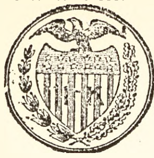
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FEDERAL RESERVE BANK
OF DALLAS

Dallas, Texas, August 6, 1920.

BANKERS ACCEPTANCES

TO THE MEMBER BANK ADDRESSED:

There is enclosed herewith for your perusal and study a booklet entitled "Bankers Acceptances- Principles and Practices", published by the American Acceptance Council. This booklet has been prepared through the collaboration of those possessing expert knowledge of this form of credit, upon a suggestion of the Federal Reserve Board to the American Acceptance Council, and therefore its contents and principles are concurred in by that body. We believe that our member banks will welcome an opportunity to receive in printed form such a clear and full discussion of this subject.

In addition to what interest may be awakened in an opportunity to extend acceptance credits to their customers by the execution of bankers' acceptances, a knowledge may be gained of the facilities available for investing surplus or temporarily idle funds in prime bankers' acceptances by purchase on the open market at a time when such funds are available.

The Federal Reserve Bank of Dallas will, upon request, cheerfully purchase in the open market, bankers' acceptances for the account of its members against and on receipt of available funds, making no charge for this service either for telegrams or otherwise. The Federal Reserve Bank of Dallas will also receive bankers' acceptances for collection for the account of owners, making no charge for its service, and it is well to note that the proceeds of any bankers' acceptances executed by any bank in any Federal Reserve city, are available for credit to the member banks' account at the Federal Reserve Bank of Dallas on the date such acceptances mature and are paid by the acceptor.

The Texas State Banking Law Amendment of 1914 authorizes state banks to execute acceptances only in transactions involving the importation or exportation of goods, to the extent of 50% of the capital and surplus of the accepting bank. Membership of state banks in the Federal Reserve System does not confer acceptance powers upon such banks but an Amendment to the State Banking Law was passed by the last Special Session of the Texas Legislature authorizing trust companies with a capital stock of not less than $500,000.00, to execute acceptances in both domestic and export and import transactions to the extent of five times their capital stock and surplus, and upon permission of the State Banking Commissioner, to ten times their capital stock and surplus. This Amendment, however, did not carry the emergency clause and does not become effective until ninety days after passage or about September 20.

Trusting that you will find a study of this subject and a perusal of the enclosed booklet of interest and value, I am,

Respectfully,

R. L. Van Zandt

Governor

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Bankers Accepta

Principles and Prac

Chapter I.
General Principles
of Acceptance Credits

AMERICAN ACCEPTANCE
111 Broadway

Bankers Acceptances

Principles and Practices

Chapter I.

General Principles of Acceptance Credits

AMERICAN ACCEPTANCE COUNCIL

111 Broadway New York

Published by
American Acceptance Council
111 Broadway, New York
May, 1920

(Copies of this pamphlet may be obtained or reprint arranged through application to the Executive Offices of the American Acceptance Council)

Foreword

The preparation of a primer on bankers acceptances was suggested at a conference of Governors of Federal Reserve banks in March, 1919, when it was proposed that some experts other than Reserve bank officers should be employed for the purpose. After the organization of the American Acceptance Council, it was subsequently decided that it would be better to have the publication prepared and issued in collaboration with and under the auspices of the Council.

In accordance with this plan a committee was appointed by the Federal Reserve Board in order to co-operate with officers of the Council for this purpose. At a meeting of the joint committee of the Board's appointees and the Publicity Committee of the Council, held in July, 1919, the matter was fully discussed and it was then decided to issue such a primer serially and in pamphlet form, each pamphlet being devoted to some particular phase of the problem. Upon its completion, it was planned, the work should represent a careful study of the whole subject of bankers acceptances as permitted under the Federal Reserve Act and the Federal Reserve Board regulations.

The present pamphlet is primarily devoted to

the principles of bankers acceptance credits and the distinction between bankers acceptance credits and money borrowed.

At present there exists a serious lack of unanimity among both bankers and users of bankers acceptance credits with regard to the sound and proper use of the acceptance facilities. As a result of its experience, deliberations and inquiries, the Council is convinced that practices have in some cases developed—partly through lack of experience and understanding, and partly from the exigencies of the war period—which, if uncorrected, might ultimately lead to disastrous consequences and restrictive legislation.

The Council believes that it is preferable that restraints on banking and business be self-imposed in conformity with sound and tested practices and principles, rather than by legislative enactment, when to be effective they generally must be arbitrary and rigid.

The Federal Reserve Act is provided with a flexibility to accommodate the needs of business, in the wide discretionary regulatory powers of the Federal Reserve Board. These powers the Board so far has used very moderately. It has consistently given in its regulations a liberal interpretation of the Act, emphasizing its desire not to impose, on the exercise of sound banking judgment, limitations hindering initiative and practice.

The American Acceptance Council feels that it would be most unfortunate if, through either ignorance or abuse of privilege, banks and business men should compel a change of attitude in the exercise of the regulatory functions of the Federal Reserve Board.

It seems appropriate, therefore, that the Council should prepare this study of the whole subject of American bankers acceptances. In placing it before its readers, the Council recommends the work to the careful attention of its members and invites their hearty support in putting sound principles into actual practices. The ultimate fate of the American bankers acceptance—whether it will be directed by self-imposed rules or by law and governmental regulations—lies in the banking community's own hands.

