BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 14, 1946.

To Chairman Eccles

Subject:

From Mr. Knapp

Attached are the following memoranda which should be of use to you in connection with the meeting on Thursday with Pete Collado:

(1) Memorandum on "Relationship of Federal Reserve System to Bretton Woods Institutions", prepared by the Staff Group on Foreign Interests;

(2) Memorandum on "Distribution of International Bank Securities by Commercial Banks";

(3) Memorandum on "Investment in International Bank Securities by Commercial Banks".

The latter memorandum, dealing mainly with the legal aspects of the question, is to be supplemented by a memorandum concerning the effect of the International Bank's operations on our money market. Among other matters, this memorandum will deal with the question of the inflationary effect of commercial bank purchases of International Bank securities.

Attachments (3)

Distribution of International Bank Securities by Commercial Banks

Several commercial bankers, in discussing the market for International Bank securities, have suggested that Section 5136 of the Revised Statutes be amended to allow banks to act as distributors and dealers in these securities. At present, the law forbids such transactions by commercial banks except in the securities of the U.S. Government and certain of its agencies, and in State and municipal bonds. Since the performance of these functions by banks in relation to International Bank securities could conceivably be of great assistance to the Bank, the question of such an amendment needs to be given serious consideration.

There are three different functions which commercial banks could be asked to undertake in this field. They are (1) underwriting, or assumption of the risk that a given issue of International Bank securities will be successfully sold; (2) the distribution of new issues of the Bank on a commission basis without assuming the underwriting risk, and (3) dealing in the securities to maintain a market after they have been distributed. It is highly unlikely that the International Bank will seek underwriting services, but it will probably desire assistance from the market in promoting the sale of new issues and in developing an orderly market. The Bank will become in time the largest single issuer of securities in our market, aside from the Government itself, and broad distribution among investors will be necessary to assure successful flotation of its issues.

The present law on this subject was enacted as part of the Banking Act of 1933, and it appears to have had two principal purposes. One purpose was to add to the protection of the banks' creditors by preventing commercial banks from assuming undue risks in connection with security market operations. This, however, was clearly not the sole purpose, since even where a bank is permitted to buy given blocks of securities for investment, it is not permitted to buy the same securities for resale as underwriter or distributor. The other purpose was to assist in rationalizing our financial structure by separating functions that were considered incompatible. Thus it was desired to insure that the nature of a bank's investment portfolio would be determined by investment considerations rather than by the exigencies of a securities underwriting or distributing business; and to insure that customers who might apply to a bank for investment counsel or for credit accommodation would not find consideration of their case prejudiced by the bank's position as a seller of securities.

The State and municipal securities and securities of Federal Government agencies which are exempted from the law's limitations

have two characteristics which served to justify this exemption: First, they are typically securities of relatively high investment quality; this tends to minimize underwriting risks, and it also tends to cause the underwriters' and distributors' "spreads" to be low, thus minimizing the incentive to a bank to indulge in undesirable practices in order to push sales. And second, the issuers of these securities are governmental as distinguished from private, so that there is no possibility that a bank might abuse its underwriting functions to assist an issuer in which officers of the bank had a personal financial interest.

These same characteristics would apply to International Bank securities, and might justify an amendment that would permit a bank to purchase these securities for distribution or dealing purposes up to the amount that the bank could legally hold for investment purposes. On the other hand, in view of the importance of the principles embodied in the present law, a departure in favor of International Bank securities should hardly be considered unless very important benefits to that Bank can be expected from it.

It is difficult to estimate how important it would be to the Bank to have the assistance of commercial banks as distributors and dealers in its securities. The existing investment securities houses already have widespread systems of branch offices, correspondents, and salesmen, which have proved adequate for the distribution of very large volumes of domestic corporate bonds, while the bond departments of banks (dealing in the restricted list of securities permitted by the present law) have few salesmen and reach a much smaller number of investors. The large banks point out, however, that they give investment information and assistance to great numbers of local banks, which in turn give information and assistance to their customers. The placing of adequate information in the hands of prospective purchasers is of great importance in the sale of securities of a new type, such as International Bank obligations, which conscientious managers of investment accounts will refuse to buy (regardless of price, yield or sponsorship) unless they feel that they fully understand them. While the banks might do much in disseminating such information even if they could not participate in distributing the securities, they would naturally do much more if they could also earn commissions as distributors. Probably only time will show how important this difference will become. Unfortunately, however, it is on the very first issue or issues that full scale commercial bank participation may be of the most importance, since these issues will probably be undertaken before most institutional investors have been authorized by State laws to invest in the International Bank's securities.

