## Lending Junctions Of The Jederal Reserve Banks: A History

Board of Governors of the Federal Reserve System

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Howard H. Hackley May 1973

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## **Foreword**

This book represents a revision and updating of an unpublished version that was mimeographed in April 1961. The earlier version was prompted by a 1955 revision of the Board's Regulation A; the present version was prompted by the 1973 revision of that regulation.

I make no apology for the length and technical nature of the book nor for the seemingly disproportionate space given to long-forgotten matters, such as the many Board interpretations during the 1920's and the chapter dealing with the obsolete authority of the Federal Reserve Banks to make working capital loans to business. This is necessary to achieve the objective of presenting a comprehensive history of the lending functions of the Federal Reserve Banks.

Following tradition, I must include here a statement that, unless otherwise indicated, any opinions expressed in this book are my own and are not to be attributed to the Board of Governors or to any member of the Board or its staff.



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## Introduction

#### STATEMENT OF OBJECTIVE

Many scholarly treatises have been written about the Federal Reserve System. In general, they have dealt with the System's vital functions in the field of monetary and credit policy or with its important responsibilities in the field of bank regulation and supervision. Writers on the subject have, of course, referred to the provisions of Federal law under which the System operates, but usually—and naturally any such references have been only incidental, or at least secondary, to economic or banking considerations. This study is based on the reverse approach. It is not primarily concerned with economic and banking considerations (the writer is neither an economist nor a banker); it is concerned primarily with legal considerations, and any references that must be made to economic and banking matters are purely incidental and secondary.

In brief, the strictly limited objective of this study is to trace the *legal* history of the lending functions of the Federal Reserve Banks: the nature of the original statutory authority of the Federal Reserve Banks to make loans; the reasons for which that authority was given to the Reserve Banks by Congress; how and why the authority has been changed, expanded, or

For NOTES AND REFERENCES, see p. 249.

modified by subsequent statutes; the nature of regulations on this subject that have been issued by the Board of Governors of the Federal Reserve System (generally referred to as the Federal Reserve Board, or the Board); how the Board has interpreted the law; and how the law has been construed and applied by the courts.

Warned by this prospectus, the non-lawyer may, forgivably, wish to read no further. Much of what follows may be regarded as technical and therefore dull. Perhaps only a few will share the writer's feeling that the legal development of the lending authority of the Federal Reserve Banks is in many respects an intensely interesting subject. In any event, it is conceivable that some useful purpose may be served by this historical discussion of the statutes, regulations, interpretations, and court decisions that lie behind and are directly related to the important part that the lending functions of the Reserve Banks have played in the economy of the Nation for some 60 years.

# DISTINCTION BETWEEN RESERVE BANK LOANS AND COMMERCIAL BANK LOANS

It is essential to preface this study with a brief indication of the differences between loans that are made by the Federal Reserve Banks and those made by ordinary commercial banks.

In the first place, there are differences in the manner in which Federal Reserve Banks and commercial banks are organized and in the purposes for which they are operated. A commercial bank may be organized by a few individuals either as a State bank or as a national bank, depending upon whether the organizers choose to comply with the requirements of the applicable State banking laws or with those of the National Bank Act, a Federal statute originally enacted in 1863. Consequently, the number of commercial banks is limited only by the inclination of individuals to organize them and by the willingness of the State banking authorities—in the case of State banks—and of the Comptroller of the Currency—in the case of national banks—to approve their organization. Like other private ventures, the number of such banks is influenced by public demand for their services and by the forces of competition. As of December 31, 1972, there were 13,928 commercial banks in the United States.

In contrast, the Federal Reserve Banks were established by a 1913 Act of Congress known as the Federal Reserve Act, and under that Act their number was limited to 12, each Reserve Bank serving a geographical district of the country. All national banks in the United States are required to be stockholders; banks organized under State laws may voluntarily become stockholders, subject to approval by the Board of their applications for membership in the Federal Reserve System. As of December 31, 1972, there were 5,705 commercial banks that were members of the System; of these, 4,613 were national banks and 1,092 were State member banks.

Any individual or corporation may be a stockholder of a commercial bank; the stock of such banks normally is acquired for purposes of investment or control. The return on an investment of this kind depends in large part upon the earnings received by the bank on its loans and investments. Stock of a Federal Reserve Bank, on the other hand, is not acquired as an investment or for control. The ownership of such stock is merely a prerequisite to membership in the Federal Reserve System.

The stock pays only a fixed statutory dividend, regardless of the earnings of the Reserve Bank. It does not entitle member banks to all the rights that usually appertain to ownership of stock in private corporations. If a Reserve Bank should be liquidated, all of its assets-after payment of debts, accrued dividends, and the amounts paid in by member banks on their stock subscriptions-would become the property of the United States. Moreover, although member banks are authorized by the law to participate in the election of six of the nine directors of a Federal Reserve Bank, the affairs of the Reserve Bank are administered by its directors under the supervision of the Board of Governors of the Federal Reserve System, an independent Government agency.

From these differences between commercial banks and Federal Reserve Banks stems one of the fundamental distinctions between commercial bank loans and Reserve Bank loans. Commercial banks make loans for profit—to all comers and for all conceivable purposes. Although loans made by the Federal Reserve Banks bear interest, they are made not for profit but for a public purpose; in general they are made only to banks that are members of the Federal Reserve System. It is for this reason that the Reserve Banks have often been called bankers' banks.

Quite apart from differences in organization and purpose, an important distinction between loans made by Reserve Banks and those made by commercial banks is that the lending operations of the Reserve Banks, often referred to as the Federal Reserve discount window, constitute a channel through which Federal Reserve credit policies can be implemented. When a Reserve Bank makes a loan to a member bank, the result is an increase in the reserves that the member bank carries with its Reserve Bank. Consequently, the member bank has more funds with which to extend credit to its own customers. Without attempting an explanation here, a Reserve Bank loan to a member bank makes possible a multiple expansion of credit the degree of which depends upon the percentage of required reserves against deposits prescribed by the Federal Reserve Board at the time. It is for this reason that credit created by Federal Reserve action, whether extended through the discount window or through purchases of securities in the open market, is sometimes referred to as "high-powered" dollars.

As just indicated, Federal Reserve credit can be provided to the banking system through purchases by the Reserve Banks of Government obligations and other securities in the open market. Open market operations of the Reserve Banks, however, are conducted at the initiative of the Reserve Banks under the direction of the Federal Open Market Committee. They do not come within the scope of this study since we are concerned here only with the credit extended by the Reserve Banks to member banks—and other borrowers—because of the borrower's need for credit and at the borrower's initiative.

The Reserve Banks also in effect extend credit to their member banks when they give credit to member banks for checks—in accordance with the Federal Reserve Banks' time schedule—before the amount of the checks is actually received by the collecting Reserve Bank. This form of Federal Reserve credit is known as "float." Again, however, it is not within the scope of this study.

## SIGNIFICANCE OF RESERVE BANK LOANS

A discussion of the nature and purposes of the Federal Reserve System is beyond the scope of this study. In general, as indicated in the preamble to the Federal Reserve Act, it may be said that the System was the outgrowth of a feeling that the country's financial system required a more elastic currency, a better mobilization of bank reserves, and more effective supervision of commercial banks. It is quite clear, however, that the so-called discount provisions of the Federal Reserve Act have been regarded as among its most important provisions and that access to the credit facilities of the Reserve Banks continues to be the chief

reason for membership in the Federal Reserve System.

The Federal Reserve Act was based in large part upon an intensive study of the banking system made by a National Monetary Commission appointed by Congress. In its final report of January 9, 1912,1 that Commission listed 17 defects in the then-existing banking system. Six of them related to the need for a wider market for commercial paper. The Commission deplored the lack of adequate means available to commercial banks for replenishing their reserves or increasing their lending powers, the "congestion of loanable funds in great centers," the inability of farmers and others to secure the credit they required, and the "marked lack of equality in credit facilities between different sections of the country."

Congress concurred in the Commission's opinion that the lending authority of the proposed Federal Reserve Banks was of paramount importance. The House Banking and Currency Committee referred to the creation of a market for commercial paper as one of the "essential features of reform" 2 and stated that the discount function was the "fundamental business purpose" of the legislation.3 The House committee felt that the new legislation would "entirely transform the conditions under which paper is bought and sold, loans contracted between banks, and funds transferred from one part of the country to another." 4 The Senate Banking and Currency Committee was unanimous in its opinion that one of the fundamentals of the legislation was "the promotion of an open discount market." 5 During the debates on the bill, one Congressman referred to the discount section as "the most important section of the bill." 6 This feeling was reflected by the fact that the preamble of the Act, as finally passed, stated that one of its purposes was "to afford means of rediscounting commercial paper."