I

General Principles of Acceptance Credits

Some general principles, as they apply to bankers acceptance credits, may be stated as corner stones in the foundation of this study. They are:

1. That credit, not money, is loaned.

2. That, in general commercial use, the *Bankers Acceptance Credit* is designed to provide short-term transactions in goods by supplying assured credit to carry goods, in process of production, transit and marketing.

That it should be based on a specific transaction or a series of transactions of these kinds, rather than be permitted to provide borrowed general working capital.

That the completion of the underlying transaction should liquidate the bankers acceptance.

That the banker, ordinarily and as far as practicable, should retain control of the goods, receive and apply the proceeds to the retirement of the credit when due; accordingly, bills should be drawn to mature so as to synchronize with the prospective liquidation of the transactions.

While the principles stated above would quite fairly and accurately describe the world's best concepts and traditions with respect to bankers ac-

ceptance credits, not all of the commercial processes above named are permitted under the provisions of the Federal Reserve Act. Thus, while the law authorizes the granting of import and export credits to finance goods in production, transit and marketing, domestic credits may not be extended for financing the production of goods.

In *domestic transportation credits, against shipping documents covering goods in transit,* the bankers acceptance is intended to provide for the financing of goods during the period of transit; and of goods sold and shipped from the time of shipment until payment for the goods is due according to the terms of the sale, but not to exceed six months. The period to be covered by an acceptance credit may not in any circumstances exceed six months.

In *domestic credits secured by "readily marketable staples in warehouse,"* the bankers acceptance is designed to provide means for the carrying of staples, from the point of completed production to the time when they are distributed. It is never to be used for speculation.

In June, 1919, the Federal Reserve Board defined "Readily Marketable Staples" as follows:

"A readily marketable staple may be defined as an article of commerce, agriculture or industry of such uses as to make it the subject of constant

dealings in ready markets with such frequent quotations of prices as to make

(a) The price easily and definitely ascertainable, and

(b) The staple itself easy to realize upon by sale at any time."

The extension of clean credit, that is, unsecured bankers acceptances, not related to any of the commercial processes referred to above, is restricted under the Federal Reserve Act to the so-called *dollar exchange credit.* This credit is designed to enable banks and bankers, in certain foreign countries, under the rules and regulations of the Federal Reserve Board, to provide exchange for remittances in anticipation of the marketing and transportation of goods sold.

While there is no limit prescribed by law as to the length of an acceptance credit a bank may extend, it may not accept any bill having a maturity beyond six months exclusive of days of grace drawn under any import, export or domestic credit, nor bills having a maturity beyond 90 days, exclusive of days of grace, drawn under any credit to furnish dollar exchange.

By discounting the bill drawn under a bankers acceptance credit, the drawer or other holder may realize on it when desired, but the acceptor should not ordinarily discount his own acceptance.

The Accepting Banker

We shall now consider the application of these general principles from the different viewpoints of the several parties to a banker's credit as they apply under the provisions of the Federal Reserve Act.

There is first the accepting banker, the grantor of credit who is asked by a commercial user of credit or another banker to lend his credit to finance a certain business transaction. If the customer is favorably known to him and one for whom he desires to extend a credit, he will inquire into the nature, conditions and terms of the proposed business to ascertain—

1. That, under the Federal Reserve Act and under the rules and regulations of the Federal Reserve Board, it is an eligible transaction.

2. That it will be completed within the period of the contemplated credit and is reasonably certain of itself at maturity to produce the funds with which to pay the obligation assumed by the borrower.

3. What further guarantee, if any, he should require beyond his customer's obligation to provide the funds in case of delay or failure in liquidating the transaction. He may thus require a guarantor or additional collateral. If the business is proposed by a banker, in behalf of a customer, the acceptor will probably require the bankers' guar-

antee in addition to such securities as will come into his control in the ordinary course of the business. If the transaction involves dollar exchange credit, the acceptor may have placed with him, or lodged in satisfactory hands for his account, acceptable securities or bills for collection. He will also consider the scope of the credit desired with relation to his own resources, existing liabilities, and facilities for handling it, and whether the accepting commission is adequate, all things considered.

If all these matters are satisfactory and he decides to grant the credit, he will issue his letter of credit on his customer's written request and guarantee, or the proper execution of an acceptance agreement, and in due course will accept the bills, after seeing that the drafts and documents, if any, are properly drawn, stamped, etc., according to agreement.

While the accepting banker seeks to avoid any preventable risk and expects merely to lend his credit to his customer for a specified time and purpose, he has entered upon an unqualified liability to the holder of his acceptance to pay it at maturity. He has, moreover, undertaken to handle for his customer a highly technical and specialized series of transactions involved in the business underlying the acceptance. The satisfactory outcome of the transaction, for both banker and customer, depends upon the ability of the banker to perform his function skillfully and successfully.

The Taker of Credit

The taker of credit has another and different relation to the transaction and views it from a different angle. He has business in hand or in prospect in which he believes he can advantageously use a bankers acceptance credit. He has carefully considered the matter; he has a definite belief that the turnover of the transaction will provide the funds to retire the bills before they mature. He has weighed the chances of failure through delays in transportation, through changed market conditions, etc., and is confident of his ability to provide the cover for the maturity of the acceptance, even in case the underlying transaction should not be liquidated in time. He decides he will do the business provided he can get satisfactory banking acceptance credit and service. He assumes that he can; that his character, standing and credit, his reputation for prudence and ability, entitle him to the credit required. Possibly several banks have solicited his business. It may be that the transaction is such that he will himself draw the bills or that he will desire to have the drafts issued by others on his behalf; in any event, he is going to obligate himself to provide funds in time to retire the banker's obligation to be created under the acceptance credit, which he is going to hire for a definite period.