A few bankers have stated that their ability to act also as dealers, making a market for International Bank securities after they are issued, would assure a more orderly market for the securities, and thereby encourage both them and their correspondent banks to make investments in the securities. As dealers they would assist not only in the initial

distribution of each issue but also in the subsequent process of directing the floating supply into the hands of strong permanent holders. It is again difficult to judge the extent to which the International Bank would benefit if banks as well as security houses were permitted to perform this function.

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Investment in International Bank Securities by Commercial Banks

When International Bank securities appear on the market, commercial banks will be able - under present Federal laws - to invest in such securities up to 10 per cent of their capital and surplus. Some banks will decide to invest in the early issues, perhaps up to the full 10 per cent limitation, while many banks may wish to wait until the new securities become more "seasoned." Some banks may hesitate to invest at first because of their uncertainty as to whether the securities will be considered by the Comptroller of the Currency to be eligible for bank investment.

The total volume of securities to be issued by the International Bank over the next five years may approach $7 billion. If the Bank adopts a policy of arranging the maturities of its obligations in a pattern corresponding roughly to the pattern of repayments due to the Bank from borrowers, most of the Bank's obligations will be long term. However, a very substantial amount (perhaps $2 billion) may have maturities of 10 years or less, and thus fall within the category of investments ordinarily considered appropriate for commercial banks. Under present laws, not more than $700 million could be taken up by the commercial banking system, even in the unlikely event that each bank bought the maximum permitted.

In connection with the present Federal bank regulations, there are two questions that will require the attention of the bank supervisory agencies -

1. When the first issue of International Bank obligations is about to be floated, the Comptroller of the Currency will undoubtedly be asked by some bankers whether he considers the obligations to be securities that are "not distinctly or predominantly speculative" and thus eligible for investment by member banks under the Comptroller's regulations. There seems to be no question but that the securities will meet this requirement; the question is whether the Comptroller should clarify the situation by answering such inquiries;

2. There may be proposed an amendment of the law to exempt International Bank securities from the 10 per cent limitation on bank investments. Congress has already given such exemptions to securities of such agencies as the Federal Land Banks and Home Loan Banks. The question will arise of the attitude the bank supervisory agencies should take toward such an amendment.

In connection with both questions it will be necessary, of course, to consider the relation of bank investment in these securities to the more general questions of the expansion and control of bank credit in the United States. A separate memorandum on this and related subjects is being prepared.

Statement by Comptroller on Eligibility.

It seems evident that the new International Bank securities will not be "predominantly speculative"; they will therefore be eligible for bank purchases under the Comptroller's regulation. As a practical matter, however, since the securities will be of a new and unfamiliar type, many bankers may tend to take a conservative attitude, and if there is any doubt as to whether purchases are permitted under the regulation, some prospective purchasers will defer action.

This subject has been discussed informally with representatives of the Comptroller's office, who agreed that the Comptroller could hardly object to bank purchases of the securities. The Comptroller would not want to issue any kind of public statement that might seem to be a recommendation of these securities. However, if a banker should make an appropriate inquiry when the securities are about to be issued, the Comptroller would probably give an answer to it, and his answer would undoubtedly spread rapidly among the banks.

After the first issue has appeared, the Comptroller cannot avoid letting bankers know that he considers the securities to be eligible, since the securities will appear in banks' portfolios, and the fact that their apearance there was not objected to by examiners will soon become known to bankers in general. Thus, on the great majority of the Bank's issues, commercial banks will not be in any doubt as to their eligibility; it is only the initial issue on which clarification by the Comptroller would affect the amount of bank purchases. The market reception of the first issue, however, will have a disproportionate effect in determining the atmosphere for the reception of subsequent issues. If there exists doubt among bankers as to eligibility, which affects the volume of bank investment in the first issue, it might lead to much greater adverse effects upon the future operations of the Bank.