The importance of the lending or discount functions of the Federal Reserve Banks has varied from time to time since 1913, depending upon prevailing economic conditions. In the early years of the System, these functions had all of the significance envisaged by the framers

#### 4 HISTORY OF LENDING FUNCTIONS

of the Federal Reserve Act. During the 1920's they were particularly important as a means of meeting the credit needs of agriculture; and during the economic depression of the early 1930's, they were instrumental in meeting the requirements of business enterprises. Thereafter, for a long period, the lending authority of the Federal Reserve Banks dwindled in importance. Between 1951 and 1959 there was some increase in the use of the discount window. Since 1959 member banks have made little use of their privilege of borrowing from the Reserve Banks except during periods of unusual stringency, as in the early weeks of 1973 when daily-average borrowings by member banks reached the highest level since the 1920's. Nevertheless, despite such marginal and periodic use of the discount window, it constitutes an ever-available source of short-term credit to member banks that cannot always be provided from other sources and it can still be used as an important, even though secondary, instrument for the effectuation of Federal Reserve credit policies.

#### SCOPE OF THIS STUDY

The provisions of the original Federal Reserve Act regarding loans by the Federal Reserve Banks were relatively brief. In a few paragraphs, section 13 of the Act merely authorized the Reserve Banks to discount for their member banks commercial paper with maturities of not more than 90 days, agricultural paper with maturities of not more than 6 months, and bankers' acceptances arising from import or export transactions with maturities of not more than 3 months. Over the years these original provisions have been expanded and supplemented by numerous amendments to the law. In 1916, acceptances growing out of domestic shipments and the storage of staple goods, as well as dollar-exchange acceptances, were made eligible for discount, and the same act authorized the Reserve Banks to make 15-day advances to member banks on their own notes secured by eligible paper or Government bonds. The Agricultural Credits Act of 1923

substantially expanded the authority of the Reserve Banks to discount agricultural paper. In 1932. Congress conferred upon the Reserve Banks new authority to make emergency discounts for individuals, partnerships, and corporations, and to make advances to member banks on any satisfactory security, although at a penalty rate of interest. In 1933, direct advances to individuals, partnerships, and corporations on the security of Government obligations were authorized, and the maturity of advances to member banks on eligible paper was increased to 90 days. The reasons for these and many other amendments to the discount provisions of the statute, as reflected in committee reports and congressional hearings and debates, are one of the major subjects of this study.

The statutory history of the provisions of the Federal Reserve Act relating to Reserve Bank loans is embodied in Appendix A to this study. By reference to that appendix, one may determine how a particular provision read in the original Federal Reserve Act or when it was added to that Act by subsequent statute, exactly how the language of the provision has been changed, if at all, by later enactments of Congress, and how the provision reads today.

Along with the development of the statutory authority of the Reserve Banks in the lending field, the Federal Reserve Board, acting under authority conferred by the law, has been called upon to issue, modify, and revise regulations governing the exercise of that authority. The Board's first regulation related to this subject and, although it has been changed many times, it is still identified as Regulation A. With each major change in the law, the regulation has had to be modified in one or more respects. Sometimes the regulation has been changed to eliminate or relax certain regulatory requirements. On a few occasions, changes have been made to reflect shifts in Federal Reserve policy as to the appropriate use of the discount window. An account of these regulatory changes forms another part of the present study. The text of the Board's present Regulation A, as substantially revised in 1973, is set forth in Appendix B; the related provisions of Regulation C, regarding bankers' acceptances, constitute Appendix C.

In addition to regulations, the Board from time to time has issued interpretations of the provisions of the law with regard to the discounting authority of the Federal Reserve Banks. Most of them have been published in monthly issues of the Federal Reserve Bulletin. Board rulings on this subject were especially numerous during the 1920's when extensive use was made by member banks of the discount facilities of the Reserve Banks. Such rulings constitute an important aspect of a legal history of the lending functions of the Reserve Banks.

In a few instances the discount provisions of the Federal Reserve Act have been the subject of judicial interpretation, and to that extent court decisions are also embraced within the scope of this history. During the early years of the System, the Reserve Banks were involved in litigation growing out of questions as to the legal rights and liabilities of parties to paper discounted with the Reserve Banks, and while these cases related chiefly to the general law of negotiable paper and not to the construction of provisions of the Federal Reserve Act, they are briefly summarized in Appendix D.

It is with all of these phases of the legal development of the lending authority of the Federal Reserve Banks that the present study is concerned. Obviously, they impinge upon the economic aspects of the subject. It would be most unrealistic to ignore the fact that the purposes of the Federal Reserve Act were essentially of an economic nature and that changes in the law have been occasioned by changes in economic conditions or economic thinking. For example, it was a drop in farm prices following World War I and an acute demand for agricultural credit that led to amendments to the statute in 1923 to liberalize the authority of the Reserve Banks to discount agricultural paper. It was a movement to promote foreign trade that led to a broadening of the authority to discount bankers' acceptances; and it was the depression of the early 1930's that prompted drastic amendments to the law to provide Federal Reserve credit to nonmember banks and business enterprises. Moreover, the fixing of discount rates has long been recognized as one of the three major instruments through which the Federal Reserve System effectuates national credit and monetary policies.

Nevertheless, as has already been indicated, it is the aim of this study to tell the story of the development of the lending functions of the Federal Reserve Banks from the lawyer's rather than the economist's point of view, with emphasis upon statutory provisions and their legislative history, regulations, rulings of the Board, and court decisions. If anything here written suggests an opinion as to economic or credit policy, it is wholly unintentional and, in any event, incidental.

It should be borne in mind that this study is intended to be a history of the System's lending activities. As such, it is not limited to present law and regulations; it covers all enactments of Congress since 1913 and all regulations and published rulings issued by the Board since that time, even though many of them were later repealed, revoked, or superseded. For example, all of Chapter 11 relates to working capital loans to business under a section of the law that was added in 1934 and repealed in 1959.

#### ARRANGEMENT

A strictly chronological account of the development of the lending functions of the Federal Reserve Banks would be disconnected, complicated, and confusing. At the same time, it seems desirable to show how these functions have gradually expanded over the years. Accordingly, whether rightly or wrongly, the writer has compromised between a chronological and a topical treatment of the subject. Each major aspect of the lending authority of the Reserve Banks is dealt with in a separate chapter according to the type of loan involved, although the chapter may cover the entire period of the System's existence, but the topics of the various chapters are arranged roughly in the order in which they assumed importance

#### 6 HISTORY OF LENDING FUNCTIONS

chronologically. Thus, while advances on Government bonds were authorized in 1916, it was not until 1932 that advances to member banks—as distinguished from discounts of eligible paper—attained real significance; consequently, the chapter dealing with such advances follows those dealing with agricultural credits and bankers' acceptances.

In the two chapters immediately following this introductory chapter consideration will be given to the general nature and purposes of the discount provisions of the original Federal Reserve Act and to certain general limitations imposed on the lending authority of the Federal Reserve Banks. The 10 succeeding chapters deal with the different categories of loans made by the Reserve Banks, some of them no longer of great significance and some no longer even authorized by present law. The study concludes with chapters covering discount rates and the relation of the discount mechanism to national credit policy and, finally, with a summary of general principles governing the extension of Federal Reserve credit.



## The Original Discount Provisions

#### LEGISLATIVE HISTORY

#### DEVELOPMENT OF THE FEDERAL RESERVE ACT

With its final report of January 9, 1912, the National Monetary Commission submitted a draft of proposed legislation that became known as the "Aldrich bill," after the name of the Commission's Chairman, Nelson Aldrich. That bill would have provided for a National Reserve Association with authority to rediscount paper for commercial banks. Although the Commission's plan for a central authority was later discarded in favor of a regional system of Federal Reserve Banks, the essential feature of its plan—the discounting of paper issued or drawn for "agricultural, industrial, or commercial purposes"—was carried over into the Federal Reserve Act.

The bill that was eventually enacted, though with many changes, was H.R. 7837. It was introduced by Chairman Carter Glass of the House Banking and Currency Committee on August 29, 1913. Often referred to as the

For NOTES AND REFERENCES, see p. 249.