In normal times he will select his banker. The

character of his business will partly determine his selection and he may use different bankers for different classes of transactions. He will be guided also in the choice of his bankers by the comparative costs, *i. e.*, commissions plus discount at home or abroad, not forgetting that some names are better known than others in particular foreign markets and that a poor rate of exchange realized by a foreign seller will likely affect the price of goods. He will not take a weak credit—an acceptance that would not sell well—because he is well aware of the fact that by drawing on a weak firm he will jeopardize his own credit. He will require of his banker intelligent service and fair treatment. He will not desire to pay for credit longer than necessary; therefore, he will arrange to have the credit mature as soon as possible after the date on which he may safely expect to receive the proceeds of the underlying transaction, and will stipulate for the privilege of retiring the credit under rebate before maturity.

What has been said here with reference to large borrowers applies with even greater force to borrowers of lesser financial strength and importance. They cannot perhaps afford to be quite so independent, but the same principles govern them and, if anything, their observance is more vital to them because any loss or excessive charge affects them so much more severely. They must try, therefore,

to buy the very best service and credit available to them.

If the taker of credit is a foreign banker he may be depended upon to be market wise and see to it that his business is in good hands.

The Guarantor of Credit

The guarantor of an acceptance credit may, or may not be, a banker. If he is a foreign banker, he may arrange for his clients' credits with his banking correspondents in foreign countries, facilities which otherwise they might not be able to secure. In such cases, on behalf of his customers, he will probably attend to proper preparation of drafts and documents, collections, etc.

If he is a domestic banker, not himself in a position to accept in sufficient amounts to supply the entire needs of his customers, he will probably act as agent in procuring other acceptors and is likely to act for them in attending to the local details of the business involved, such as holding collateral, receiving and remitting proceeds, etc. He may also negotiate the paper for his customers, *but his obligation as guarantor* is to the grantor of the credit, generally the acceptor.

His obligation, broadly stated, is to insure fulfillment of the obligation of the taker of credit to provide funds but may include other obligations stipulated as an essential condition to the granting of the credit, such as assurance that funds derived

from the credit will be applied only to the uses for which the credit was given, and that the proceeds of the underlying transactions when realized will be applied as agreed.

In such cases the guarantor is paid by his clients a commission which may, or may not, include the acceptor's commission. The acceptor's commission, however, will probably be lower on a credit guaranteed by a banker than if it were not so guaranteed. There may be other profits accruing directly or indirectly to the banking guarantor such as proper charges for exchange and collections, and the benefits accruing from having exchange for remittance. Or the guarantor may be a merchant or manufacturer desiring goods available through an importer or producer who for one reason or another, without the granting of these acceptance facilities, could not swing the business in the volume required. Their own lines might be full or too large a margin might be required by their bankers unless they received additional guarantee against loss. Such a guarantor may stipulate a commission or he may act without special compensation, being primarily interested in getting the goods, or to control their market, and for these reasons he may be willing to assist in the financing by guaranteeing the contract of the person that does control their disposition. Or there may be reasons of friendship or relationship that may form the motive for a guarantee of credits.

II

When the Beneficiary of a Banker's Credit Makes It Available to a Third Party

When the taker of credit makes it available to the drafts of a third party, (to illustrate, when the buyer of goods furnishes a bankers acceptance credit to the seller), different considerations arise than in cases where the seller takes an acceptance credit to extend credit to his buyer; or to carry his unsold goods.

In the first case, goods have been sold and the seller is entitled to payment in the form of an approved bankers acceptance according to terms of sale.

All sellers normally prefer cash payment as soon as practicable, but cash before or on shipment is not normally practicable. The most desirable and entirely usual course where cash payment cannot be had is to draw against documents for an agreed term on a responsible drawee. Such draft can be readily discounted by the seller in his own market. Such settlements, through confirmed acceptance credits, from long and satisfactory experience are to all intents and purposes regarded as the equivalent of cash in the markets of the world, and they serve their purpose equally well in the financing of domestic sales and shipments of goods.

If the seller is satisfied with the financial responsibility of his drawee he may consider his

contingent liability as drawer to be negligible, so also the buyer or discounter of the exchange may regard his credit risk as slight. But if the drawee is not so favorably known the purchaser of the bill may consider more carefully the credit and financial position of the drawer and the character and value of the goods, and possibly may limit the volume of drawings he will handle or may place restrictions on the delivery of documents. Therefore, when the credit of the drawee is for one reason or another considered as not beyond question, the seller's credit will prove a considerable factor in the terms upon which the bill may be sold and this will react unfavorably upon the buyer.

Some importers are of such undoubted standing and repute that bills on these drawn by reputable sellers (*i. e.*, foreign trade commercial bills) find a ready sale in foreign markets at good rates, but in the vast majority of cases a banker's credit is preferred. So also in domestic business; where goods are sold and shipped there are many opportunities for the buyer to provide a banker's credit with advantage to himself and the seller, rather than to lean too heavily on the credit of the seller or on his own bank for money borrowed.

