FEDERAL RESERVE BANK
OF NEW YORK

Circular No. 6407
September 19, 1969

REVISED PROPOSED AMENDMENTS TO REGULATIONS D AND Q
Certain Federal Funds Transactions as Deposits

To the Member Banks of the Second Federal Reserve District:

Following is the text of a statement issued today by the Board of Governors of the Federal Reserve System:

> The Board of Governors of the Federal Reserve System today issued for comment a revised proposal to narrow the category of "Federal funds" transactions that are exempt from Regulation D (Reserves of Member Banks) and Q (Interest on Deposits).
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> As revised, the proposal would exempt from the reserve requirements and interest rate limitations of these regulations a member bank's liabilities on "Federal funds" transactions only with another bank and its subsidiaries, various governmental institutions or a securities dealer. Such transactions with mutual savings banks as well as commercial banks would be exempt.
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> An earlier version issued on June 27 was modified after consideration of comments received by the Board, and in view of the complexity of the issues involved and subsequent related actions by the Board involving Euro-Dollars. Comments on the revised proposal should be received by the Board no later than October 20.
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> A "Federal funds" transaction is one involving the purchase or sale of member bank deposits at Federal Reserve Banks (or other immediately available funds) for one business day at a specified rate of interest.

Printed below is the text of the revised proposed amendments. Comments on the proposed amendments should be submitted by October 20 and should be sent to our Bank Examinations Department. Additional copies of this circular will be furnished upon request.

Alfred Hayes,
President.

[Regs. D, Q]

RESERVES OF MEMBER BANKS; INTEREST ON DEPOSITS
Certain Borrowings Classified as Deposits

On June 27, 1969, the Board of Governors published for comment proposed amendments to Part 204 (Regulation D) and Part 217 (Regulation Q) designed mainly to narrow the category of so-called "Federal funds" transactions that are exempt from such regulations (Federal Register of July 9, 1969, 34 F.R. 11384). In view of comments received, the complexity of the issues involved and related actions taken by the Board subsequent to the June 27 proposal, the Board considers that it would be in the public interest to publish the present revised proposal for further comment.

In the Board's view, four classes of Federal funds "purchases" and other short-term borrowings by member banks should be excluded from the provisions of Regulations D and Q. Borrowings from other banks are one such class, because these are necessary for effective functioning of the Federal funds market, which is useful in the implementation of monetary policy. Two other classes are (a) "repurchase" (RP) transactions in Government and Federal agency securities eligible for Federal Reserve purchase and (b) Federal funds borrowings from securities dealers arising from the clearance of securities, both of which facilitate the effective functioning of United States financial markets. Finally, the Board considers that it is appropriate to permit short-term borrowings by member banks from various governmental institutions outside the basic provisions of Regulations D and Q.

The June 27 proposal was a reoffering of the Board's September 25, 1968 notice of proposed rule making (Federal Register of

October 1, 1968, 33 F. R. 14648) so far as the earlier proposal related to bringing a bank's liabilities on nondocumentary "non-deposits" obligations within the coverage of Regulations D and Q. Adoption of the proposal offered for comment at this time would complete the Board's action on the September 25, 1968 proposal as well as the June 27, 1969 proposal.

With this view in mind, the Board is considering amending section 204.1(f) of Regulation D to read as follows:

(f) Deposits as including certain promissory notes and other obligations. — For the purposes of this part, the term "deposits" also includes a member bank's liability on any promissory note, acknowledgement of advance, due bill, or similar obligation (written or oral) that is issued or undertaken by a member bank principally as a means of obtaining funds to be used in its banking business, except any such obligation that:

(1) Is issued to, and held for the account of, (i) a domestic banking office [5a] of a bank, (ii) an "Edge" or "Agreement" corporation operating under section 25(a) or section 25 of the Federal Reserve Act, or (iii) an agency of the United States;

(2) Evidences an indebtedness arising from a transfer of direct obligations of, or obligations that are fully guaranteed as to principal and interest by, the United States or any agency thereof that the bank is obligated to repurchase;

(3) Has an original maturity of more than 2 years, is unsecured, and states expressly that it is subordinated to the claims of depositors; or

(4) Arises from a borrowing by a member bank from a dealer in securities, for one business day, of proceeds of a transfer of deposit credit in a Federal Reserve Bank (or other immediately available funds), commonly referred to as "Federal funds", received by such dealer on the date of the loan in connection with clearance of securities transactions.

This paragraph shall not, however, affect (i) any instrument issued before June 27, 1966, or (ii) any instrument that evidences an indebtedness arising from a transfer of assets under repurchase agreement issued before July 25, 1969.

[5a] Any banking office in any state of the United States or the District of Columbia of a bank organized under domestic or foreign law.