"Glass bill," it was reported by the House Banking and Currency Committee on September 9, 1913, and it was passed by the House on September 18.

The Senate Banking and Currency Committee split into two sections. On November 22, 1913, it reported two bills without recommendation. The Democratic section, headed by Chairman Owen, reported a bill that generally followed the Glass bill, although with some important differences. The Republican section, led by Senator Hitchcock, submitted a separate draft that became known as the "Hitchcock bill." On December 1, a substitute bill was offered on the floor of the Senate by Senator Owen. It was generally similar to the original Owen bill, but it included some features of the Glass bill. It was passed by the Senate on December 19.

With some changes, the Owen substitute bill was adopted by the conference committee. The conference report was agreed to by the House on December 22 and by the Senate on December 23. On the latter date the bill became law with President Wilson's signature.

# DIFFERENCES AMONG THE DISCOUNT PROVISIONS OF VARIOUS BILLS

Insofar as the discount provisions were concerned, the general objectives of all of the competing bills were the same. All of them authorized the proposed Federal Reserve Banks to discount for member banks paper arising out of commercial transactions, and all provided for the discounting of acceptances drawn to finance the importation or exportation of goods.

In certain respects, however, the Glass, Owen, Hitchcock, and Owen substitute bills reflected differences, some of a minor nature and some that gave rise to sharp debate and controversy.

The principal differences related to (1) the general maturity of paper eligible for discount, (2) the kinds and maturities of bankers' acceptances that might be discounted, (3) whether member banks should have a right to obtain discounts, and (4) whether advances might be made on any satisfactory securities.

With regard to maturity, the Glass bill fixed a maximum of 90 days, but with permission for the discounting of paper with maturities of from 90 to 120 days in certain circumstances. The Owen bill prescribed a maturity of not more than 90 days, without any exceptions. The Hitchcock bill would have allowed maturities of up to 120 days, provided that not more than half the paper discounted for any member bank had a maturity of more than 90 days and provided also that no member bank had more than \$200,000 of rediscounts with maturities longer than 90 days.

With respect to bankers' acceptances, the Glass bill permitted only the discounting of acceptances growing out of the importation or exportation of goods, whereas the Owen and Hitchcock bills would have also covered acceptances drawn to finance domestic shipments of goods. On the other hand, the Glass bill would have permitted 6-month maturities for acceptances, whereas the Owen bill would have limited such maturities to 3 months and the Hitchcock bill would have fixed a 6-month maximum for acceptances arising from the

importation or exportation of goods and a 4-month maximum for those arising from domestic shipments.

The Hitchcock bill would have given a member bank an absolute right to obtain discounts up to the amount of its capital stock. Under the other bills, the discounting of paper was left to the discretion of the Reserve Banks, although the Owen bill contained a provision that required the Reserve Banks to extend credit with due regard "for the claims and demands of other member banks."

The Owen and Hitchcock bills would have authorized advances on the direct obligations of member banks secured by satisfactory securities, and this authority was in the bill as it passed the Senate. No such authority was contained in the Glass bill.

#### RESOLUTION OF DIFFERENCES

In one way or another, these differences were eventually resolved. As to maturity, the conference committee adopted the flat 90-day maximum of the Owen bill, but with an exception of 6 months for agricultural paper. Authority to discount bankers' acceptances was limited, as in the Glass bill, to those arising from foreign shipments. The compulsory discount proposal and the suggestion for direct advances on satisfactory securities were both rejected, but only after considerable debate. As will be seen later in this study, some of these matters were reconsidered by Congress in the years that followed. For example, the proposal to authorize bankers' acceptances covering domestic shipments was adopted in 1916, and many years later, in 1932, Congress finally authorized direct advances to member banks secured "to the satisfaction" of a Federal Reserve Bank, but only with a penalty rate of interest.

#### THE FINAL PROVISIONS

In its final form, the original Federal Reserve Act gave the Federal Reserve Banks authority: (1) to discount for their member banks paper arising out of actual commercial transactions, that is, paper issued or drawn for agricultural, industrial, or commercial purposes, with the

definition of such paper left to the determination of the Federal Reserve Board; (2) to discount bankers' acceptances based on the importation or exportation of goods; and (3) to rediscount the discounted paper of other Federal Reserve Banks if permitted or required by the Federal Reserve Board.

Limitations on this authority were imposed as follows: (1) Discounted paper was required to be endorsed by the discounting member bank, with a waiver of demand, notice, and protest; (2) paper discounted was required to have a maturity at the time of discount of not more than 90 days, except that a maturity of not more than 6 months was allowed for agricultural paper and of not more than 3 months for bankers' acceptances; and (3) the aggregate amount of paper of any one borrower discounted for a member bank was limited to 10 per cent of the member bank's capital and surplus.

All discounts were made subject to such regulations, limitations, and restrictions as might be prescribed by the Federal Reserve Board. Discount rates were required to be established from time to time by each Federal Reserve Bank, subject to review and determination by the Board.

Incidental provisions of the Act authorized member banks to accept paper growing out of the importation or exportation of goods and amended the National Bank Act to except from the limitations imposed on the aggregate indebtedness of national banks any liabilities "incurred under the provisions of the Federal Reserve Act," that is, liabilities incurred on paper discounted with the Federal Reserve Banks.

Finally, in section 4 of the original Federal Reserve Act, the board of directors of each Federal Reserve Bank was required to administer the affairs of such Bank "fairly and impartially and without discrimination in favor of or against any member bank" and to extend to each member bank such discounts, advancements, and accommodations as might be "safely and reasonably made with due regard for the claims and demands of other member banks."

These were the discount provisions of the original Federal Reserve Act. Essentially, they constitute the basis for the lending powers of the Reserve Banks today, except for the important additions in later years of authority to make advances to member banks on the security of Government obligations or on any paper eligible for discount or for purchase by the Reserve Banks, authority to make advances to member banks at a penalty interest rate on any satisfactory security, and authority to extend credit in exceptional circumstances to individuals, partnerships, and corporations.

#### **BASIC PURPOSES**

## CREATION OF A MARKET FOR COMMERCIAL PAPER

One of the basic purposes of the original Federal Reserve Act, as stated in its preamble, was "to afford means of discounting commercial paper." The National Monetary Commission had emphasized the need for a wider market for commercial paper. The House Banking and Currency Committee, in its report on the Federal Reserve bill, stated that the first fundamental feature of reform was: 1

Creation of a joint mechanism for the extension of credit to banks which possess sound assets and which desire to liquidate them for the purpose of meeting legitimate commercial, agricultural, and industrial demands on the part of their clientele.

Similarly, the Senate Banking and Currency Committee asserted that one of the chief purposes of the legislation was to "make available effective commercial credit for individuals engaged in manufacturing, in commerce, in finance, and in business to the extent of their just deserts"; the committee also referred to the fundamental necessity of "establishing an open market for liquid commercial bills, by providing through the reserve banks a constant and unfailing market for such bills at a steady rate of interest." <sup>2</sup>

#### PREVENTION OF PANICS

With the financial panic of 1907 still fresh in their minds, various Congressmen repeatedly expressed the view that the discounting authority of the Federal Reserve Banks would serve to prevent the recurrence of similar panics. Thus, in the House, it was alleged that the Federal Reserve bill would provide banks with "sources of strength" in times of stress. In the Senate, likewise, Senator Swanson regarded the bill as one that made "impossible another panic in this country." 4

#### **EXPANSION OF BUSINESS**

The market for commercial paper provided by the bill was considered to be not only a prophylactic against panics but also a means of enabling banks in normal times to expand their business. Congressman Phelan stated: <sup>6</sup>

\* \* \* In times of stress, when a bank needs cash, it can obtain it by a simple process of rediscounting its paper with the Federal reserve banks. Many a bank will thus be enabled to get relief in time of serious need. Moreover, if a bank desires to expand its business, it may do so far beyond its present capacity by this rediscounting process. Suppose, for instance, a bank has \$1,000,000 in deposits and \$120,000 in reserves. Under such conditions the bank can not further extend its loans because of the legal-reserve requirements. Under such circumstances, by taking \$12,000 of its paper to the Federal reserve banks and rediscounting it, it can increase its reserves by \$12,000. An increase in its reserves of \$12,000 increases its loaning power by \$100,000. By this very simple process the bank is enabled to increase its loans and extend its accommodations to its patrons.

