirements.

(e) Eliminate some unnecessary wording in the FOMC authorization to the Desk. Specifically, the proposed change would eliminate the reference to purchases or sales "on a cash, regular, or deferred delivery basis", and would eliminate the limitation of System holdings to 10 percent of total acceptances outstanding. The reference to delivery dates introduces technical jargon that serves merely to clutter up the authorization. The 10 percent limitation is not necessary, because with outstanding acceptances currently in excess of $8 billion, the binding limitation is the $125 million limit which it is proposed to leave intact. In the unlikely event of a sharp decline in the total outstanding volume of acceptances, the FOMC could re-impose a percentage limitation.

Items (a) through (c) were recommended initially by earlier System committees on bankers' acceptances. Item (d) is a new change that would provide further liberalization in the eligibility of trade-related acceptances for System operations.

We also considered authorizing System purchase of some nontrade-related acceptances, such as bills created to finance the processing of goods. The objective of such a move would be to broaden further the types of credits that might be financed through the acceptance market, while retaining some connection with physical goods and thus preserving the sense of a tangibly secured credit that has long been associated with bankers' acceptances. We decided against this approach for the time being, however, because acceptance credit growing out of the financing of goods in process could be difficult, and perhaps impossible, to document in the same specific manner as goods in shipment or storage. Once goods are subject to processing, they begin to lose their identity. From the standpoint of a creditor seeking to attach "the security", there is little difference between an acceptance backed by goods in process, and one backed by the general credit of the borrower, which would be simply a working capital acceptance or finance bill.

ATTACHMENT A

Recommended Changes in the FOMC Authorization to the Federal Reserve Bank of New York Regarding Desk Operations in Bankers' Acceptances

(Deletions are shown by cancelled type and additions by capital letters.)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York...

(b) To buy or sell ~~prime-bankers'-acceptances-of-the kinds-designated-in-the-Regulation-of-the-Federal-Open-Market Committee~~ in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, ~~on-a-cash,-regular-or-deferred-delivery-basis~~, for the account of the Federal Reserve Bank of New York at market discount rates, PRIME BANKERS' ACCEPTANCES WITH MATURITIES OF UP TO NINE MONTHS AT THE TIME OF ACCEPTANCE THAT (1) ARISE OUT OF THE CURRENT SHIPMENT OF GOODS BETWEEN COUNTRIES OR WITHIN THE UNITED STATES, OR (2) ARISE OUT OF THE STORAGE WITHIN THE UNITED STATES OF GOODS UNDER CONTRACT OF SALE OR EXPECTED TO MOVE INTO THE CHANNELS OF TRADE WITHIN A REASONABLE TIME AND THAT ARE SECURED THROUGHOUT THEIR LIFE BY A WAREHOUSE RECEIPT OR SIMILAR DOCUMENT CONVEYING TITLE TO THE UNDERLYING GOODS; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed ~~(1)~~ $125 million ~~or-(2)-10-percent-of-the-total-of-bankers'-acceptances-outstanding as-shown-in-the-most-recent-acceptance-survey-conducted-by-the Federal-Reserve-Bank-of-New-York,-whichever-is-the-lower.~~

(c) To buy .... prime bankers' acceptances ~~with-maturities~~ of THE TYPES AUTHORIZED FOR PURCHASE UNDER 1(b) ABOVE, ~~six-months-or less-at-the-time-of-purchase~~, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such .... acceptances in 15 calendar days or less, at rates that .... shall be determined by competitive bidding .... provided .... that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

ATTACHMENT B

August 14, 1973

CONFIDENTIAL (FR)

To: Federal Open Market Committee
From: The Secretariat

Subject: Proposed actions with respect to bankers' acceptances

On July 3, 1973, the Board of Governors considered a memorandum from its Legal Division dated June 28, 1973 (copy attached), in which it was recommended that the Board revoke its Regulation B[1/] -- which relates to open market purchases of bills of exchange and bankers' acceptances--and that, on the same effective date, the Federal Open Market Committee amend Section 270.4(c)(2) of its Regulation to delete the reference therein to the Board's Regulation B.

