

FEDERAL RESERVE BOARD
WASHINGTON

X-3413

May 23, 1922.

SUBJECT: Acceptance Practices.

Dear Sir:

The Comptroller of the Currency recently held a conference in Washington with the Chief National Bank Examiners and through his courtesy the Board is enabled to lay before you copy of a report made to him by a committee of examiners upon improper acceptance practices which have been discovered. The Board requests that you bring this report to the attention of your bank's own examiners, of the discount committee and of those of your officers who purchase acceptances.

Very truly yours,

G o v e r n o r .

(Enclosure)

TO THE CHAIRMEN OF ALL F. R. BANKS.
Copy to the Governors.

COPY.

Washington, D. C.

May 5, 1922.

Comptroller of the Currency,

Washington, D. C.

Sir:

Your committee No. 1 submits its report upon improvement of the character of acceptances by national banks and a discussion of bad practices which have been found.

The new regulations which have been issued by the Federal Reserve Board, in connection with the use of bankers' acceptances covering export and import transactions, emphasize the necessity of more carefully considering the basis upon which acceptance credits are being granted by the various member banks. In spite of the comprehensive regulations issued by the Federal Reserve Board regarding this phase of banking practice, there have been numerous and flagrant violations upon the part of the large as well as the small banks. The duty of strict supervision of the underlying principles upon which national banks grant their acceptance facilities devolves to a very great extent upon the National Bank Examiners, and special attention should be paid to that part of the examination, to see that not only the letter but the spirit of the law is carried out. It might be helpful to point out some of the more common abuses of the acceptance privilege, which have been met with recently in the examination of national banks.

Perhaps the most frequent abuse in connection with granting acceptance facilities against import and export transactions is found in the continued renewals given by some banks to their customers, aggravated to a considerable extent by the difficulties which have arisen in American foreign trade during the past two years. When the Federal Reserve Board announced its intention of showing greater leniency towards rediscounting by the Federal Reserve Banks of renewals, in connection with transactions effected by the world wide depression in business, many banks took advantage of this ^{to} too great and unintended an extent, and advances which were originally made by means of acceptance credits, but which should have long since been either liquidated or turned into a direct bank loan, were carried along by the banks by means of continued renewals of acceptances. A national bank should not commit itself regarding renewals of acceptances at the time of the opening of the credit. Each application for a renewal should be judged upon its own merits at the maturity of the acceptance. It is found, however, that some banks have agreed to one or more renewals at the time of the opening of the credit. There have also been a number of cases where acceptances have been renewed as many as five or six times against

imports or exports of both raw materials and finished products. The tendency in such cases is for the bank to furnish working capital to concerns by means of acceptance credits rather than by making them a direct loan.

Some banks have granted acceptance facilities to American exporters against their foreign bills, which have been lodged with them for collection. This method has in some cases been abused through the continued renewals of such acceptances, in spite of the fact that the collections upon which they were based had been dishonored, extended or returned because of non-payment. All of these acceptances should have been retired at maturity and a direct advance secured from the bank, if necessary, to finance the delay. There has even been one case of a bank, which after finding that payment was delayed on various export bills which they had discounted for one of their customers, requested him to put them in funds by drawing a ninety day bill on the bank, which was accepted and discounted, thus wiping out the debit in the direct advance account.

In the recent Cuban crisis there were many instances of too liberal renewals of acceptances in connection with various sugar credits. In some cases the credit was in force from the time that the sugar cane was growing until long after the arrival of the refined sugar in America. The "dead season" financing has proved to be particularly objectionable. Practically all of the so-called "sugar credits", in which most of the large accepting banks participated, were subject to a considerable amount of criticism as to the method by which the collateral was handled, particularly while the sugar was in Cuba. There was no attempt made in connection with these credits at the time of the various renewals to adequately reduce the amount of the acceptances outstanding to conform to the actual marketable value of the sugar held. Although the sugar was not really being financed by means of acceptances for a speculative purpose, still, the banks enabled large amounts of sugar to be kept off the market while stocks that were being held and which were not being financed by the acceptance credits, were disposed of in the market.

Some member banks have not taken definite steps in connection with granting acceptance facilities against export transactions to assure themselves that there were actual and definite shipments involved. They have thought that it was sufficient to have a general understanding that the proceeds of an acceptance would be used for the financing of shipments of merchandise between any particular countries. Also that it was quite in order to grant acceptance credits with continued renewals to finance continuous shipments of raw materials imported into the United States. This financing should more properly have been taken care of as a direct borrowing proposition rather than by means of continuously renewed acceptances.