It is significant to note from this statement that the expansionary effect of Federal Reserve credit was recognized. In fact, some Congressmen feared that the discount provisions of the bill would be inflationary. Chairman Carter Glass of the House Banking and Currency Committee agreed, but contended that it would be a "wise expansion." <sup>a</sup>

#### BENEFIT TO COUNTRY BANKS

It was felt that the creation of a market for commercial paper through the rediscounting authority of the Reserve Banks would particularly benefit the country banks. There were some, it is true, who doubted this and believed that country banks had very little paper that they could discount and that, therefore, the rediscount provisions would be "valueless" to them.7 The majority, however, were convinced that these provisions would result in the creation of a "competitive money market for the country banks"; such a market would eliminate the necessity for country banks to go to New York for funds and thereby tend to reduce interest rates.8 It was contended that the rediscount section of the bill would "come to the relief of every small bank in the United States," that it would "break down the tyranny of the money power in the great centers," and that the small banker, having the same discount facilities as the big bank, would "be freed from his dependency upon the big banks and be able to serve his customers according to his own judgment, subject only to reasonable supervision by the Government board." 10

It was recognized that the traditional reluctance of banks to borrow would need to be overcome. The House committee noted that such a prejudice had "more or less artificially sprung up." 11 Mr. Phelan conceded that banks were "very much averse" to discounting their paper with other banks and that such rediscounting had been regarded as "a sign of weakness"; but he believed that with the enactment of the Federal Reserve Act, rediscounting would be regarded, "as it should be, as an ordinary and proper part of a bank's business." 12 Similarly, Senator Norris felt that the prejudice of bankers against rediscounting paper would pass away, and Senator Smoot expressed the view that while the change would

be gradual, the feeling about rediscounting would be "changed materially" if the bill should become law.<sup>13</sup>

#### LESSENING OF SPECULATION

There was a general feeling at the time of the original Federal Reserve Act that the creation of a market for commercial paper through the rediscounting authority of the Federal Reserve Banks would have the incidental advantage of tending to lessen speculation. Thus, the National Monetary Commission had described one of the defects of the banking system as follows: 14

The narrow character of our discount market, with its limited range of safe and profitable investments for banks, results in sending the surplus money of all sections, in excess of reserves and local demands, to New York, where it is usually loaned out on call on Stock Exchange securities, tending to promote dangerous speculation and inevitably leading to injurious disturbances in reserves. \* \* \*

Senator Owen explained how the absence of a ready discount market had led to the use of bank funds for stock speculation: 15

Mr. President, one of the most far-reaching results which will follow will be the abatement of the nuisance of the national menace of the stock-gambling operations in this country, because this measure proposes to gradually withdraw these reserves, which have heretofore been pyramided in the three great central reserve cities. I call the attention of the Senate to the peculiar situation in which a banker in a Federal reserve city finds himself. \* \* \* He has no great public utility bank in this country to which he can go for credit. He has no open discount market in this country. He can not convert quickly into cash his liquid commercial bills. The only place that he can get his resources quickly in cash is upon the stock market. Therefore these men have been forced by the conditions surrounding them to lend money by hundreds of millions upon the stock exchange. \* \* \*

It was expected that the ability of banks to obtain credit from the Reserve Banks would help to halt the use of bank funds for speculation in stocks. In addition, however, it was deemed desirable that the new law include an express prohibition against the rediscount by the Reserve Banks of paper drawn for the purpose of trading in stocks. All of the principal bills involved in the evolution of the Federal Reserve Act contained a provision to the effect that paper eligible for discount should not include notes or bills "issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities." In the Senate, an exception was made, for obvious reasons, with respect to bonds and notes of the United States. With this sole exception, the injunction against discounting paper drawn for stock investment purposes became, and has ever since remained, a qualification on the discount authority of the Federal Reserve Banks.

It was emphasized in the debates on the original Act that this provision had the effect of "withdrawing the privilege of the act from stock-exchange transactions." <sup>16</sup> The provision was referred to as "one of the splendid provisions of the bill." <sup>17</sup> It was regarded as prohibiting "the resources of these reserve banks being used for the purposes of stock speculation." <sup>18</sup>

#### ELASTIC CURRENCY

In addition to its deterrent effect on speculation, the creation of a market for commercial paper was regarded as having a direct relation to another stated purpose of the Federal Reserve Act, namely, "to furnish an elastic currency." It was expected that member banks would obtain currency from the Federal Reserve Banks by discounting short-term commercial paper. As such paper was paid off, the currency would automatically return to the Federal Reserve Banks, thus causing the amount of currency in circulation to fluctuate with the varying needs of business, agriculture, and commerce.

Mr. Phelan explained the relation between the proposed discounting of commercial paper and the elasticity of Federal Reserve notes as follows: <sup>19</sup>

Based upon commercial paper as security, these notes increase and decrease with the demands of commerce. As more currency is needed the want is supplied by the deposit of more commercial paper as security and the issuance of more notes. As all this paper is of short maturity, other commercial paper must in a short time be deposited as security in the place of the paper which matures. As business slackens the amount of commercial paper diminishes and Federal reserve banks will return Federal reserve notes to be destroyed instead of putting up new commercial paper as security.

At another point during the House debates, Mr. Beakes explained how the elastic quality of a Federal Reserve note was expected to operate: 20

\* \* \* Its elasticity is secured in this way: It is issued to a bank needing it when they present as much of their current paper to be rediscounted as they call for in currency. All of the paper so discounted matures within 90 days, and so within 90 days as much money will be back in the reserve banks as was issued in currency. \* \* \* Thus is elasticity secured in the currency of each local community and the volume of currency outstanding expands and contracts as the business needs of each community require.

A similar concept was expressed in the Senate by Senator Hollis: 21

\* \* \* They [the Federal Reserve Banks] may rediscount for member banks promissory notes, based on genuine commercial paper, which are payable in 90 days. \* \* \*

Loans and rediscounts for member banks will ordinarily be made from the funds deposited as reserves and by the Government, but if funds are getting low any reserve bank may apply to the reserve agent for the district for reserve notes. \* \* \*

The Federal reserve board will pass upon the application for reserve notes and, if it approves the application, the reserve agent will deliver to the reserve bank United States reserve notes to the face of the commercial paper put up with him as collateral.

The transaction will then stand as follows:

A member bank has obtained currency from its reserve bank by rediscounting commercial paper. \* \* \*

The reserve bank has replenished its funds by putting up with the reserve agent, say, \$100,000 in amount of commercial paper, and has received \$100,000 in United States reserve notes. These reserve notes are loaned to it by the Government, and it may hold them, loan them, or invest them. In this way the currency is expanded, but no faster than the needs of business require, as shown by the amount of commercial paper offered for rediscount.

The commercial paper put up with the reserve agent as collateral for the reserve notes will become due from time to time, and the payers will transmit the funds through the member banks and the reserve banks in gold, reserve notes, or lawful money to the reserve agent. He will take the cash, surrender the particular piece of collateral, and lock the proceeds up for future transactions.

#### SECONDARY OBJECTIVES

While it is proper to say that the primary objective of the original discount provisions was to provide a wider market for commercial paper that would meet the credit needs of business and at the same time tend to lessen speculation and contribute to an elastic currency, it should also be borne in mind that the discount provisions of the original Federal Reserve Act had two secondary but important objectives. One was to afford special credit assistance to farmers; the other was to encourage foreign trade by establishing a market for bankers' acceptances. Both of these objectives were clearly evidenced in the committee reports and congressional debates on the original Act. They will be discussed in detail in subsequent chapters of this study.

## **General Limitations**

#### **MATURITY**

#### INTRODUCTION

The various types of loans made by the Federal Reserve Banks will be considered separately in subsequent chapters, along with the special limitations and restrictions placed by the law upon each type of loan. There are three general limitations, however, that might be discussed before dealing with specific limitations applicable to particular kinds of loans. In the first place, there are maturity limitations both with respect to the discounting of paper and to direct advances; second, there are limitations as to the amount of the paper of any one person that may be used as a basis for a Federal Reserve loan; and, third, the law requires that all discounted paper be endorsed by the discounting member bank. As a fourth general limitation, all discounted paper was required until 1970 to be negotiable. Unfortunately, consideration of these general limitations will plunge us immediately into some of the most complicated and technical aspects of the lending authority of the Reserve Banks.