The Board was favorably inclined toward the Legal Division's recommendations, but decided to defer action with respect to its own Regulations until the Open Market Committee had had an opportunity to consider the recommendation for an amendment in the FOMC Regulation. The latter recommendation, specifically, is to delete from Section 270.4(c)(2) the words stricken by dashes in the following:

Section 270.4 Conduct of Open Market Operations.

* * * * * * * * *

(c) In accordance with such limitations, terms and conditions as are prescribed by law and in authorizations and directives issued by the Committee, the Reserve Bank selected by the Committee is authorized and directed--

* * * * * * * * *

1/ The concurrent recommendation that the Board revoke Regulation C, "Acceptance by member banks of drafts or bills of exchange", is not relevant for present purposes.

(2) To buy and sell bankers' acceptances ~~of-the-kinds-made-eligible-for-purchase-under-Part-202 of-this-Chapter-(Regulation-B)~~ in the open market for its own account.

If the FOMC Regulation is amended in the manner proposed, paragraph 1(b) of the Committee's Authorization for Domestic Open Market Operations would also be in need of amendment. This is because that paragraph authorizes the New York Bank "To buy and sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee...." and the revised Regulation would no longer designate any particular kinds of acceptances. To meet this problem, a description of the kinds of bankers' acceptances in which the Committee wishes transactions to be undertaken could be incorporated in the authorization itself, or in separate guidelines analogous to those now in effect for operations in agency issues.

The Committee may wish to take advantage of the occasion on which these technical changes are made to introduce substantive changes appropriately liberalizing and modernizing its rules governing the kinds of acceptances in which the Desk is authorized to operate. The present rules are set forth in the Board's Regulation B--which, as noted in the Legal Division's memorandum, has not been amended since 1923--and in the opinion of Board members and staff they are badly in need of liberalization and modernization. Various proposals for this purpose have been debated within the System in recent years.

The Secretariat recommends:

1. That the Committee agree in principle at this time that it will amend Section 270.4 of its Regulation, in the manner described above, at such time as it is prepared to approve the necessary amendment to paragraph 1(b) of its Authorization, possibly

involving modified rules regarding the kinds of bankers' acceptances in which the Desk is authorized to operate.

2. That a staff committee be appointed to develop recommendations regarding the content of these rules and the manner in which they might be incorporated in the authorization and/or separate guidelines.

Messrs. Holmes, O'Connell, and Partee concur in these recommendations.

ATTACHMENT

June 28, 1973

To: Board of Governors

From: Legal Division
(J. Ferrell)

Subject: Revocation of Regulations B and C regarding bank acceptances.

ACTION REQUESTED: Revocation of Board Regulations B and C, and an amendment by the FOMC of the FOMC Regulation Relating to Open Market Operations of Federal Reserve Banks.

Regulation B

Regulation B--which relates to open market purchases of bills of exchange and acceptances--has not been amended since 1923, thus antedating, in unamended form, the Federal Open Market Committee by ten years. When section 12A of the Federal Reserve Act was added in 1933 to establish a Federal Open Market Committee, it provided that "no Federal reserve bank shall engage in open-market operations under section 14 of this Act except in accordance with regulations adopted by the Federal Reserve Board." In 1935, this provision was amended to read:

> No Federal Reserve bank shall engage or decline to engage in open-market operations under section 14 of this Act except in accordance with the direction of and regulations adopted by the Committee [i.e., the FOMC].

Thus, only the FOMC has the authority to adopt regulations governing open-market operations. Therefore, the Board's Regulation B is invalid, and has been invalid since 1935.

The FOMC Regulation presently authorizes the Reserve Bank selected by the Committee "to buy and sell bankers' acceptances of the kinds made eligible for purchase under Part 202 of this Chapter [Regulation B] in the open market for its own account" (§ 270.4(c)(2)). Thus, it could be argued that, although Regulation B itself is invalid, portions of it are incorporated by reference into the FOMC Regulation, which is a valid regulation.