In dealing with credits available to a drawer other than the taker of credit, the ordinary procedure is for the banker to issue in behalf of the taker of credit, against his agreement to put the

banker in funds, etc., a commercial letter of credit, advice of which is forwarded and confirmed to the authorized drawer, who draws when his shipment is ready and presents the bill and documents to an exchange bank for sale. Such bank names a rate of exchange (based on the length and quality of the paper and current conditions of exchange) which it will pay for the bill. If sale is made it sees that the bill or bills are properly drawn in conformity with the terms of the credit, that the documents are in good shape and convey title and control of the goods to it. These being arranged the bill and documents are forwarded with appropriate instructions to the exchange bank's agent or correspondent at the place where the drawee is located for acceptance and collection at maturity, or for rediscount upon arrival or later, as may be desired.

As in many cases documents are required to be delivered on acceptance, there then comes the time when the bill is not directly secured by the goods and the element of unsecured credit is injected. The drawer and first discounter of the bill have considered this in appraising the credit and standing of the drawee, to whom they look for payment of his acceptance at maturity. The drawee has considered it in granting the credit to his customer, the taker of credit, and as the documents covering the goods usually are surrendered by the holder of the bill to the drawee banker against his acceptance of the

bill, the latter may, before releasing the goods to his customer, require other collateral or payment.

From the above it is obvious that a transaction in goods is being financed and that up to the time of surrender of the documents by the acceptor to his customer the goods have been under continuous control of one or another of the creditors. In these credits it is the drawer who must first be satisfied of the quality of the acceptance offered, then the exchange market in the place where the bill is to be sold. Therefore, the taker of credit will assure himself that the credits he secures will be acceptable to the seller and the bankers in the seller's market.

When Taker of Credit Himself Intends to Draw

The situation is different where the taker of a banker's commercial acceptance credit is intending to draw himself.

This will probably be in cases where he desires accommodation to carry staples unsold or goods sold but not shipped, or to anticipate realization on sales in which he has extended credit. In either event there is no third party involved. The relation is directly between him and his banker. He is in a relation more like a borrower of money. He might get his accommodation through secured loans or rediscount of his receivables or perhaps on his unsecured promissory note. If he has the option between these and bankers acceptance credit, he will use the cheapest.

In this phase of the use of acceptance credit, we find limitations that perhaps are not so well understood and closely observed in practice as they are definite when tested by the application of our principles, and there are border line cases that only intelligent regard for principles and the spirit of the law will properly classify.

Proper Use of Acceptances by Drawer Under Credit Taken by Himself

There is a proper field for the use of bankers acceptances by the drawer under credit taken by himself in cases such as the following:

When an importer has arranged to bring in goods under conditions that require longer credit than the usual terms or than the seller would wish to extend or to draw for. Frequently in such cases the terms stipulate payment on presentation or "sight against documents," whereas some further time is required for the sale of the goods that will furnish the funds to pay for them. A bankers acceptance credit may be used to finance the carrying of these imported goods during such an interval provided it was arranged for with the banker as a condition to engaging in the importation or the transaction which involved the importation.

Or, where goods have been sold and exported and, instead of discounting the bills on the foreign buyers, these bills are lodged with a banker for collection and application of proceeds to liquidate

an acceptance credit granted against the exports represented by the pledged bills and documents covering the exportation.

Or, where bills are drawn by a shipper against documents in either export or domestic shipments, delivered to the banker for forwarding and delivery against cash, the latter, when received, to be applied by the banker in payment of the acceptance credit.

Or, where there is a contract to export, to perform which goods must be manufactured or assembled, requiring use of credit before actual export can begin, or ocean or through bills of lading can be procured, but which the exporter has agreed to procure and deliver to the accepting banker.

Or, where goods have been sold or contracted for export but are delayed in transit to port or are at port awaiting bottoms.

Or, where staple commodities properly stored and insured are awaiting shipment or market or manufacture and are pledged to secure credit taken.

Or if from some unforeseen cause or delay interfering with the prompt liquidation of the transaction a continuation of credit is required and an importer or exporter might properly wish to draw a new bill to retire one maturing.

All of these cases, and possibly others, would fall well within the spirit of the law and principles. All are confined to certain transactions involving im-

portations, exportations or domestic shipments, the proceeds of which will come into the banker's hands in due course to be applied in liquidation of credit, or are properly secured by pledge of staples.

Improper Basis for Granting Acceptance

On the other hand, goods sold in open account either at home or abroad are not a proper basis for granting bankers acceptance under the Federal Reserve Act;

Nor is the pledge of goods other than readily marketable staples;

Nor is the pledge of such staples out of control of banker or in owner's hands;

Nor is the mere exhibition of a bill of lading or a copy of invoice by the shipper;

Nor is a bill of lading in the hands of the consignee covering non-staple goods beyond the period when the goods represented by it are in transit;

Nor are assigned accounts receivable, promissory notes, or other bills receivable.

Such transactions, and the balances resulting from them, may be proper considerations for the loan of money. But each involves a use of credit in a way or to an extent not contemplated in the Federal Reserve Act as a basis for making eligible bankers acceptances.

Acceptance credits in such cases would not be self-liquidating in the sense of our principles, nor

secured during their life by staple goods which might provide liquidation in case of need. They should be avoided so as not to bring reproach upon the bankers acceptance, the undoubted standing of which as the finest class of short investment paper should not be permitted to be affected.