For NOTES AND REFERENCES, see pp. 249-51.

The first of the general limitations has to do with the maturity of paper eligible for discount by the Reserve Banks. With but one exception, the original Federal Reserve Act required all discounted paper to have a maturity of not more than 90 days at the time of discount. The single exception was agricultural paper, which was permitted to have a maturity of not more than 6 months. As will be noted in a later chapter, this exception was made even more liberal in 1923. Another exception was provided in 1932 when the law was amended to authorize advances to member banks for periods of up to 4 months, but only at a penalty rate of interest. In 1934 another amendment provided for working capital loans to business enterprises with maturities as long as 5 years, but that authority expired in 1959.

By and large, the 90-day maturity prescribed by the original Federal Reserve Act has consistently been adhered to as the legal limitation on the maturity of all Federal Reserve loans except discounts of agricultural paper—not only with respect to rediscounts of eligible paper but also with respect to advances to member banks on their secured notes. In actual practice, maturities have been even shorter. Following the general principle that member bank borrowings should normally be only for the purpose of temporary adjustments in their reserve positions, extensions of Federal Reserve credit are usually made only for a period of a few days.

In subsequent chapters, more detailed attention will be given to the maturity limitations imposed on special types of paper. At this point it is worthwhile to consider briefly why and how the basic 90-day limitation was adopted by the framers of the original Federal Reserve Act, subject to the one exception for agricultural paper.

## REASONS FOR 90-DAY LIMITATION

That the paper to be discounted by the Federal Reserve Banks should be short-term paper was a corollary of the premise that such paper should arise out of actual commercial transactions. In its report on the original Federal Reserve Act, the Owen section of the Senate Banking and Currency Committee—after observing that, according to European banking practices, paper based on commercial transactions of short maturities was regarded as "self-liquidating" and "almost the exact equivalent of cash"—proposed that the Reserve Banks be permitted to discount "commercial bills and acceptances of the qualified liquid class." 1

The House committee report on the original Act stated: 2

\* \* \* The limitation of business which is proposed in the sections governing rediscounts, and the maintenance of all operations upon a footing of relatively short time will keep the assets of the proposed institutions in a strictly fluid and available condition, and will insure the presence of the means of accommodation when banks apply for loans to enable them to extend to their clients larger degrees of assistance in business.

In addition to enabling the Reserve Banks to meet demands for credit, a short maturity was considered desirable because the discounted paper was expected to be the basis for an elastic currency. It was conceded that long-term paper might be fully as sound as short-term paper, but it was argued that long-term paper was not so suitable as a basis for an asset currency. On the floor of the House, Mr. Borland stated: <sup>3</sup>

\* \* ° The asset currency provided for in the Glass bill is secured upon current commercial transactions which liquidate themselves within a comparatively short time without undue pressure on the borrower. The difference between short-time paper and long-time paper is not the difference in its intrinsic soundness, but a difference in what the bankers call its liquid character.

The critical question was just how short maturities should be in order to make the paper liquid. Based on the practice of European banks, the conclusion was reached that a maturity of 90 days was the most reasonable. Senator Shafroth explained: 1

\* \* \* When we look around in the history of the world we find that there are banks of this kind; that is, discount banks; and when we find that in England the paper must run only 28 days, when we find that in France it runs but 26 days, when we find that in Germany it does not exceed 90 days, and that there is no bank in the world which discounts paper in excess of 90 days, does it not become us, in the interest of caution, to say that until it is demonstrated the other way we had better adhere to 90-day paper?

#### AGRICULTURAL PAPER

It was recognized, however, that a 90-day maturity requirement might not be adequate in all cases, especially with respect to agricultural paper. Hence, in addition to 90-day maturities, the House Banking and Currency Committee allowed a Federal Reserve Bank to discount paper with a maturity of up to 120 days provided (1) that its own cash reserve exceeded one-third of its outstanding liabilities, other than Federal Reserve notes, by an amount fixed by the Federal Reserve Board, and (2) that not more than half the paper discounted for

any particular member bank had a maturity of more than 90 days. The committee felt that this provision would "fulfill the requirements of portions of the country with an extremely long term of credit." <sup>5</sup>

In explaining the bill on the floor of the House, Chairman Glass sought to refute the contention that the 90-day maturity requirement would render the discount provisions of no use to the farmer. He stated, first, that there had been some misapprehension as to the meaning of the 90-day provision and explained that it did not mean the paper had to have an original maturity of not more than 90 days but only that it could not be discounted until it was within 90 days of maturity; and, second, that even if a country bank at certain seasons should find its funds tied up in longer-term paper, it could take advantage of the 120-day provision of the House bill and be in a position "to take six months' paper as soon as it was two months old to a Federal Reserve bank and rediscount it."

Nevertheless, there were Congressmen from the farm belt who thought that the maturities allowed by the Glass bill were not sufficiently long to accommodate agricultural loans. Mr. Norton of North Dakota introduced an amendment to increase the normal maturity limit from 90 to 120 days and the exceptional maturity (when the Reserve Bank would have reserves in excess of one-third of its liabilities) from 120 days to 6 months. His proposal, however, was rejected.

In the Senate, agitation for a longer maturity for agricultural paper met with more success. The Owen bill was severe, requiring a 90-day maturity at the time of discount in all cases and with no exception. The Hitchcock bill, however, was more liberal. It provided that discounted paper should have a maturity of not more than 180 days, with two qualifications: not more than half of the paper discounted for any member bank could have a maturity of more than 90 days, and in no case could a member bank have more than \$200,000 of rediscounts with a maturity longer than 90 days. By way of justification, Senator Hitchcock said: <sup>0</sup>

The six months' paper is just as legitimately a commercial paper as is the 90-day paper of the East, where the processes of manufacturing and mercantile business are perfected in 90 days, and the man who gives his note for 90 days is able to pay it out of the proceeds which come from the sale of his property, his stock. In the West the man who buys cattle to feed during the winter months and borrows money for the purpose of buying them is not able to meet his paper in 90 days, but at the end of six months his paper is liquidated just as naturally, just as fully, and just as freely as is the mercantile and manufacturing paper of the East. \* \*

Proponents of the Owen bill defended the 90-day provision of that bill. They argued that even the country banks would always have a substantial amount of paper maturing within 90 days; <sup>10</sup> that a maturity of 90 days had been found adequate in Europe; <sup>11</sup> and that under a special provision of the Owen bill, a bank under certain circumstances could discount its own 90-day obligations secured by longer-term paper of farmers.<sup>12</sup>

These arguments failed to satisfy the farmbelt Senators. They protested that the 90-day requirement was discriminatory against the country banks and pointed to the fact that the bill allowed a maturity of 6 months in the case of foreign acceptances.<sup>13</sup>

An amendment to the Owen bill proposed by Senator Hitchcock to increase the required maturity from 90 to 180 days was defeated.14 In the end, however, Senator Owen himself offered an amendment to his substitute bill. The amendment, while retaining the basic 90day limitation, permitted the discounting of paper drawn for agricultural purposes or based on livestock if the paper had a maturity of not more than 6 months; the amount of such discounts was limited to a certain percentage of the capital of the Federal Reserve Bank, which percentage was to be fixed by the Federal Reserve Board. This amendment was agreed to by the Senate.15 Subsequently, it was accepted by the conference committee and became a part of the original Act.

Thus, the net effect was adoption of the 90day limitation as a general rule, with a more liberal maturity requirement for agricultural paper.

To avoid confusion, it is important to bear in mind—as Carter Glass pointed out in the debates—that the 90-day limitation applies to the maturity of paper at the time of discount, not to the original maturity of the paper. For example, member banks are authorized to accept drafts and bills with maturities of up to 6 months, but bankers' acceptances not drawn for agricultural purposes are eligible for discount by the Reserve Banks only if they have a maturity of not more than 90 days at the time of discount.

#### DAYS OF GRACE

Only one slight change has been made in the 90-day maturity requirement since it was originally enacted. In 1916 the requirement was modified to exclude days of grace from the computation of the 90-day period as well as from the longer-maturity requirement applicable to agricultural paper. The amendment was made on the recommendation of the Federal Reserve Board, which had pointed out that some States provided for days of grace in the payment of obligations. The states are the payment of obligations.