In 1923, the Board ruled that "bankers' acceptances may ... be eligible for purchase in the open market by Federal Reserve banks, even though not of the kinds and maturities made eligible for rediscount"; in this connection, it was noted that the "language of section 14 of the Federal reserve act is broader than that of section 13." 1923 F. R. Bulletin 317, 317. In effect, any bankers' acceptance is legally eligible for purchase in the open market (if authorized for purchase by the FOMC), although only certain types of such acceptances are eligible for discount by a Federal Reserve Bank.

The thrust of the recent revisions in the FOMC Regulation was "to incorporate in the Regulation general authorizations for transactions of the kinds subject to the regulatory jurisdiction of the FOMC and at the same time to make it clear that such general authorizations may be limited and restricted by specific authorizations and directives of the Committee." Final Report dated January 4, 1973 of the *Ad Hoc* Staff Committee on FOMC Rules and Regulations, page 25. Consistent with this effort, the Legal Division recommends (1) that § 270.4(c)(2) of the FOMC Regulation be amended to authorize the selected Reserve Bank "to buy and sell bankers' acceptances in the open market for its own account," subject to such authorizations and directives as may be issued by the Committee from time to time,* and (2) that the Board revoke its Regulation B. The proposed changes would be technical and need not entail any change in the actual conduct of open market operations.

Regulation C

The Board's Regulation C ("Acceptance by Member Banks of Drafts or Bills of Exchange") is premised on the assumption that a member bank may make acceptances only of the type described in section 13 of the Federal Reserve Act. However, in 1923 the Board ruled that "the acceptance power of State member banks is not necessarily confined to the provisions of section 13, inasmuch as the laws of many States confer broader acceptance powers upon their State banks . . . ." 1923 F.R. Bulletin 316, 317. (Under F.R. Act § 19, paragraph 13, "any bank becoming a member of the Federal Reserve System shall retain its full charter and statutory rights as a State bank or trust company, and may continue to exercise all corporate powers granted it by the State in which it was created.") Therefore, under the 1923 ruling, a State member bank may make acceptances that are not of the type described in § 13 if they are so authorized under State law. In 1963, the Comptroller ruled that "[n]ational banks are not limited in the character of acceptances which they may make in financing credit transactions, and bankers' acceptances may be used for such purpose, since the making of acceptances is an essential part of banking authorized by 12 US.C. 24." Comptroller's Manual 7.7420. Thus, national banks are authorized by the Comptroller to make acceptances that are not of the type

*This would require action on the part of the FOMC, not on the part of the Board itself.

described in § 13. (See Legal Division dated January 12, 1973, entitled "Working-capital acceptances".) Therefore, the premise for Regulation C is no longer valid.

From 1963--the date of the Comptroller's acceptance ruling--until April 18, 1973, the only real significance of Regulation C was in determining the eligibility of bankers' acceptances for discount. The old Regulation A contained a cross-reference to Regulation C (12 CFR 203), viz., by referring to "such transactions . . . more fully described in § 203.1(a)(1), (2), and (3), respectively, of this subchapter" and referring to dollar exchange acceptances "as provided in § 203.2 of this subchapter." Effective April 19, 1973, this reference to Regulation C was deleted. In the bankers' acceptance provisions in the new Regulation A, the sole reference is to "applicable requirements of section 13 of the Federal Reserve Act."

Most of Regulation C merely repeats the statutory provisions of section 13. It adds very little of a substantive nature to the statutory provisions, and the few substantive provisions that are contained in the Regulation are of questionable legality. If Regulation C were revised so as to contain only those provisions that (1) do not merely restate the statute and (2) are clearly a permissible exercise of the Board's regulatory powers, there would be virtually nothing left to the regulation.

Accordingly, it is recommended that Regulation C be revoked.