III

Distinction Between Money Borrowed and Bankers Acceptance Credit

Money borrowed is available only to the extent of a bank's loanable funds, but acceptance credits may be extended even where the bank has *no funds* to loan. The open market will provide the funds drawn from other banks and other sections, and from other countries where money is seeking an opportunity for investment.

Money borrowed is frequently immobilized—

By investment in plant or other capital investment;

By employment in carrying non-liquid assets, such as unsold and unmarketable goods, and manufactures made up in anticipation of seasonal demand, old or over-due accounts; and

By employment to replace proprietors' working capital sunk in ill-conceived business, but for which hope for recovery persists.

Money borrowed, either with or without security, is often considered and used as invested capital, the withdrawal of which would more or less seriously embarrass the borrower. Bank's loans to customers, except for seasonal requirements or specific purposes, are, therefore, as a class not always highly liquid.

A bankers acceptance credit taken under provisions of the Federal Reserve Act must be of self-liquidating character; if a secured credit, it may in case of default be liquidated from realization on collateral enjoying a wide market, or, if unsecured, from completion of underlying transactions which, barring failure or fraud, will automatically yield in the banker's hands the funds for retirement.

Such a credit, based on current commercial transactions, within limitations designed to minimize credit risks, may, therefore, be granted more freely, and with greater expectation of retirement at maturity than money might be loaned in ordinary course.

In loaning credit the underlying transaction should always be considered. Cautious regard for the acceptor's own reputation will require this. His obligation to accept for none but well-considered transactions of proper character is an obligation towards the whole money market, which scrutinizes with expert eye his acceptances sold in the market as evidences of his conduct of business. It is not

necessarily so with regard to loans of money—there the lender need satisfy none but himself, unless he seeks rediscount. Within legal limits and free from the scrutiny of the discount market he may lend on general belief and without specific knowledge of the purpose for which his assistance is sought.

This may be seen by a comparison of the relative requirements for eligibility at a Federal Reserve bank of commercial paper, including promissory notes given for borrowed money, and of bankers acceptances. As to the note, the use of its proceeds is the determining factor. That use must be commercial, *i. e.,* in one or more of the steps in the process of producing, carrying or distributing goods. The evidence of such use, however, may be, and in practice is, the financial statement of the borrower, which must disclose a reasonable excess of quick assets over current liabilities.

Such a condition, however, indicates no more than that, at the time the trial balance for the statement was taken, the amount of money borrowed, other than mortgage money or other long time obligations, was not invested in plant, equipment, or other capital investment. It may be assumed that the statement was prepared at not the most unfavorable period as it is given for the purpose of securing credit.

Under existing conditions such a statement is per-

haps the most definite and precise information available to the lender of unsecured money, although, of course, good reputation and confidence based on personal acquaintance and knowledge of the character, habits and methods of the borrower form other and most important bases for extension of accommodation.

But how different and how much more definite must be the banker's knowledge of the nature and details of the business which he assists by extending his acceptance credit. There are the documents, which in many cases he receives, covering actual goods in transit bought or sold; in other cases the contracts to export must be disclosed, and the banker must be satisfied with regard to the value of the goods and the ability of the buyer to pay for them, and in some cases security by pledge of goods or staples is necessary.

In granting acceptance credit, the banker, if he be prudent and has conscientious regard for the law, must have a more complete knowledge of the business to be financed than he ordinarily would have in the case of money borrowed from him, which, once borrowed, may be put to any use at the borrower's pleasure.

It is the essence of commercial banking that money borrowed should be loaned on the general faith and confidence of the lender in the borrower, involving, nevertheless, a legitimate and unavoid-

able credit risk. It must not be assumed that there is an entire absence of such credit risk or even a smaller risk in granting acceptance credit. Indeed the hazards in extending acceptance credits are very real.

Risks: What They Are and How to Minimize Them

Some risks are similar to those in lending money, others are of a different character. What are they and how are they minimized?

The accepting banker has to take the hazard of relying on the strength and good faith of the taker of credit and of the buyer or consignee of the goods. In the first case he must depend upon the borrower's ability and desire to protect the banker, in case the underlying transaction fails to produce the funds necessary to meet the maturing acceptance. The accepting banker in this case is in a position very similar to that of a commercial banker relying on his customer's willingness and ability to repay borrowed money under adverse circumstances. The acceptor's risk should be appraised in the same way with this distinction, however, that even greater care should be exercised by him, first, because of his obligation to the discounters of his acceptance credit, and second, because the amounts involved are apt to be larger.

The risk involved in having to rely upon the strength, ability and good faith of the buyer or con-

signee of the goods sold by the taker of credit, is similar and may be more difficult to appraise, particularly if buyer or consignee is abroad. Time may be required to conduct inquiries. If there is doubt, suitable guarantees may be suggested or required which may result in the buyer providing credit instead of the seller extending it.

It may be wise to decline to finance exports on seller's credit in cases where he is not abundantly able to stand a loss, if loss should occur. In this regard, the other class of risks must be considered, such as the nature of the goods and their value. Are they perishable or subject to material depreciation in quality in transportation? Is their market wide or restricted? Is their market value stable or liable to sudden decline? In case of delayed shipment or delivery at the other end, will they still hold their value? What facility has the banker for disposing of the goods in a foreign port if not accepted by the buyer or consignee? What expenses would this involve, and what loss might result? Expenses would include customs duties, transportation, storage, legal fees, commissions, etc. Loss might include these and also depreciation in quality through delay, loss on adjustment of insurance, etc., loss in value from a failing market, loss in exchange and interest.