#### REGULATIONS

The Board's discount regulations have never done more than paraphrase the 90-day requirement of the law itself. In 1915 the Board's Regulation B stated simply that, to be eligible for discount, commercial paper "must have a

maturity at the time of discount of not more than 90 days." 15 This provision was retained in a 1916 revision of Regulation A,19 but with an exclusion of days of grace in accordance with the amendment to the law enacted in that year. A similar provision was contained in Regulation A, as revised in 1955,20 but a footnote stated that advances to member banks are normally made for periods of not more than 15 days. That footnote was eliminated in 1968.21 The 1973 revision of the regulation provided that paper eligible for discount must have "a period remaining to maturity of not more than 90 days." It also eliminated the reference to exclusion of days of grace, but this was presumably in the interest of simplicity and without intending to modify the statutory exclusion of days of grace.

#### **DEMAND PAPER**

In 1917 the Board ruled that demand paper was not eligible for discount because, at the option of the holder, it might be held and not presented for payment until after 90 days.<sup>22</sup> This ruling led to an amendment to the law in 1923 making demand or sight drafts eligible for discount if drawn to finance shipments of agricultural staples.

In 1966 the Board reconsidered and reversed its 1917 ruling. The Board pointed out that, as a matter of law, demand paper is due and payable on the day of issue. Therefore, it concluded that such paper satisfies the maturity requirements of the statute and that, if it meets other eligibility requirements, demand paper is eligible for discount and as security for advances by the Reserve Banks.<sup>23</sup>

#### **AMOUNT**

#### AGGREGATE AMOUNT

Apart from special provisions with respect to agricultural paper and bankers' acceptances, the Federal Reserve Act has never placed any limit upon the total amount of credit that may be extended by the Reserve Banks either to any one member bank or to all member banks.

The National Monetary Commission had suggested in 1912 that, in order to provide a safeguard against possible abuses, the aggregate amount of paper rediscounted for any bank should be limited to the amount of its capital stock.<sup>21</sup> The framers of the Federal Reserve Act, however, apparently believed that discounts should be limited only by the amount of short-term commercial paper available for discount. Mr. Glass emphatically stated that no limitation on the aggregate amount that could be discounted for member banks was intended.<sup>25</sup> As a matter of fact, there were some who felt that the volume of eligible paper available for rediscount might not be sufficient to support the contemplated issuance of Federal Reserve notes.<sup>26</sup>

Senator Hitchcock, however, was disturbed by the lack of any limit on the amount of paper that the Federal Reserve Banks might discount. He felt that there was a need for "some automatic check" on the amount of discounting and that, without restraints, excessive discounting might lead to inflation. He proposed, therefore, that discounts for a member bank in excess of its capital stock should bear a higher rate of discount and that in no event should a Federal Reserve Bank be permitted to discount paper for a member bank in an amount greater than twice the amount of the member bank's capital stock.<sup>27</sup> His proposed amendment for this purpose was tabled by a close vote of 37 to 31.<sup>28</sup>

After the Glass bill had been reported in the House, it was discovered that although no limitation on the amount of discounts had been contemplated by the committee, the amount of paper that a national bank could rediscount with a Federal Reserve Bank would nevertheless be limited to the amount of its capital stock by virtue of the existing provisions of section 5202 of the Revised Statutes. That section provided that the aggregate indebtedness of a national bank should not exceed its capital stock, except for certain specified kinds of liabilities such as circulating notes and liabilities to stockholders for dividends. These provisions of the National Bank Act would therefore have effectively limited the amount of paper that national banks could rediscount with the Federal Reserve Banks, whereas, as pointed out by Mr. Glass, State banks that became members of the System would not be similarly limited. It was noted that, actually, national banks would not be able to discount paper up to even 100 per cent of their capital because their liability for the unpaid part of their subscriptions to Federal Reserve Bank stock and also their liability on any acceptances they might make under the new law would be liabilities within the meaning of section 5202 of the Revised Statutes.<sup>29</sup>

In order to remove this limitation on the ability of national banks to rediscount paper with the Reserve Banks, an amendment was introduced on the floor of the House by Mr. Bulkley 30 to except from the provisions of section 5202 of the Revised Statutes "liabilities incurred under the provisions of sections 2, 5, and 14 of the Federal Reserve Act"; and after some debate the amendment was adopted.31 This provision was not contained in either the Owen bill or the Hitchcock bill as reported in the Senate; but it was incorporated in Senator Owen's substitute bill and, with the language modified to refer simply to "liabilities incurred under the provisions of the Federal Reserve Act," it was approved by the conference committee. It is still to be found in existing law.

#### PAPER OF ONE BORROWER

While the law does not limit the total amount of discounts that may be made by the Federal Reserve Banks, it has always included provisions restricting the amount of paper of one obligor that may be rediscounted for any member bank. It is important to note that this restriction relates not to the amount borrowed from the Reserve Bank by the member bank itself, but to the amount borrowed from the member bank by a customer of the member bank.

Section 13 of the original Act provided that the aggregate amount of notes and bills bearing the signature or endorsement of any one person, company, firm, or corporation rediscounted for any one bank should at no time exceed 10 per cent of the unimpaired capital and surplus of the member bank, but the restriction was made inapplicable to bills of exchange "drawn in good faith against actually existing values."

This general limitation on discounts by the Reserve Banks of paper of one person was considered to be in harmony with the then existing provisions of section 5200 of the Revised Statutes prohibiting a national bank from lending to any one borrower more than 10 per cent of the national bank's capital and surplus. However, the exception in the Federal Reserve Act provision for bills drawn against actually existing values was not contained in the national bank provision. Describing it as a new feature that had long been called for in the interest of legitimate business transactions, the report of the House Banking and Currency Committee stated: <sup>32</sup>

\* \* \* Obviously when a bill of exchange is secured by bills of lading and other documents accompanying it, it is primarily dependent for liquidation upon this unquestionably marketable wealth. There is therefore no reason for limiting the amount of the discount to be granted by any reference to the resources of the person applying for the accommodation or by the capital and surplus of the bank granting the discount, that being merely a question of banking judgment, while the bill itself is salable and will presumably be protected at the point where it is presented.

It was soon found, however, that even the general 10 per cent limitation was not in all respects the same as the limitation imposed by section 5200 of the Revised Statutes on loans made by a national bank to one borrower. Section 5200 limited the amount of a customer's liability "for money borrowed," whereas under the Federal Reserve Act a bill otherwise eligible for discount was rendered ineligible by the extra or additional endorsement of some third person who had already borrowed from the member bank up to the statutory limit, even though the obligor on the bill had not himself borrowed up to the limit. At the Board's suggestion,33 section 13 was amended in 1916 to make the limitation applicable to the aggregate amount of paper bearing the signature or endorsement of "any one borrower," rather than "any one person, company," and so forth, thus bringing it in line with the national bank limitation.31

Another discrepancy arose from the fact that under an exception contained in section 5200 of the Revised Statutes, a national bank could acquire "actually owned" commercial or business paper from the same person in excess of the 10 per cent limitation, while a Federal Reserve Bank under section 13 of the Federal Reserve Act could not rediscount such paper unless it consisted of bills of exchange drawn "against actually existing values." 35 The Board in 1916 suggested to Congress that this provision of section 13 be amended to except actually owned commercial and business paper, as well as bills of exchange drawn against actually existing values.36 This suggestion was not acted upon at that time. In 1917, however, when certain provisions of section 9 of the Act were being revised to make membership of State banks more attractive, a new provision was inserted in that section that conformed to the Board's recommendation. According to this provision, State banks joining the System would retain their full charter and statutory rights under State law, provided in general that no Federal Reserve Bank could discount for a State member bank any paper of any person who had borrowed from such bank an amount greater than 10 per cent of the bank's capital and surplus. However, there were two exceptions: Bills drawn against actually existing values or against actually owned commercial or business paper were not to be considered as borrowed money.37

While this amendment met the Board's point as to the exception of actually owned business or commercial paper, it nevertheless gave rise to a conflict between the new provision in section 9—applicable only to State member banks—and the old provision of section 13—applicable ostensibly to all member banks but actually only to national banks—with national banks gaining an unintended advantage over State member banks. This advantage arose for the following reasons.