* * *

Section 217.1(f) of Regulation Q would be amended to read as follows:

(f) Deposits as including certain promissory notes and other obligations. — For the purposes of this part, the term "deposits" also includes a member bank's liability on any promissory note, acknowledgement of advance, due bill, or similar obligation (written or oral) that is issued or undertaken by a member bank principally as a means of obtaining funds to be used in its banking business, except any such obligation that:

(1) Is issued to, and held for the account of, (i) a bank, foreign government, monetary or financial authority of a foreign government when acting as such, or international financial institution of which the United States is a member, (ii) an "Edge" or "Agreement" corporation operating under section 25(a) or section 25 of the Federal Reserve Act, or (iii) an agency of the United States;

(2) Evidences an indebtedness arising from a transfer of direct obligations of, or obligations that are fully guaranteed as to principal and interest by, the United States or any agency thereof that the bank is obligated to repurchase;

(3) Has an original maturity or more than 2 years, is unsecured, and states expressly that it is subordinated to the claims of depositors; or

(4) Arises from a borrowing by a member bank from a dealer in securities, for one business day, of proceeds of a transfer of deposit credit in a Federal Reserve Bank (or other immediately available funds), commonly referred to as "Federal funds", received by such dealer on the date of the loan in connection with clearance of securities transactions.

This paragraph shall not, however, affect (i) any instrument issued before June 27, 1966, or (ii) any instrument that evidences an indebtedness arising from a transfer of assets under repurchase agreement issued before July 25, 1969.

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Upon adoption of these proposed amendments, the interpretation published as section 217.137 (Published Interpretations of the Board, para. 3261) ("Transfer from deposit account to 'borrowed money' account and payment of interest thereon") would be revoked.

The principal effect of the proposal is to bring within the coverage of Regulations D

and Q a member bank's liability on a so-called "Federal funds" transaction with any person other than a bank and its subsidiaries, various governmental institutions, or a securities dealer.*

Under the proposal, a member bank that "purchases" Federal funds would be under a duty to take such action as may be necessary to ascertain the nature of the "seller" in order to justify classification of its liability on the transaction as "Federal funds purchased" rather than as a deposit. Any member bank that has given general assurance to another member bank that sales by it of Federal funds ordinarily will be for its own account, and thereafter executes such transactions for the account of others, would be expected to indicate the nature of the actual lender with respect to each such transaction. If it failed to do so, the selling bank would be responsible for any resulting violation of Regulation Q and would be deemed by the Board as violating section 19 and Regulation Q, since it would have caused the purchasing bank's inadvertent nonconformance.

Although the proposal relates mainly to the permissible scope of Federal funds transactions outside Regulations D and Q, the proposal is also designed to maintain the effectiveness of the Board's 1966 action under which promissory notes issued by a member bank principally as a means of obtaining funds to be used in its banking business are classified as deposits.†

To the same extent as at present, liabilities on borrowings from a bank (including a member bank, a nonmember commercial bank, a mutual savings bank, a cooperative bank, the Export-Import Bank of the United States, the Government Development Bank in Puerto Rico, and a foreign bank) would remain exempt from the reserve requirements and interest rate limitations of Regulations D and Q, in particular liabilities on borrowings from foreign offices of banks, while remaining exempt from Regulation Q, would remain subject to the special reserve requirements of section 204.5(c) of Regulation D, which became effective September 4, 1969 (Federal Register of August 20, 1969, 34 F.R. 13409).

New provisions would be added under which (1) a member bank's liability on a borrowing from a Federal agency would be exempt from Regulations D and Q, and (2) a member bank's liability on a borrowing from a foreign government, a monetary or financial authority of a foreign government when acting as such, or an international financial institution of which the United States is a member would be exempt from Regulation Q. If the latter provision is adopted, section 204.5(c) of Regulation D will be amended so that the special reserve requirement thereof would apply to borrowings from the specified classes of institutions, just as are borrowings from foreign banking offices.

The proposal applies to nondocumentary obligations as well as documentary obligations undertaken by a member bank to obtain funds for use in its banking business. Also, under the proposal, in order for any bank liability to another bank, Edge or Agreement corporation, or certain official institutions to be classified as a nondeposit, the liability must be for the account of such an organization. Except for Federal funds transactions, the procedures with respect to which have already been described, the Board expects that any such liability would be issued on a nontransferable basis.

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*The only liability on a Federal funds transaction with a securities dealer that would be exempt from the reserve requirements and interest rate limitations of Regulations D and Q is one that arises from a borrowing for one business day of Federal funds received by the dealer from the clearance of securities transactions on the date of the borrowing. The Board considers that the option of settling securities transactions in Federal funds facilitates the efficient functioning of certain key United States securities markets. Use of this option might tend to be inhibited if dealer sales of such Federal funds to banks were subject to the regulations.

†Where a member bank issues an obligation principally for another purpose--such as usually would be the case with respect to a due bill issued to evidence the bank's liability to deliver securities or foreign exchange sold--it need not classify its liability thereon as a deposit. However, the circumstance surrounding an obligation issued principally for a purpose other than obtaining funds for use in the ordinary course of business may cause an obligation to become subject to Regulation Q--for example, if the bank's liability on a due bill extended beyond a period exceeding that necessary to complete the securities sales, or if the bank paid interest to the customer in excess of the amount that accrued on the securities sold during the delay in delivery.