It is apparent, therefore, that the accepting banker must have wide and special knowledge of

goods and commodities, their values and markets; also of the special dangers and risks incident to their transportation, storage and sale. He must, if financing export trade on credit furnished by the seller, have special knowledge of foreign credits, foreign laws and business customs, or employ agents who have this knowledge. The American foreign trade banks, in which he possibly has a proprietary interest, can serve him in these regards in lieu of, or in addition to, other relations or correspondents, and by their specialized knowledge and facilities can greatly assist those acceptors who have not developed foreign departments or established satisfactory connections abroad.

Many of the same risks in varying degrees surround acceptance credits in domestic shipments, but trouble in these may frequently be more quickly adjusted. In credits secured by warehoused staples, the applicable risks among those mentioned are very apparent, and there is another which should always be guarded against—the danger in lending on commodities held for speculation. Aside from the almost always ominous speculative hazard, bills drawn against speculative holdings are not eligible at Federal Reserve banks. As a precaution in these credits, as indeed in many others, an ample margin of collateral security in the commodity itself should be required, and the banker should inform himself as to the nature and

extent of any prior liens on goods and the volume of similar credits taken from others. Credits against unsold goods ordinarily should be restricted to the period of time required to move the goods into channels of distribution through sale.

Distinction in Banking Law

The distinction between money borrowed and bankers acceptance credit is emphasized not only in prudent banking practice but in our banking laws. Section 5200 (U. S. revised statutes)* is the applicable section of the National Bank Act, and its limitations are partially and variously reflected in Sections 9, 11 (m) and 13 of the Federal Reserve Act where they affect *national and state bank members in their rediscount operations.* Thus, while with certain exceptions in Section 5200 with regard to money borrowed on the security of certain United States Government obligations, and also with regard to loans for limited periods secured under certain conditions by non-perishable staples, no person, natural or legal, may be indebted to a national bank *for borrowed money,* secured or unsecured, for an amount in excess of 10% of the unimpaired capital and surplus of the bank.

But there is no legal limit in either the National Bank Act or the Federal Reserve Act to the amount of accommodation that may be granted to one cus-

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* For text of Section 5200 see Page 33 of Appendix.

tomer through discount by a national bank of commercial paper actually owned by him.*

The philosophy of the limitations of and exemptions from the statutes may be briefly stated, viz., that while it may be, and frequently is, necessary and proper for banks to accommodate business with loans of money for employment more or less temporarily as working capital, or to finance capital operations, such advances should and must be confined within a maximum limit which no borrower may exceed; but nevertheless, it would be unwise and needlessly restrictive to limit by statute the extent of accommodation to business through rediscount of paper resulting from sales of goods on credit or arising in credit transactions against goods in being and presumably moving to or awaiting movement to market.

These are the broad principles which, while subject to infinite refinement in particular applications, must remain broad to permit the essential elasticity to sound banking judgment required for it to function freely in its every day adjustment of and adaptation to business affairs and conditions.

Bankers acceptance credit taken is not money borrowed either within the meaning of the law or in practice, but is immediately transmuted into money borrowed when the acceptor discounts or otherwise

* The Federal Reserve Board's analysis of the loaning powers of National Banks under the amendment to Section 5200, as approved Oct. 22, 1919, appears on Pages 38, 39 and 40 of the Appendix.

acquires his own acceptance, before receiving the funds with which to retire it. This is because when acceptance credit is granted there is an obligation created or implied that the taker of the credit under which the drafts were drawn will put the banker in funds at or before their maturity. Such payment to the banker is the retirement of the credit by the taker. The debtor's obligation to provide cover for the payment of the acceptance is the banker's asset against which, by his act of acceptance he creates his liability for payment of the draft to its holder. If he subsequently becomes the holder of his own acceptance obligation at or before maturity, and before he has been placed in funds for its payment, his liability to pay has been extinguished, as he cannot be obligated to pay to himself, and he becomes in fact a lender of money against his customer's obligation to repay him. He is in a similar position when his customer defaults in providing funds before the banker is required to meet his obligation, *i. e.*, pay his acceptance to the holder at maturity. In both cases, if the amount of such debt, which must be considered as an evidence of money borrowed, either by itself or if added to other money loans to the same borrower, exceeds 10% of the capital and surplus of a national bank acceptor, such acceptor is in violation of Section 5200, and the excess over 10% is not eligible for discount by a Federal Reserve bank.

It is clear, therefore, that the acceptor's own acceptance, if offered by him to a Federal Reserve bank for discount or purchase, must be regarded as the promissory note of a drawer offered for rediscount, and as such is subject to the limitations covering rediscounts of single name commercial paper and does not take the preferred classification of commercial paper actually owned or bills of exchange exempt from the limitations of the Acts, as it would if the acceptance were held by some one other than the acceptor. In the latter case it would nowhere count against the line of the drawer; but as the obligation of the acceptor it would circulate either as commercial paper actually owned or as a bill of exchange against actually existing values, and without the limitations of Section 5200 and the relative sections of the Federal Reserve Act.

