F E D E R A L R E S E R V E B O A R D

W A S H I N G T O N

October 27, 1916.

SUBJECT: Acceptances of Member Banks.

My dear Governor:

Section 13 of the Federal Reserve Act, as amended by the Act of September 7, 1916, vests in member banks the power to accept drafts or bills of exchange in certain specified transactions. This Section reads in part as follows:

> "Any member bank may accept drafts or bills of exchange drawn upon it having not more than six months' sight to run, exclusive of days of grace, which grow out of transactions involving the importation or exportation of goods; or which grow out of transactions involving the domestic shipment of goods provided shipping documents conveying or securing title are attached at the time of acceptance; or which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples."

A number of member banks have submitted questions for the Board's consideration in reference to the circumstances under which these acceptances may be made. Briefly summarized the questions submitted are as follows:

(1) Does Section 5202, Revised Statutes, which limits the liabilities that may be incurred by national banking associations, apply to acceptances made by member banks under authority of Section 13 of the Federal Reserve Act?

(2) May a member bank purchase and hold its own ac-

ceptances carrying them as newly acquired assets of the bank?

(3) Are acceptances of member banks, made under authority of Section 13, subject to the limitations imposed by Section 5200, Revised Statutes, which limits the amount that any person, firm, or corporation may borrow from a national bank?

(4) If a member bank has the right to purchase and hold its own acceptances, are such acceptances, when purchased, subject to the limitations imposed by Section 5200 above referred to?

In order to answer these questions it is necessary to consider the nature of the obligation assumed by a member bank when it accepts a draft or bill of exchange drawn against it and the purpose of that part of Section 13 which adds this new power to those heretofore vested in national banks.

Under the Negotiable Instruments Law and the decisions of the courts, a bank accepting a draft or bill of exchange enters into a contract substantially similar to that of the maker of a note. An acceptance is defined by Norton on Bills and Notes (Fourth Ed. p. 116) as "an undertaking by the drawee to pay the bill when due".

The maker of a note assumes a similar obligation, so that while the form of the instrument differs the legal effect is the same.

The use of a bank's acceptance, however, differs from the use of its promissory note. A bank desiring to borrow money will ordinarily execute its promissory note or bill payable and discount this note with another bank, receiving the proceeds in cash or in the form of a credit balance. Where a bank accepts a draft or bill of exchange for one of its customers, however, it merely lends its credit responsibility to its customer in order that he may procure the funds elsewhere.

The holder of a bank's acceptance has the same legal rights against the bank as the holder of a bank's promissory note or bill payable, but banks are not authorized by Section 13 to use their acceptance power for the purpose of borrowing money for their own use. They are specifically limited by the terms of the Act to the acceptance of drafts or bills of exchange -

> "(a) Which grow out of transactions involving the importation or exportation of goods;
> "(b) Which grow out of transactions involving the domestic shipment of goods;
> "(c) Which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples;
> "(d) Which are drawn upon it * * * by banks or bankers in foreign countries * * * for the purpose of furnishing dollar exchange, as required by the usages of trade in the respective countries."

The use of the bank's acceptance is limited to the foregoing purposes which are expressly enumerated in the Act and where it appears that this form of obligation is used for unauthorized purposes, or for the purpose of evading restric-

tions imposed by statute upon the exercise of other banking powers, the substance of the transaction engaged in rather than the form of the obligation assumed should be considered in determining whether such other statutory limitations are applicable.

Considering the foregoing questions in the order in which they appear -

1. Does Section 5202, Revised Statutes, which limits the liabilities that may be incurred by national banking associations, apply to acceptances made by member banks under authority of Section 13 of the Federal Reserve Act?

Section 5202, Revised Statutes, as amended by the Federal Reserve Act, provides that:

> "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:
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> "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.
> "Fourth. Liabilities to the stockholders of the association for dividends and reserve profits.
> "Fifth. Liabilities incurred under the provisions of the Federal Reserve Act."

If, therefore, a member bank assumes the liability of an acceptor in any of the transactions authorized by the Federal Reserve Act, as amended, such liability is expressly exempt

from the limitations imposed by Section 5202 above referred to by the fifth exception to this Section, namely, "Liabilities incurred under the provisions of the Federal Reserve Act".