If the rating agencies assign ratings to these bonds, that would assist bankers in determining their eligibility. However, there is not yet any indication whether or not the agencies will assign ratings initially, and there appear good reasons why the agencies should not be pressed to do so. The basis on which the rating system is founded is well designed for distinguishing between the quality of one railroad or industrial bond and another, or one municipal or foreign government bond and another, but it is not well suited for comparing bonds of entirely different kinds of institutions.

While there seems no questions that the new bonds of the Bank will be "not distinctly or predominantly speculative" it would be very difficult to determine exactly which one of the first four quality ratings is fairly applicable to them at this stage in the Bank's career.

Relaxation of 10 per cent Limit on Bank Investment.

Section 5136 of the Revised Statutes prohibits any national bank from investing more than 10 per cent of its capital and surplus in securities of any one obligor, and the Federal Reserve Act (Sec. 9) applies this same rule to state member banks. The purpose of the limitation was to protect a bank's creditors by preventing the bank from risking an undue amount, in relation to its capital funds, in any one situation. The statute exempts United States Government bonds, general obligations of states and political subdivisions and securities of certain Federal agencies such as the Federal Land Banks. The question arises whether the statute should be further amended to give a similar exemption to obligations of the International Bank.

Obligations of the United States Government are exempted because they involve no risk of the obligor's failure to make repayment when due. Exemptions are also provided for obligations of the Federal Land Banks and certain other Federal Government agencies and for State and municipal obligations; these exemptions might be justified on several different grounds: (1) they are the obligations of issuers whom Congress, in the public interest, desired to help; (2) the exempted securities are generally of comparatively high investment quality; and (3) since issuers of these securities are governmental as distinguished from private, there is no danger of improper use of banks' assets on behalf of particular private interests.

These grounds for the existing exemptions would also seem applicable to securities of the International Bank. An additional reason for special treatment of the International Bank securities lies in the nature of the assets behind them.

In the first place, while the 10 per cent limitation was intended to insure that the risk elements in a member bank's investment portfolio would be diversified rather than concentrated in issues of a single obligor, it should be observed that the International Bank represents in itself a diversification of risks. Each dollar of the Bank's liabilities will be covered in effect by two different sets of Governmental liabilities, since the liabilities of the Bank must be fully covered (1) by the Bank's assets in the form of loans, each made to a foreign government or to a borrower with foreign government guarantee, and also (2) by the subscriptions of the member Governments, 80 per cent of which can be called only when needed to meet the Bank's liabilities.

Furthermore, the United States subscription is large and amounts in effect to a United States Government guarantee of the principal of the Bank's securities up to at least 35 per cent of their aggregate principal amount. This percentage may be reduced by the admission of additional member countries, but can never be less than 27 per cent, and under certain circumstances, might prove to be considerably more than 35 per cent. For the remainder not covered by this U. S. guarantee, the liability of other member countries as subscribers to the Bank's capital will be divided among numerous countries with none having more than 16 per cent of the total, while the liability of member countries as obligors (or guarantors) on the Bank's loans will also undoubtedly show a wide diversification among borrowing countries.

For these reasons an amendment on behalf of these securities seems justifiable in principle. Instead of exempting these securities entirely from any limitation, it might be preferable merely to raise the figure from 10 per cent to some higher figure such as 20 or 25 or 50 per cent. A figure of 20 per cent would almost be justified by the U. S. Government guarantee alone; if a bank invested up to 20 per cent of its capital and surplus, the part of its investment not covered by the U. S. Government guarantee could not in any circumstances greatly exceed 10 per cent.

It may be possible to defer any decision on the matter, at least until the summer of 1947, because in the beginning the 10 per cent limitation will not exert any significantly restrictive effect on the International Bank's sale of its securities. Few banks would consider investing above the 10 per cent limit before the securities have begun to be "seasoned", and since the securities will be issued gradually, rather than in very large volume at any one time, a year or more may elapse before the 10 per cent limitation becomes seriously restrictive.

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