Appendix

Section 5200, U. S. Revised Statutes

[H. R. 7478.]

An Act to amend Sections 5200 and 5202 of the Revised Statutes of the United States as amended by Acts of June 22, 1906, and September 24, 1918.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 5200 of the Revised Statutes of the United States as amended by the Acts of June 22, 1906, and September 24, 1918, be further amended to read at follows:

Sec. 5200. The total liabilities to any association of any person or of any company, corporation, or firm for money borrowed, including in the liabilities of a company or firm the liabilities of the several members thereof, shall at no time exceed 10 per centum of the amount of the capital stock of such association, actually paid in and unimpaired, and 10 per centum of its unimpaired surplus fund: *Provided, however,* That (1) the discount of bills of exchange drawn in good faith against actually existing values, including drafts and bills of exchange secured by shipping documents conveying or securing title to goods shipped, and including demand obligations when secured by documents covering commodities in actual process of shipment, and also including bankers acceptances of the kinds described in section 13 of the Federal Reserve Act, (2) the discount of commercial or business paper actually owned by the person, company, corporation, or firm negotiating the same, (3) the discount of notes secured by shipping documents, warehouse receipts, or other such documents conveying or securing title covering readily marketable nonperishable staples, including live stock, when the actual market value of the property securing the obligation is not at any time less than 115 per centum of the face amount of the notes secured by such documents and when such property is fully covered by insurance, and (4) the discount of any note or notes secured by not less than a like face amount of bonds or notes of the United States issued since April 24, 1917, or certificates of indebtedness of the United States,

shall not be considered as money borrowed within the meaning of this section. The total liabilities to any association, of any person or of any corporation, or firm, or company, or the several members thereof upon any note or notes purchased or discounted by such association and secured by bonds, notes, or certificates of indebtedness as described in (4) hereof shall not exceed (except to the extent permitted by rules and regulations prescribed by the Comptroller of the Currency, with the approval of the Secretary of the Treasury) 10 per centum of such capital stock and surplus fund of such association and the total liabilities to any association of any person or of any corporation, or firm, or company, or the several members thereof for money borrowed, including the liabilities upon notes secured in the manner described under (3) hereof, except transactions (1), (2), and (4), shall not at any time exceed 25 per centum of the amount of the association's paid-in and unimpaired capital stock and surplus. The exception made under (3) hereof shall not apply to the notes of any one person, corporation or firm or company, or the several members thereof for more than six months in any consecutive twelve months."

Sec. 2. That section 5202 of the Revised Statutes of the United States as amended by section 20, Title I, of the Act approved April 5, 1918, be further amended so as to read as follows:

"Sec. 5202. No national banking association shall at any time be indebted, or in any way liable, to an amount exceeding the amount of its capital stock at such time actually paid in and remaining undiminished by losses or otherwise, except on account of demands of the nature following:

"First. Notes of circulation.

"Second. Moneys deposited with or collected by the association.

"Third. Bills of exchange or drafts drawn against money actually on deposit to the credit of the association, or due thereto.

"Fourth. Liabilities to the stockholders of the association for dividends and reserve profits.

"Fifth. Liabilities incurred under the provisions of the Federal Reserve Act.

"Sixth. Liabilities incurred under the provisions of the War Finance Corporation Act.

"Seventh. Liabilities created by the indorsement of accepted bills of exchange payable abroad actually owned by the indorsing bank and discounted at home or abroad."

Approved, October 22, 1919.

What a Federal Reserve Bank May Discount for its Member Banks

The limitations imposed upon the amounts of rediscounts which a Federal Reserve bank may make for a member bank, whether State or national, are determined by the provisions of the Federal Reserve Act and are not in any way affected by the amendment to Section 5200.

Under the provisions of Section 13 of the Federal Reserve Act any Federal Reserve bank may rediscount for any member bank, whether State or national, the obligations of any one borrower to the extent of ten per cent. of the member bank's capital and surplus but it is expressly provided that "bills of exchange drawn against actually existing values" shall not be included in determining that ten per cent. limit.

In the opinion of the Federal Reserve Board this phrase "bills of exchange drawn against actually existing values" includes "drafts or bills of exchange secured by shipping documents conveying or securing title to goods shipped" and "bankers' acceptances of the kinds described in Section 13 of the Federal Reserve Act" even though Section 13 (unlike the amendment to Section 5200) does not expressly state that those two classes of paper are bills of exchange drawn against actually existing values. In the opinion of the Board, however, accepted demand bills on which the drawer is released from liability are not "bills of exchange" within the meaning of Section 13 and must, therefore, be included in determining the limits on the amount of paper of any one borrower which a Federal Reserve bank may rediscount for any member bank.

Under the terms of Section 11 (m), as amended by the Act of March 3, 1919, any Federal Reserve bank may,

until December 31, 1920, rediscount for any member bank, whether State or national, the obligations of any one borrower to the extent of *twenty* per cent. of the member bank's capital and surplus, provided, however, that the excess over and above *ten* per cent. must be secured by bonds or notes of the United States issued since April 24, 1917, or by certificates of indebtedness of the United States.

