Strictly Confidential

X-1972

MEMBER BANKS COLLATERAL NOTES
SECURED BY GOVERNMENT WAR OBLIGATIONS.

The Act approved September 7, 1916, amended Section 13 of the Federal Reserve Act by adding thereto the following paragraph:

"Any Federal Reserve Bank may make advances to its member banks on their promissory notes for a period not exceeding fifteen days at rates to be established by such Federal Reserve Bank, subject to the review and determination of the Federal Reserve Board, provided such promissory notes are secured by such notes, drafts, bills of exchange or bankers' acceptances as are eligible for rediscount or for purchase by Federal reserve banks under the provisions of this Act or by the deposit or pledge of bonds or notes of the United States."

This particular amendment was suggested to the Banking and Currency Committees of the House and Senate by the Federal Reserve Board in the Spring of 1916, at a time when little use had been made of the rediscount facilities of the Federal Reserve Banks. Experience had shown that quite a number of the larger member banks could use funds to advantage for a few days at a time and would be willing to secure accommodations from the Federal Reserve Banks for short periods, while they would have no occasion to use the funds for thirty, sixty or ninety day periods, and the banks as a rule were reluctant to offer for discount paper the maturity of which ran longer than the time for which funds were needed. It frequently happened that banks having occasion to use funds for a few days only would not have available paper of very short maturity in sufficient volume to satisfy their requirements and in order that the Federal Reserve Banks might be in position to respond to the short time needs of member banks the Board suggested the foregoing amendment.

Before Congress had taken action, however, and as the summer advanced, it became more and more evident that the United States might be drawn into the World War, and in order to be in a position to facilitate Government financing in such an event the Board suggested that member banks' fifteen day collateral notes might be secured also by the deposit or pledge of bonds or notes of the United States. Up to May, 1917, member banks' collateral notes discounted by Federal Reserve Banks were secured almost entirely by "notes, drafts, bills of exchange or bankers' acceptances eligible for rediscount or purchase", but since the issue of the first series of Treasury Certificates of Indebtedness and of the first Liberty Loan, member banks' collateral notes have been secured almost entirely by bonds and notes of the United States.

It seems, therefore, that it would be proper to divide member banks' fifteen day collateral notes into two classes; (1), those secured by "notes, drafts, bills of exchange or bankers' acceptances eligible for rediscount or purchase", and (2), those secured by "bonds and notes of the United States". With respect to the first class, it is evident that such notes are offered by member banks for the purpose of securing short time accommodations for the exact time the funds are needed. Where credit is required for a longer time a member bank would endorse the "notes, drafts, bills of exchange or bankers' acceptances" and rediscount them with the Federal Reserve Bank. Transactions of this kind do not call for any concession in rate and such notes should properly take the rate established for rediscounts of longer maturities.

As to class (2), however, the situation is different. Member banks have always been the purchasers and distributors of Treasury Certificates and they were to a very large extent the purchasers and distributors of the various issues of the Government's war bonds. Pending distribution it was necessary for most of the member banks, and particularly those which subscribed for liberal amounts, to borrow from the Federal Reserve Banks and the fifteen day collateral notes secured by Treasury Certificates, Liberty Bonds and Victory Notes have always been used as a means of getting the needed accommodations from the Federal Reserve Banks.

Paragraph (d) of Section 14 authorizes the Federal Reserve Banks, subject to the review and determination of the Federal Reserve Board to establish rates of discount "for each class of paper" and while the banks may classify paper according to maturity or according to the character of security, they cannot draw any distinction between notes secured by the same class of collateral. Thus a Federal Reserve Bank may establish one rate of discount for member banks' collateral notes secured by commercial paper eligible for discount and another rate of discount on notes secured by bonds and notes of the United States, but it cannot establish two distinct rates of discount on notes secured by notes and bonds of the United States.

Therefore while the purpose of Congress in permitting notes or bonds of the United States to be used as collateral to members banks' fifteen day notes was to facilitate the war financing of the Government, no consideration can be given in establishing discount rates for such paper to the circumstances attached to the ownership of notes and bonds of the United States by borrowing banks. It follows, therefore, that if a preferential rate of discount should be established for notes of class (2), member banks could avail themselves of the opportunity thus afforded of securing commercial accommodations at the lower rate, and an incentive would be given to the borrowing of bonds by member banks and there would be danger of an undue expansion of credit.