Under authority of Section 13 of the Federal Reserve Act, therefore, a member bank may incur authorized acceptance liabilities to an amount equal to one-half of its paid-up and unimpaired capital stock and surplus in addition to those liabilities which are limited by Section 5202 to one hundred per cent of its capital and surplus.

2. May a member bank purchase and hold its own acceptances, carrying them as newly acquired assets of the bank?

In order to answer this question it is necessary to determine the legal effect of such a purchase, that is to say, whether or not the purchase of a bill by the acceptor before maturity, extinguishes the debt and releases the drawer and endorsers. When a bill is paid before maturity by the drawer or indorser there is no question but that the payer may reissue and further negotiate it.

French v. Jarvis, 29 Conn. 347;
Palmer v. Gardiner, 7 Ill. 143;
West Boston Savings Bank v. Thompson, 124 Mass. 506;
Am. & Eng. Enc. of Law, 2d Ed., Vol. 4, page 500.

While the authorities are not entirely agreed in the case of a payment before maturity by the acceptor, the weight of authority seems to be that such a payment operates as a mere purchase of the bill and not a payment of the debt, and that the acceptor may in such case properly reissue the instrument before maturity. The transferee may recover on it against all parties as a bona fide holder for value.

Morley v. Culverwell, 7 M. & W. 174;
Rogers v. Gallagher, 49 Ill. 182;
Eckert v. Cameron, 43 Pa. St. 120;
Am. & Eng. Enc. of Law, Vol. 4, 2d Ed., p. 501.

In such a case the parties to the instrument are bound as though it had not passed through the hands of the acceptor.

Rogers v. Gallagher, 49 Ill. 182.

A few jurisdictions hold that the payment by the acceptor before maturity extinguishes the instrument, and that a subsequent transferee cannot hold the other parties liable.

Beebe v. Real Estate Bank, 4 Ark., 546;
Long v. Cynthiana Bank, 1 Litt (Ky) 29;

The purchasing bank, however, does not acquire any new or additional assets by this transaction. It uses its cash resources to purchase its own obligation thus reducing its assets and its outstanding liabilities by the amount of the acceptance purchased.

It is assumed that when the draft or bill of exchange was accepted the customer procuring the acceptance entered into a collateral contract with the bank to place it in funds by or before maturity to pay the acceptance when due. As a result of this transaction the acceptance of the bank would constitute a liability and it would have as an offsetting asset the liability or guaranty of the customer. When the bank anticipates payment of or purchases its acceptance it reduces its outstanding liabilities and reduces its cash resources by a corresponding amount, but retains its rights against the customer as one of its assets.

If it should be claimed that since the bank has the right to reissue or to sell this acceptance at any time before maturity, it should continue to show it as an outstanding liability, it would of course be necessary for it to show the acceptance itself as an offsetting asset in order to balance its books.

The better practice, however, would seem to be to treat the liability as acceptor as discharged and not to show the acceptance purchased as an additional asset.

3. Are acceptances of member banks, made under authority of Section 13, subject to the limitations imposed by Section 5200, Revised Statutes, which limits the amount that any person, firm, or corporation may borrow from a national bank?

From the foregoing it seems clear that if a member bank merely contracts to pay an obligation at maturity by accepting a draft or bill of exchange drawn against it and this acceptance is discounted with a third party, the customer procuring the acceptance cannot be said to have borrowed money from the accepting bank but has merely borrowed its credit, and such an acceptance should not be treated as a liability for money borrowed from such bank within the meaning of Section 5200.

4. If a member bank has the right to purchase and hold its own acceptances, are such acceptances, when purchased, subject to the limitations imposed by Section 5200 above referred to?

When a bank purchases its own acceptance, however, it has ceased to lend merely its credit responsibility, and has utilized its own funds in purchasing the rights of the holder of the acceptance.

