FEDERAL RESERVE BOARD

X-4654

WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE TO
THE FEDERAL RESERVE BOARD

August 16, 1926.

SUBJECT: Eligibility for Rediscount of Certain Notes of a Cold Storage and Warehouse Company.

Dear Sir:

I am enclosing herewith for your information a copy of a ruling which the Federal Reserve Board recently made upon the eligibility for rediscount at a Federal reserve bank of certain notes of a cold storage and warehouse company.

Very truly yours,

J. C. Noell,
Assistant Secretary.

Enclosure.

TO ALL FEDERAL RESERVE AGENTS AND GOVERNORS

Eligibility of Notes of Cold Storage and Warehouse Company.

The Federal Reserve Board has been requested to rule upon the eligibility of certain notes of a cold storage and warehouse company for rediscount at a Federal Reserve Bank.

It appeared that this company is regularly engaged in the finance business through the making of loans to customers against the security of goods stored with the company. It issues two classes of paper: (1) collateral trust notes secured by the pledge to a trustee of customers' notes payable to the company, representing advances made to customers on the security of goods stored; and (2) straight unsecured notes payable to banks. It conceded that its collateral trust notes are ineligible for rediscount; but contended that its straight unsecured notes are eligible, on the ground that they are issued to finance its current operations. In support of this contention it was stated that the company's quick assets (exclusive of advances to customers) are in excess of its current liabilities (exclusive of its liability on collateral trust notes); that its current accounts receivable consist of accrued storage charges billed to customers but not yet paid and bills rendered to customers for services, ice and material; and that its current operating expenses consist of labor, electric power, material, interest on bonds, administrative expenses, and other usual expenses incident to a going business. On the other hand, it was admitted that the company's bills receivable representing advances made to customers sometimes exceed its collateral trust notes outstanding by as much as 10 or 15%, although the usual practice is to deposit customers' notes in the hands of the trustee, and issue collateral trust notes against them as soon as possible, and the amount of customers' notes pledged to the trustee is approximately the amount of the collateral trust notes outstanding, the only margin required being represented in the value of the goods in storage against which advances have been made.

The Board has given careful consideration to the question presented, and is of the opinion that these notes are not properly eligible for rediscount at a Federal Reserve Bank.

The financial statement showing an excess of quick assets over current liabilities is valuable only as indicating that the borrower is in a liquid condition and that the borrowing is not for capital purposes or for permanent or fixed investments of any kind. In order to be eligible for rediscount under the terms of Section 13 of the Federal Reserve Act, a note must arise out of an actual commercial transaction, that is, it must have been issued or drawn for agricultural, industrial or commercial purposes or the proceeds must have been used or must be intended to be used for such purposes. The eligibility of the notes in question therefore, depends upon the char-

acter of the transactions out of which they arise or the use made of the proceeds, and the mere fact that the company's statement shows an excess of quick assets over current liabilities is not alone sufficient to establish the eligibility of the notes.

It appeared that this corporation is regularly engaged in the finance business through the making of loans to other parties against the security of goods stored with the company by such parties, and that it finances the major portion of this business through the issuance of collateral trust notes secured by the notes of its customers. It conceded that such collateral trust notes are ineligible for rediscount, because they clearly are finance paper under the terms of Section II(b) of the Board's Regulation A and the ruling published on page 308 of the March 1921 Bulletin.

This company, however, borrows some money from banks on its own straight unsecured notes and desired to have such notes declared eligible for rediscount, on the theory that the proceeds of such notes are used exclusively for its current operating expenses. The company's current operating expenses, however, are necessarily incidental to its principal business and their character must be determined by the character of its principal business. Even if its borrowings for current operating expenses could be completely segregated from its borrowing of funds to be advanced to other parties, therefore, it would seem that its borrowings for current operating expenses should be classed as a borrowing for finance purposes, because it arises out of the finance business and not out of a commercial, agricultural or industrial business within the meaning of the Federal Reserve Act and the Board's Regulations.

Moreover, a corporation engaged in the finance business necessarily must have some working funds to enable it to make advances to its customers in the first instance and to carry paper resulting from such advances until it can refinance itself by the issue and sale of collateral trust notes secured by such paper. The proceeds of the unsecured notes made by such a corporation, therefore, would almost certainly be used to some extent in making advances to its customers, and this corporation admits that the amount of advances made to its customers occasionally exceeds the amount of collateral trust notes outstanding by as much as 10 or 15%. It is clear that the borrowings of the company on its straight unsecured notes payable to the bank would, at least to the extent of such excess, be for the purpose of making loans to third parties. As a practical matter, it is almost certain that the proceeds of all borrowings made by the company either on collateral trust notes or on straight notes payable to the banks go into a common fund out of which advances to customers as well as current operating expenses are taken, and it would be impossible to distinguish the proceeds of one class of loans from the proceeds of the other, even if the borrowings of a finance company for its current operating expenses could be considered a borrowing for a commercial instead of a finance purpose.

In view of these considerations the Board is of the opinion that the notes of this corporation cannot properly be considered eligible for rediscount at a Federal reserve bank.