There have also been instances where acceptance credits have not been granted directly to the exporter or importer but to corporations which have used the funds thus obtained for the purpose of financing the foreign business of their customers.

In a general way the abuses which have come up in connection with the granting of acceptance facilities against export and import transactions apply in the case of credits governing domestic acceptances. In these credits we again meet a number of cases where there have been excessive renewals; where the banks have financed the carrying of goods for a considerable period of time, if not for the speculative holding, at least for the maintenance of prices above what would otherwise be the real economic value; and where little regard has been paid in the case of renewals to the depreciated value of the collateral against which the acceptances were made.

There have been instances where domestic acceptances have been given with practically no attention paid to the question of the accepting bank being secured during the life of the acceptance. As an instance of this, one bank accepted drafts drawn against crude and refined oil in storage on their customer's property or in his pipe lines.

Domestic acceptance credits have also been used for the purpose of securing continued finance. An example may be mentioned where a bank accepted time bills drawn upon them secured by warehouse receipts covering cotton in warehouses. These receipts were deposited by the bank with a correspondent in the town where the warehouse was located, with instructions to permit substitutions, allowing their customer to receive the documents against trust receipt. This resulted in the collateral being continually changed, so that the accommodation was really in the nature of a permanent loan.

In another case acceptances were made for the account of a cotton factor, who at the time of the acceptance pledged and deposited warehouse receipts and signed contracts of sale with a bank. The amount of the acceptances included his profit on the transaction, and no definite time for the taking up of the cotton by the purchaser was agreed upon. As the acceptances were renewed on a falling market for cotton no effort was made to have the amount of the acceptances conform to the real value of the cotton.

In one instance a bank was accepting against a domestic shipment when the goods were being transported across the city by truck; a trip requiring about thirty minutes.

A flagrant misuse of acceptances may be mentioned where a firm desired to purchase some furs from another concern and wrote a letter to a bank stating that it was holding the furs at their disposal and induced the bank to accept their time draft on them. With the money secured from the discount of the bank's acceptance the furs were actually secured and gradually sold during the life of the acceptance.

There have been instances of some misconceptions arising in connection with the interpretation of the Federal Reserve Board's definition of a readily marketable staple. One bank stretched this definition to include bristles and brushes.

In another case watch parts were construed as staples and in still another case acceptances were executed against dolls' heads in storage.

Another unwarranted abuse has been met where acceptances have been given for the purpose of securing overdrafts. Acceptances have also been executed by the same bank for the financing of the building of a steamship in the United States for foreign owners.

The above is a summary of the most common abuses of acceptances found in the recent examinations of national banks. In view of the excellent material which has been issued by the Federal Reserve Board and the American Acceptance Council on the correct method of financing domestic and foreign business by means of acceptances, it would be quite useless to reiterate the clear and concise suggestions made by them. In fact during the past seven years there has not been a subject in banking practice which has received as much publicity as that of the acceptances. In spite of this, scarcely an examination is made of one of the larger accepting banks without finding some violations of the intent and purpose of the Federal Reserve Act in connection with acceptances. It is very difficult for the Federal Reserve Banks to discriminate between which acceptances are drawn in accordance with the law and which are not, when member bank acceptances are offered to them for rediscount. Furthermore it is extremely awkward, if not impossible for them to make inquiries regarding the transaction actually behind an acceptance, when the bill is presented to them for rediscount through a third party as it would necessarily have to be.

Perhaps the most practical method of remedying the situation is to have more attention paid by the bank examiners to a bank's acceptance activities. A study should be made by a fully qualified member of the bank examiner's force of each acceptance credit, and he should satisfy himself that the bank is entirely familiar with all of the details regarding the business, and especially that the underlying transactions

will liquidate the credits within a reasonable length of time. The examiner should assure himself that there is a responsible officer in each bank who is thoroughly conversant with the law and regulations governing acceptances, and any changes therein. Particular inquiry should be made in the case of all renewals to ascertain that the transaction is still alive, and still forms a proper basis for being financed by means of acceptances. Above all an earnest endeavor should be made to obtain the active cooperation of the bank officials as regards the placing of national bank acceptances upon a correct basis.

(Signed) D. C. Borden
T. C. Thomas
H. W. Scott
L. K. Roberts.