Special Provisions Relating to Rediscounts for Member State Banks

The above discussion relates to the general powers of a Federal Reserve bank to make rediscounts for any member bank, whether State or national. It must be observed, however, that under the terms of Section 9 of the Federal Reserve Act, no Federal Reserve bank can rediscount for a member State bank *any* of the paper of any one borrower who is liable to such member State bank in excess of ten per cent. of the capital and surplus of that State bank but it is provided that the discount of bills of exchange drawn against actually existing values and the discount of commercial or business paper actually owned by the person negotiating the same shall not be included in determining the amount to which a borrower is liable to such member State bank.

The provisions of this Section 9 are in no way affected by the amendment to Section 5200 of the Revised Statutes and the same test as to the eligibility of any part of the line of paper of any one borrower which is held by a member State bank is applicable now as before that amendment to Section 5200.

Under the provisions of Section 11 (m) as amended by the Act of March 3, 1919, the Board has ruled that a Federal Reserve bank may, until December 31, 1920, rediscount for a member State bank paper secured by not less than a like face amount of bonds or notes of the United States issued since April 24, 1917, or certificates of indebtedness of the United States, without regard to the amount the borrowing bank may already have loaned to its customer under his regular line of credit, provided, however, that the aggregate of all rediscounts of the paper of any one borrower must in no case exceed twenty

per cent. of the capital and surplus of the member State bank.

In other words, if the regular line of credit of the borrower from a member State bank is *not more* than the ten per cent. limit fixed by Section 9 of the Federal Reserve Act, Federal Reserve banks may rediscount for State member banks to the same extent that they may for member national banks. If, however, the regular line of credit of the borrower from the member State bank is more than that ten per cent. limit, then the Federal Reserve bank cannot rediscount any of that regular line of credit but may rediscount that paper which is secured by Government obligations of the kinds specified up to the limits described above. (See ruling of the Federal Reserve Board printed on pages 361 and 362 of the April, 1919, *Federal Reserve Bulletin.*)

October 24, 1919.

Loaning Powers of National Banks, Under the Amendment to Section 5200, U. S. R. S., Approved October 22, 1919

The amendment to Section 5200 of the Revised Statutes which became a law on October 22, 1919, has made certain material changes in the loaning powers of national banks. For the convenience of national banks and others interested in the effect of those changes, there is submitted herewith an analysis of the provisions of Section 5200 now in force.

The amounts which a National Bank may properly lend to any one person, company, corporation or firm (including in the liability of a company or firm, the liabilities of the several members thereof) under the various clauses of Section 5200, as amended by the Act approved October 22, 1919, are stated in terms of the percentage of the paid-up and unimpaired capital stock and surplus of the lending bank.

Character of Loans	Amounts Loanable
(A) Accommodation or straight loans, whether or not single name.	Maximum limit, 10% of bank's paid-up and unimpaired capital and surplus.
(B) "Bills of exchange drawn in good faith against actually existing values." The law expressly provides that this phrase shall also include: (a) Drafts and bills of exchange secured by shipping documents conveying or securing title to goods shipped. (b) Demand obligations, when secured by documents covering commodities in actual process of shipment. (c) Bankers' acceptances of the kinds described in Section 13 of the Federal Reserve Act.	No limit imposed by law.

Character of Loans	Amounts Loanable
(C) Commercial or business paper (of other makers) actually owned by the person, company, corporation or firm negotiating the same.	No limit imposed by law.
(D) Notes secured by shipping documents, warehouse receipts or other such documents, conveying or securing title covering readily marketable non-perishable staples, including live stock. No bank may make any loan under (D), however, (a) Unless the actual market value of the property securing the obligation is not at any time less than 115% of the face amount of the note, and (b) Unless the property is fully covered by insurance, and in no event shall the privilege afforded by (D) be exercised for any one customer for more than six months in any consecutive twelve months.	15% of bank's capital and surplus *in addition to* the amount allowed under (A); or if the full amount allowed under (A) is not loaned then the amount which may be loaned in the manner described under (D) is increased by the loanable amount not used under (A). In other words, the amount loaned under (A) must never be more than 10% but the aggregate of (A) and (D) may equal, but not exceed, 25%.
(E) Notes secured by not less than a *like face amount* of bonds or notes of the United States issued since April 24, 1917, or by certificates of indebtedness of the United States.	10% of bank's capital and surplus, *in addition to* the amount allowed under (A), or if the full amount allowed under (A) is not loaned, then the amount which may be loaned in the manner described under (E) is increased by the loanable amount not used under (A). In other words, the amount loaned under (A) must never be more than 10%, but the aggregate of (A) and (E) may equal, but not exceed, 20%.

(F) Notes secured by U. S. Government obligations of the kinds described under (E) the face amount of which is at least equal to 105% of the amount of the customer's notes.	No limit, but this privilege, under regulations of the Comptroller of the Currency, expires December 31, 1920.

Some Examples of What a National Bank May Lend at Any One Time to Any One Customer Under the Amendment to Section 5200, Approved October 22, 1919, Expressed in Terms of Percentage of the Bank's Capital and Surplus

	Illustration 1	Illustration 2	Illustration 3
(A) Accommodation or straight loans	10%	5%	5%
(D) Notes secured by warehouse receipts, etc.	15%	20%	15%
(E) Notes secured by a like face amount of Government obligations	10%	10%	15%
Total	35%	35%	35%
(B) Bills of exchange drawn against actually existing values..........	No limit imposed by law.		
(C) Commercial or business paper.....	No limit imposed by law.		
(F) Notes secured by at least 105% of U. S. Government obligations	No limit imposed by law.		

October 24, 1919.