As holder it would have recourse only on the collateral contract for reimbursement against the customer for whom the acceptance was made, and not against the other parties to the bill since the bank as the acceptor is the party primarily liable. Even though the bill were secured by shipping documents, warehouse or trust receipts, this security could be realized on only in the event that the customer defaulted in his contract to furnish funds to pay the acceptance at maturity. Accordingly, when the bank purchases its own acceptance it uses its funds to anticipate the payment of a liability which its customer has agreed to pay at a later date, and in effect makes a loan of its funds to such customer. The evidence of the debt thus created is the customer's contract to place the bank in funds to pay the acceptance when it matures or to repay the advance or loan made by the bank when it purchased the acceptance. The liability of the customer under such circumstances should be treated as subject to the limitations of Section 5200 which provides in part that:

> "The total liabilities to any association, of any person, or of any company, corporation, or firm, for money borrowed * * * shall at no time exceed one-tenth part of the amount of the capital stock of the association actually paid in and unimpaired and one-tenth part of its unimpaired surplus."

The same result would be reached if the accepting bank was called upon to pay the acceptance atmaturity and the customer

who procured the acceptance had not furnished to the bank the necessary funds to pay it. In either case the liability of the customer would be subject to the limitations of Section 5200. It necessarily follows that where a bank accepts a draft or bill of exchange for one of its customers and immediately discounts such acceptance for the customer, the transaction constitutes merely a subterfuge for permitting the customer to borrow money from the bank. Acceptances discounted in this manner should be treated as money loaned to the customer subject to the limitations imposed by Section 5200 above referred to.

DISCOUNT OF ACCEPTANCES

The purchase or discount of a bank's own acceptance should not be confused with the purchase or discount of acceptances of third parties.

From some of the inquiries submitted there appears to be a tendency to confuse the acceptance power of a member bank with the power of member banks to discount acceptances and it, therefore, seems advisable to consider in this opinion the question of whether or not bills of exchange and acceptances discounted by a member bank are subject to the limitations of Section 5200 above referred to.

It should be remembered that national banks have had the power to discount bills of exchange and acceptances of third parties ever since the national banking system was created in 1864. The right to lend their credit by assuming the obligation

of an acceptor, however, was not authorized until the passage of the Federal Reserve Act on December 23, 1913. According to the original provisions of this Act this power was limited to the acceptance of drafts or bills of exchange which grew out of transactions involving the importation or exportation of goods.

By the Act of September 7, 1916, it was extended to include acceptances in certain domestic transactions and those made for the purpose of creating dollar exchange. The exercise of this power, however, is in no sense the same as the exercise of the power heretofore vested in member banks to discount bills of exchange and acceptances.

In determining whether the limitations of Section 5200 apply to the discount of bills of exchange or acceptances it is necessary to consider the circumstances in each transaction. Section 5200 excepts from its limitations "the discount of bills of exchange drawn in good faith against actually existing value, and the discount of commercial or business paper actually owned by the person negotiating the same." It is clear, therefore, that a bill secured by shipping documents, or by the pledge of goods actually sold, might be discounted by a member bank before acceptance without being subject to the limitations imposed by Section 5200 since this would constitute a bill drawn in good faith against actually existing value. When such bill has been accepted by the drawee, and the documents attached have been removed, though the direct obligation of the drawee to pay such bill at maturity is substituted for the "actual value" against

which the bill was originally drawn, nevertheless, when discounted by a bona fide owner for value, its discount would not be subject to the limitations of Section 5200, because it would be "commercial or business paper actually owned by the person negotiating the same."

Should the drawee who accepts the bill, however, attempt to discount it with a member bank it would be subject to the limitations of Section 5200 since in that case the party primarily liable would in effect borrow money from the bank on his own obligation and while such an acceptance might be in the form of commercial or business paper it could not be said to be "actually owned by the person negotiating it." In other words, a bill or an acceptance when offered for discount to a member bank must be in fact as well as in form what it purports or is represented to be, if it is to be treated as coming within the exceptions to Section 5200.

For example, a bill secured by warehouse receipts and drawn by the owner of the goods against himself or his agent or against a fictitious drawee for the purpose of borrowing money would not be a bill drawn in good faith within the meaning of Section 5200. An accommodation acceptance not growing out of a commercial transaction and not representing any debt actually due from the drawee to the drawer of the bill, but drawn solely for the purpose of enabling one of the parties to the bill to borrow money from the member bank, would not be "commercial or business

paper actually owned by the person negotiating it." Where, however, the bill is drawn in good faith against actually existing value, or where the person discounting the commercial paper is the actual owner of the debt represented by the acceptance, it would come within the exceptions to Section 5200.

Respectfully,

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Hon. W. P. G. Harding,
Governor.

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