S-441
Reg. D-15

INTERPRETATION OF LAW OR REGULATION

(Copies to be sent to all Federal Reserve Banks)

February 21, 1942

Mr. __________, First Vice President,
Federal Reserve Bank of ___________,
________________, _______________.

Dear Mr. _______:

This refers to your letter of August 8, 1941, with enclosures, requesting the Board's opinion as to whether the balance in a "differential account" set up in connection with certain proposed contracts for the purchase of instalment paper by the Bank of _______, gives rise to a deposit liability against which reserves must be carried with the Federal Reserve Bank. As you know, since the receipt of your letter, this matter has been the subject of correspondence between Mr. Wyatt, the Board's General Counsel, and Mr. _____, General Counsel for your Bank, who has given it careful consideration in consultation with representatives of the Bank of _______.

While the four proposed forms of contracts enclosed with the bank's letter of July 29, 1941, vary somewhat in language because of their different subject matter, it is understood that all of such contracts may be regarded as having the same effect in so far as the present question is concerned. It appears that under these contracts the bank would purchase instalment paper at a price less than the face amount of the paper and that at the time of the purchase the dealer would be credited with the amount of the purchase price and full title to the paper would pass to the bank. Under the agreement, no further amounts would be credited to the dealer until "an amount in excess of the purchase price, plus ___% per annum computed monthly of the unpaid balance of the amount paid by the bank for such paper, is realized by the bank"; and any excess so realized would be applied first to satisfy any past due indebtedness of the dealer to the bank arising under the contract or otherwise, and any balance then remaining would be paid or credited to the dealer.

In practice, it is understood that the transaction is handled in the following manner. At the time of the purchase, in order to maintain a record of payments, the bank sets up what is termed a "differential account" representing the difference between the face amount of the paper and the purchase price. As monthly collections are made on the face amount of the paper, any amount realized in excess of the proportionate monthly part of the purchase price (plus the agreed interest or discount) is paid over to the dealer; and at the same time the differential account is reduced by the amount of such additional payment. As a result, the differential account at all times represents a certain percentage of the unpaid balance.

As you know, the Board had under consideration in 1938 a case involving somewhat similar facts. In that case it appeared that a national bank, in connection with its purchase of instalment paper from dealers, required each dealer to set aside out of the proceeds of the paper and carry with the bank in a "special reserve account" a certain percentage of the face amount of the paper or of the unpaid balance thereon. The bank was authorized to charge this account with any losses sustained in the collection of the paper discounted for the dealer or as the result of any other indebtedness incurred by the dealer. In a letter dated March 22, 1938 (S-81; F.R.L.S., #5978), the Board ruled that the amounts held in such a special reserve account, not being segregated from the other assets of the bank, should be regarded as deposits against which reserves must be carried with the Federal Reserve Bank.

In the case now under consideration it appears that the so-called differential account constitutes merely a current record of the excess of the unpaid balance of the face amount of the paper over the unpaid balance of the agreed purchase price. Under the terms of the contract, the bank is under no liability to the dealer for the amounts credited to the differential account until actually collected. In the case considered by the Board in 1938, it was understood that the bank at the time it acquired the notes gave the dealer credit for the full face amount thereof but set aside an agreed percentage of this amount as a special reserve fund which was not available to the dealer until after full payment of the paper. In this respect, therefore, it is believed that the present case may be distinguished from the case above mentioned.

On the basis of the facts as outlined above, and without undertaking to approve specific forms of contracts, the Board has reached the following conclusions:

1. If the purchase price of the paper is credited to the dealer's account, the resulting credit obviously is a deposit against which reserves must be maintained.

2. The uncollected difference between the purchase price and the face amount of the paper is in practical effect a potential margin of security and does not constitute a deposit against which reserves must be maintained.

3. Where, however, an instalment payment has been received and a portion of such payment (say 90 per cent) has been credited against the purchase price and the remainder (say 10 per cent) has not been credited against the purchase price, the 90 per cent of the payment which has been applied against the purchase price does not constitute a deposit balance, but the remaining 10 per cent of the payment does constitute a deposit unless and until it is paid over to the dealer or applied against his indebtedness.

4. Whenever the payments received on any paper purchased aggregate an amount in excess of the purchase price plus interest or discount, any such excess which is not paid over to the dealer or credited against his indebtedness likewise constitutes a deposit against which reserves must be maintained.

Very truly yours,
(Signed) L. P. Bethea
L. P. Bethea,
Assistant Secretary.