Under section 5200 of the Revised Statutes, a national bank could make loans to a single borrower in excess of the general 10 per cent limit by discounting certain excepted types of paper described in that section, such as notes secured by shipping documents, warehouse receipts, and other documents covering readily marketable staples and notes secured by bonds

of the United States. Consequently, a national bank could have outstanding loans to a single customer represented by notes of the kinds just described in excess of the 10 per cent limitation, and a Federal Reserve Bank, under the provision of section 13, could rediscount the paper of that customer for the national bank up to 10 per cent of the national bank's capital and surplus. On the other hand, because of the language of the provision of section 9 of the Act that had been added in 1917, if a State member bank with the same amount of capital and surplus had made loans to one of its customers in the same amount and represented by the same kinds of paper, the Reserve Bank would be prohibited from rediscounting for the State member bank any of that customer's paper.38

To remove this inconsistency, Congress in 1922 again amended the limitation in section 9 to provide simply that a Reserve Bank should not discount for a State member bank the paper of any one borrower who was liable for borrowed money to that bank "in an amount greater than that which could be borrowed lawfully from such State bank or trust company were it a national banking association." 39 This meant that thereafter a State member bank that had made loans to one borrower in excess of its capital and surplus but on the security of, for example, warehouse receipts covering readily marketable staples or notes secured by Government bonds would not be precluded from offering paper of that borrower as a basis for rediscount.

Nevertheless, there were still significant discrepancies between the provisions of sections 9 and 13. In the first place, the amount limitation in section 13 was subject to only one exception—bills of exchange against actually existing values. However, the limitation in section 9 was clearly subject to all of the exceptions provided in section 5200 with respect to loans by national banks to one borrower. This meant, strangely enough, that paper representing loans to a single borrower that was permitted for a national bank under section 5200 was eligible for discount if offered by a State member bank but was not eligible if offered by a national bank.

In the second place, both the Comptroller of the Currency in interpreting section 5200 and the Federal Reserve Board in construing section 13 had held that the limitations on loans to one borrower applied only to direct liabilities such as those of a maker or acceptor, and not to indirect liabilities such as those of a drawer, endorser, or guarantor. The McFadden Act in 1927 amended section 5200 to make its limitations expressly applicable to the indirect liability of a drawer, endorser, or guarantor; but section 13 was not similarly changed.

Both of these inconsistencies were corrected by the Act of April 12, 1930,<sup>43</sup> which amended the provision of section 13 so that, like the provision of section 9, it referred specifically to the limitations on loans to one borrower contained in section 5200 of the Revised Statutes. As thus amended, section 13 stated: <sup>44</sup>

The aggregate of notes, drafts, and bills upon which any person, copartnership, association, or corporation is liable as maker, acceptor, indorser, drawer, or guarantor, rediscounted for any member bank, shall at no time exceed the amount for which such person, copartnership, association, or corporation may lawfully become liable to a national banking association under the terms of section 5200 of the Revised Statutes, as amended; Provided, however, That nothing in this paragraph shall be construed to change the character or class of paper now eligible for rediscount by Federal reserve banks.

This provision has not been changed since 1930. Literally, it permits a member bank to rediscount with a Federal Reserve Bank as much paper of a single borrower as a national bank is permitted to acquire from a single borrower under section 5200 of the Revised Statutes. The latter section has been amended on a number of occasions to provide additional exceptions to the 10 per cent limitation (there are now 13 of them); but a discussion of the provisions of that section is beyond the scope of this study.

As being of historical interest, it may be noted that in March 1919 Congress amended section 11(m) of the Federal Reserve Act to authorize the Federal Reserve Board, upon the

affirmative vote of five members, to permit the Federal Reserve Banks to discount for any member bank paper of one borrower in excess of 10 per cent of its capital and surplus, but not to exceed 20 per cent, if the amount exceeding 10 per cent were secured by bonds or notes or certificates of indebtedness of the United States.<sup>45</sup> Presumably, this was a postwar measure to encourage bank holdings of Government bonds. By its own terms, the provision became inoperative after December 31, 1920.

The Board's discount regulations in general have paraphrased the provisions of the law limiting the amount of paper of any one borrower that may be discounted for a member bank, with successive revisions of Regulation A reflecting changes in the statutory provisions. As revised in 1955, the regulation set forth the substance of the provisions of both section 13 and section 9 of the Federal Reserve Act: limiting the aggregate amount of paper of any one person discounted for any member bank to the amount for which such person could lawfully become liable to a national bank, and forbidding a Federal Reserve Bank to discount for any State member bank paper of any one borrower who is liable to such bank for borrowed money in an amount greater than could be borrowed lawfully from such bank if it were a national bank.46

A literal reading of the law and of these provisions of Regulation A meant that a Reserve Bank could discount for a national bank paper of one borrower in an amount up to the amount that the national bank was permitted to lend to a single borrower under section 5200 of the Revised Statutes, but that a Reserve Bank could not discount for a State member bank any of the paper of one borrower if the amount exceeded the amount that a national bank could lend to a single borrower. The absurdity of this distinction was recognized by the Board in an unpublished letter to a Federal Reserve Bank in 1966 when, notwithstanding the statutory provisions, the Board held that a Reserve Bank could not "discount for any member bank, national or State, any obligation of a borrower who is liable to such member bank in an amount greater than that which

could be borrowed lawfully from a national bank in the circumstances of the particular case." This position was in effect incorporated in Regulation A by an amendment in 1970 that provided that any member bank requesting Reserve Bank credit shall be deemed to represent and guarantee that, except as to credit granted under section 10(b) of the Federal Reserve Act, "as long as the credit is outstanding no obligor on paper tendered as collateral or for discount will be indebted to it in an amount exceeding the limitations in section 5200 of the Revised Statutes, which for this purpose shall be deemed to apply to State member as well as national banks." 47

Even with this amendment, the regulation continued to provide, inconsistently, that the aggregate amount of paper of one borrower discounted for any member bank should at no time exceed the amount that such person could borrow from a national bank under section 5200 of the Revised Statutes. The general revision of Regulation A adopted by the Board in 1973 eliminated this inconsistent provision of the regulation. It did, however, continue in effect the language of the provision added in 1970 under which any member bank applying for credit is deemed to guarantee that no obligor on paper offered as collateral or for discount will be indebted to it in an amount exceeding the limitations prescribed by section 5200 of the Revised Statutes.

On a number of occasions the Board has published interpretations of the statutory limitations on the amount of paper of one borrower that may be discounted, but only a few of the more important need be mentioned here.

Before the limitations in section 13 of the Federal Reserve Act were amended in 1930 to conform to those of section 5200 of the Revised Statutes, the only exception, as has been seen, was that with respect to bills drawn against actually existing values. However, when section 5200 was changed in 1919 to except paper secured by shipping documents and bankers' acceptances of the kinds described in section 13 of the Federal Reserve Act, the Board expressed the opinion that both of these kinds of paper might be regarded as bills drawn against

actually existing values and therefore as excepted from the discount limitations of section 13.48

Since the 1930 amendment to section 13 conforming its limitations to those prescribed by section 5200 of the Revised Statutes, the Board in applying section 13 has followed interpretations made by the Comptroller of the Currency under section 5200. Thus, notes of farmers for the purchase of agricultural implements, which had been interpreted by the Comptroller to constitute actually owned commercial or business paper within the meaning of section 5200, were similarly held by the Board to be exempt from the amount limitation set forth in section 13.40

Although the limitation with respect to the discounting of paper of a single borrower literally applies only to rediscounts for member banks, the Board in 1938 took the position that, in order to comply with the spirit of the law, a Federal Reserve Bank, in making advances to a member bank secured by eligible paper as well as in discounting paper, should not acquire paper upon which one person is liable in an aggregate amount in excess of the 10 per cent limitation. 50 At the same time, however, the Board expressed the opinion that advances under section 10(b) of the Federal Reserve Act on the security of any satisfactory collateral should not, in view of the purposes of that section, be subject to any limitation of this kind. These interpretations—the applicability of the limitation to advances as well as to rediscounts and the inapplicability of the limitation to advances under section 10(b)—were subsequently incorporated in Regulation A. The first interpretation was clearly justified, but today one might question why advances under section 10(b) to a national bank should be permitted to be secured by any paper of a single borrower in an amount greater than that which could be borrowed from the national bank under section 5200 of the Revised Statutes.

