FEDERAL RESERVE BOARD

WASHINGTON

January 2, 1920.

X-1784

Subject: Collateral Loans; Relation of Collateral back of Note to face amount of Note.

Dear Sir:-

There is quoted below for your information the text of a letter addressed by the Board to the chairman of one of the Federal Reserve Banks:

"The Board has considered your letter in which you call attention to a case where a member bank buying Government securities in the open market at a discount sought to discount its fifteen-day paper with the bonds as collateral at their face value. You state that when the situation was made clear to the member bank that as the transaction was an open market one and the bonds had been purchased at a discount additional collateral should be deposited in order to margin the loan up to one hundred per cent., or else the loan should be reduced to the market value of the collateral, it recognized the propriety of the suggestion and agreed to comply with it.

The Board takes the view that the attitude of the Federal Reserve Bank was entirely sound. The underlying principle of a collateral loan is that aside from the value of the maker's name from a moral standpoint the chief reliance for security is placed upon the collateral, and collateral notes provide as a rule for the maintenance of a certain margin and for the calling for additional security should the market value of the collateral decline.

We are now getting away from war financing and from the principles which governed the Federal Reserve Banks in facilitating such financing. It is quite probable that there are no longer existent any commitments to carry securities, and the Board feels that it is sound banking policy to require notes secured by Government bonds to be limited to the market value of the bonds. It assumes, of course, that it is not the policy of the Federal Reserve Banks, as it certainly is not the Board's policy, to do anything to reflect on the value of Government obligations, but the banks have already established higher rates of discount for paper secured by Government bonds than were in effect several months ago and the adoption of a well-established banking principle as to adequacy of collateral does not constitute, and should not be regarded as any reflection upon the collateral itself."

Very truly yours,

Governor.

Letter to Governors and Chairmen of all F.R. Banks.