S-15
Reg. U-17

INTERPRETATION OF LAW OR REGULATION

(Copies to be sent to all Federal reserve banks)

July 15, 1937.

Mr. _____, Vice President,
Federal Reserve Bank of _____,
_____, _____.

Dear Mr. _____:

Reference is made to your letter of June 25, 1937, identified as "Inquiry No. 8 re Regulation U," with which you inclosed copies of two letters received from certain banks in your district under date of June 8 and June 15, respectively, raising certain questions with respect to section 3(e) of Regulation U relative to the transfer of loans.

1. Essentials of the Transfer of a Loan.

Section 3(e) of Regulation U provides in part as follows:

> "A bank may accept the transfer of a loan from another bank, or permit the transfer of a loan between borrowers, without following the requirements of this regulation as to the making of a loan, provided the loan is not increased and the collateral for the loan is not changed; * * *"

The first question presented in connection with this provision is whether it should be considered that a bank accepts the transfer of a loan if it makes a loan to a customer to enable him to reduce or retire existing indebtedness at another bank or to replace funds which the borrower has used to reduce or retire indebtedness at another bank.

It is the view of the Board that a transaction such as that described should not be considered to be the accepting of the transfer of a loan pursuant to section 3(e). The provisions of section 3(e) apply only to a loan which is transferred by the process of payment by the transferee bank to the transferor bank against the receipt of the proper collateral, and a transaction such as that described above does not come within the provisions of the section.

2. The Indebtedness and Collateral to be Transferred.

Questions also are raised as to the indebtedness and the collateral to be transferred. In general, two different types of cases arise in this connection, one relating to indebtedness incurred on or after May 1, 1936, and the other to indebtedness incurred prior to that date. Since the

inquiry did not present any question as to the requirements that might affect the transferor bank, the two types of cases will be examined only with respect to the requirements that affect the transferee bank.

Nonexcepted loans made for the designated purpose on or after May 1, 1936. - The first type of case involves indebtedness that is for the purpose of purchasing or carrying stocks registered on a national securities exchange, that is not excepted by section 2 of the regulation, and that was incurred on or after May 1, 1936. Although the transferor bank may have treated certain portions of this indebtedness as separate loans for certain purposes, the agreement between the customer and the bank is such that all the collateral for any of the described indebtedness secures all such indebtedness.

In this connection, it is to be noted that the second paragraph of section 1 of Regulation U provides that:

> "* * * the entire indebtedness of any borrower to any bank incurred on or after May 1, 1936, for the purpose of purchasing or carrying stocks registered on a national securities exchange shall be considered a single loan; and all the collateral securing such indebtedness shall be considered in determining whether or not the loan complies with this regulation."

In view of this provision, it is evident that the regulation contemplates that, in certain connections, the aggregate of the described indebtedness and all the collateral that secures that indebtedness should be considered a unit, regardless of whether or not the transferor bank may have treated a portion of such indebtedness as a separate loan and assigned particular collateral to that portion. It is clear that it would be permissible under section 3(e) for a transferee bank to accept the transfer of the aggregate of such indebtedness accompanied by the aggregate collateral, but there is presented the additional question of whether it is permissible under section 3(e) to accept the transfer of a portion of this aggregate indebtedness accompanied by a proportionate part of the aggregate collateral.

It is the opinion of the Board that if a bank accepts a transfer of a portion of the aggregate indebtedness the bank may properly be considered to have accepted a transfer of a loan within the meaning of section 3(e), and that if the transferred indebtedness is accompanied by its proper portion of the collateral so that the ratio of loan value to indebtedness is the same with the transferred portion of the indebtedness and transferred portion of the collateral as with the aggregate indebtedness and aggregate collateral, it should properly be considered that "the collateral for the loan is not changed." If a transfer meets both these conditions and the indebtedness is not increased, the transferee bank may, pursuant to section 3(e) of the regulation, accept the transfer "without following the requirements of this regulation as to the making of a loan."

Nonexcepted loans made for the designated purpose before May 1, 1936. - The other type of case involves indebtedness that is for the purpose of purchasing or carrying registered stocks, that is not excepted by section 2 of the regulation, but that was incurred prior to May 1, 1936.

It will be noted that the provision of section 1 of the regulation quoted above with respect to the treatment of aggregate indebtedness and aggregate collateral as a unit does not apply to indebtedness incurred prior to May 1, 1936. In the case of such an old loan, therefore, identification of the loan and the collateral therefor, all or part of which are to be transferred, should be made on the basis of the practice which the transferor bank and the borrower have consistently followed in good faith in dealing with the loan. Any indebtedness which has been treated as constituting a single loan, and collateral which has been treated as having loan value for the purposes of that loan and as not having loan value for other purposes, should be considered as a unit, and they should be so considered without regard to a customers' agreement under which collateral for one loan secures another.

If the entire amount of such an old loan thus identified is to be accepted by the transferee bank pursuant to section 3(e), it should be accompanied by all the collateral which, as indicated above, has been treated as having loan value for the purposes of the loan and as not having loan value for other purposes. If a portion of such a loan is to be accepted by the transferee bank pursuant to section 3(e), it should be accompanied by the proper proportion of the collateral which has been so treated, so that the collateral would not be changed, i.e., the ratio of loan value to indebtedness is the same with the transferred portion of the indebtedness and transferred portion of the collateral as with the indebtedness originally treated as a single loan and the collateral treated as having loan value only for the purposes of that loan.

3. Determination of Facts Regarding Transfer of Loan.

A question is also presented as to the method which a transferee bank may use to determine whether or not the conditions necessary for the transfer of a loan pursuant to section 3(e) are being followed. Specifically, the question is raised whether the transferee bank may rely upon a signed statement of the borrower or the transferor bank which it accepts in good faith to determine these facts.

As in the case of a number of other facts that are relevant to operations under the regulation, no specific method of determining these facts is required. The requirement is that the bank operate diligently and in entire good faith, and in doing this it may utilize various methods for ascertaining the facts in particular cases. As one method of determining

the facts in connection with the transfer of a loan, a transferee bank would be justified in relying upon a signed statement of the borrower or the transferor bank which the transferee bank accepts in good faith.

Very truly yours,

(Signed) Chester Morrill

Chester Morrill,
Secretary.