But while a Federal Reserve Bank cannot establish differential rates on paper of a given maturity having the same security, it is not prohibited by law from adopting the policy of receiving certain notes for discount and declining to consider application for discount of other notes. Therefore it would seem in the present circumstances that a Federal Reserve Bank might properlydivide member banks' collateral notes into two classes as outlined above, and discount class (1), that is, notes secured by eligible commercial paper, at the current market rates for thirty day paper, and decline to receive for discount notes of class (2), that is, notes secured by bonds and notes of the United States, unless the bonds and notes of the United States are actually owned by the borrowing bank and are directly connected with the war financing of the Government. As Treasury certificates are being issued to take care of the floating obligations of the Government arising out of the war, and as the purchase of these certificates by the banks is an accommodation to the Government, member banks'promissory notes secured by such certificates, having not longer than fifteen days to run, should be taken freely and there can be no objection to a preferential rate on paper of this class. The Board's policy has been to approve the same rate on paper secured by Certificates of Indebtedness as the certificates themselves bear.

This leaves to be considered member banks' promissory notes secured by the various issues of Liberty Bonds and Victory Notes. The Board has never approved any preferential rate on member banks' collateral notes which were secured by bonded obligations of the United States other than bonds issued since April, 1917, but has taken the position consistently that the preferential rates given to notes of this class are for the accommodation of the Government in its war financing. In some districts there are many member banks which for patriotic reasons subscribed heavily to the Government war bond issues and some of them have not liquidated their holdings of such bonds to an extent which would relieve them of the necessity of borrowing from the Federal Reserve Banks on them. There are cases also where member banks have liquidated entirely their original subscriptions to Government bonds and have repurchased bonds for the sake of investment at the lower rates now prevailing in the market, or where member banks have borrowed bonds from their customers and have used them as collateral to fifteen day notes for the purpose of obtaining funds with which to make commercial loans.

There does not seem to be any reason why a Federal Reserve Bank should receive for discount member banks' collateral notes which are secured by borrowed bonds or bonds bought purely for investment, and the inquiry is therefore made whether your Federal Reserve Bank would care to adopt the policy of declining to discount for member banks their fifteen day collateral notes when secured in this manner and announce that hereafter it will be its policy to confine such transactions only to offerings of notes which are secured by Liberty Bonds and Victory Notes, actually subscribed for in good faith by the borrowing bank before the allotment of the final issue of Government war bonds, that is, the Victory Notes.

The Federal Reserve Banks should also require that all collateral pledged as security to member banks' fifteen day notes have a market value at least equal to the face of the note. Therefore in discounting member banks' collateral notes secured by Liberty Bonds and Victory Notes actually subscribed for and owned by the member bank, a Federal Reserve Bank should require, first, that such notes be secured by an amount of such bonds, the face value of which is equal to the amount of the note, and second, that the deficiency between the market value of such bonds and the face of the note be covered by the pledge of additional notes or bonds of the United States, or by the pledge of notes, drafts, bills of exchange or bankers acceptances eligible for discount or purchase by the Federal Reserve Banks.

In consideration of all the attendant circumstances and in further consideration of the fact that by the limitations above outlined, it is clear that under this plan there can be no use of Government war obligations as collateral to member banks' fifteen day notes for the purpose of securing commercial accommodations at reduced rates, and therefore no additional inflation or expansion of credit, it would be proper for a Federal Reserve Bank to bear in mind the circumstances under which the bonds pledged with it are acquired and to make a liberal concession in the discount rate on such paper, that is, on member banks' fifteen day promissory notes secured by Liberty Bonds and Victory Notes actually subscribed for and acquired from the Government by the borrowing bank, or taken before the final allotment of Victory Notes, from borrowing subscribers in default. In the Board's opinion, however, it would not be wise to make the rate on paper of this classification uniform with the rate borne by the bonds, for there should be no incentive to the borrowing banks to hold bonds as a basis of collateral to loans indefinitely. It has been suggested that where the notes are secured by Victory Notes which bear 4-3/4% interest that the rate of discount be 5% and where notes are secured by Liberty Bonds bearing 4-1/4% interest that the rate of discount be 4-1/2%. It is further suggested that a Federal Reserve Bank, if it should adopt the foregoing policy and schedule of rates, should inform its member banks that they will be expected in view of the favorable rate accorded them to make a reasonable reduction in the amount of such notes at the end of each fifteen day period. The member banks could well afford to make this reduction equal at least to the amount of interest saved.

It is clearly impracticable to give any preferential rate to customers' notes which are secured by Liberty Bonds. This would open up avenues for too large an extension of credit when the large volume of Liberty Bonds outstanding is considered. A Federal Reserve Bank, therefore, should continue to discount for member banks customers' notes secured by Liberty Bonds and Victory Notes at the established commercial rate. Such customers' notes, however, ought not to be used as collateral to member banks' fifteenday notes of class (2).

July 3, 1920.