In 1934 Congress amended section 9 of the Federal Reserve Act to provide that, for purposes of membership of any State bank in the System, the terms "capital" and "capital stock" should include capital notes and debentures issued by such bank and purchased by the Reconstruction Finance Corporation (RFC).51 On the theory that the RFC was authorized to purchase such capital notes and debentures in order to provide capital funds to banks, the Board held that, for purposes of various provisions of the Act, capital notes and debentures of a bank bought and held by the RFC should be treated as capital stock; and that among these provisions were those of sections 9 and 13 of the Federal Reserve Act limiting the discounted paper of one borrower to 10 per cent of the discounting member bank's capital stock and surplus.52

In concluding this section, it is appropriate to observe that, quite apart from the statutory limitations on discounting paper of one borrower, a Federal Reserve Bank, in determining whether to discount paper for a particular member bank, may properly take into consideration the total amount of paper of the same borrower that has been discounted for other member banks. In the early days of the System the Board publicly stated that it was "both lawful and proper" for a Reserve Bank to place an aggregate limit on the amount of the paper of any one borrower that it would discount for all of its member banks, and that a policy of declining to receive more than a certain proportion of the paper of a particular borrower was not itself a discrimination but a general and conservative policy applicable to all member banks alike.53

### **ENDORSEMENT**

#### **PURPOSE**

In addition to general limitations on maturity and amount, the Federal Reserve Act imposed a third limitation that was designed to afford the Reserve Banks some protection against possible loss on paper discounted by them—a requirement that the paper be endorsed by the discounting member banks.

During the debates on the original Federal Reserve Act there was evidence of some confusion between eligibility for discount and the soundness of the paper discounted. In general, however, it was agreed that, even though particular paper was eligible for discount, a Reserve Bank would still have a right to determine whether the paper was "good" and to inquire into the solvency of the maker. The requirement for endorsement by the borrowing member bank was the one statutory requirement aimed at assuring the soundness of the loan. The report of the House Banking and Currency Committee stated: 55

The fundamental requirement throughout all of the discount section of the proposed bill is that antecedent to the performance of a service by a Federal reserve bank for a member bank which applies therefor the member bank shall indorse or guarantee the obligations which it offers for rediscount.

During the House debates Mr. Phelan asserted that discounted paper would be "gilt-edge paper, entirely safe" because, after passing the scrutiny of the member bank that had made the original loan, it must then pass the scrutiny of the Federal Reserve Bank and, in addition, have the endorsement of the member bank.<sup>56</sup>

# WAIVER OF PROTEST

To further protect the Reserve Banks and to avoid trouble and expense, Congress adopted a requirement, originally contained only in the Hitchcock bill, that a member bank's endorsement must be accompanied by a waiver of demand, notice, and protest. During the debates Senator Nelson explained that if the Reserve Banks "were in every instance required to protest those notes it would cause them great expense, and they would have to present them for payment and protest them at the local bank where they were payable." <sup>57</sup>

#### **REGULATORY PROVISIONS**

The Board's first discount regulation, in listing the requirements to be met by all paper offered for discount, stated: 58

First. It must be indorsed by a National or State bank or trust company which is a member of the Federal reserve bank to which it is offered for rediscount.

Second. Such bank must, with its indorsement, waive demand, notice and protest.

A 1915 revision of the regulation provided simply that discounted paper "must be indorsed by a member bank, accompanied by a waiver of demand, notice, and protest." 59

Among certain technical amendments made to section 13 of the Federal Reserve Act by the Act of September 7, 1916,60 the requirement for endorsement was changed to provide that paper might be discounted by a Federal Reserve Bank "upon the indorsement of any of its member banks, which shall be deemed a waiver of demand, notice and protest by such bank as to its own indorsement exclusively." This meant that the act of endorsement by a member bank constituted, without more, a waiver of demand, notice, and protest as to its own endorsement. Consequently, all subsequent revisions of Regulation A have provided only that paper offered for discount must be endorsed by a member bank, with no specific reference to waiver of demand, notice, and protest.

# FORM AND EFFECT OF ENDORSEMENT

With respect to the form of the required endorsement, the Board ruled that it was sufficient if the discounted paper bore the simple written endorsement of the discounting member bank; <sup>61</sup> and that it was even permissible for the endorsement to be on a separate but attached piece of paper, a so-called allonge. <sup>62</sup>

As previously indicated, the purpose of the endorsement requirement is to provide a Federal Reserve Bank with a certain measure of protection against loss. According to the law, the member bank's mere endorsement carries with it a waiver by that bank of the right it would otherwise have to deny liability in the absence of notice, demand, and protest. The effect is to make the member bank primarily liable on the paper so that the Reserve Bank does not have to proceed first against the maker or prior endorsers. The Reserve Bank is given the advantage of "a right to proceed against the bank that indorses the paper." <sup>63</sup>

It is important to observe again that endorsement by a member bank is not an essential prerequisite to the eligibility of paper for discount; it is simply a condition precedent to the discount of eligible paper. Thus, under the authority to make advances to member banks on their own notes secured by paper eligible for

discount or purchase by the Federal Reserve Banks, a Reserve Bank may make such advances on notes secured by paper that is not endorsed by the member bank.64 In such a case, the Reserve Bank relies on the member bank's own note; the additional endorsement of the paper securing the note would provide no further protection. For many years, loans by the Reserve Banks to member banks have been made not through the rediscounting of eligible paper, but through advances on the notes of member banks secured by eligible paper or by Government securities or other securities eligible for purchase by the Reserve Banks. As a result, the endorsement requirement of the law no longer has any great significance.

A distinction should also be made between endorsement as a requirement for discount and endorsement in connection with purchases of paper by the Reserve Banks under section 14 of the Federal Reserve Act. Under the latter section, bills of exchange and bankers' acceptances are expressly made eligible for purchase by the Reserve Banks with or without the endorsement of a member bank.

### **NEGOTIABILITY**

#### REGULATORY REQUIREMENT

The law itself has never required that paper discounted by the Federal Reserve Banks be negotiable paper. However, one of the earliest versions of the Board's discount regulations 65 defined the terms "promissory note" and "draft or bill of exchange" in language that, under the Uniform Negotiable Instruments Law, had the effect of prescribing negotiability as a requirement for discount; and from 1923 until 1970 Regulation A specifically provided that any paper offered for discount "must be a negotiable note, draft, or bill of exchange." 66 This meant not only that discounted paper had to be negotiable but also that any eligible paper offered as security for direct advances to member banks likewise had to meet the test of negotiability.

#### **EXCEPTIONS**

Only two exceptions were made to the regulatory requirement for negotiability before that requirement was eliminated. In 1942, Regulation A was amended to except from this requirement paper evidencing war production loans guaranteed by the War and Navy Departments and the Maritime Commission pursuant to the V-loan program of World War II; 67 this exception was broadened in 1944 to cover loans similarly guaranteed pursuant to the Contract Settlement Act. 68 After the war, the exception was eliminated,60 but in 1951 it was restored to make negotiability unnecessary for paper representing defense production loans guaranteed by Government agencies under the Defense Production Act of 1950.70

The other exception from the negotiability requirement related to notes evidencing loans made pursuant to commodity loan programs of the Commodity Credit Corporation and subject to a commitment to purchase by that Corporation. An amendment to Regulation A providing for such an exception was adopted by the Board in 1949.<sup>11</sup>

It should be noted that, under section 10(b) of the Federal Reserve Act, the Reserve Banks may make advances to member banks on any satisfactory security—but at a penalty interest rate—whether paper offered as security is negotiable or nonnegotiable.

#### MEANING OF NEGOTIABILITY

In general, an instrument is negotiable if it evidences an unconditional promise or order to pay, on demand or at a fixed or determinable future time, a certain sum of money to order or bearer. In the final analysis, the question whether a particular note or draft is negotiable is a matter for determination by the courts in the light of applicable provisions of State law. Negotiability is governed by Article III of the Uniform Commercial Code, which has been adopted in all States except Louisiana.

This is not the place for a discussion of the various elements of negotiability. It may be noted, however, that, in administering the discount provisions of the Federal Reserve Act, the Board undertook during the early years of the System to express opinions as to whether particular instruments were negotiable and therefore eligible for discount. In general, these opinions related to whether the paper involved was "unconditional," or was payable at a "fixed or determinable" future time, or provided for payment of a "certain" sum of money.

For example, the Board expressed the opinion that bills were not unconditional—and therefore were nonnegotiable—if they were payable out of the proceeds of an import or export transaction; <sup>72</sup> but that negotiability was not affected either by a provision authorizing the consignee of goods to inspect the goods before accepting a draft covered by a bill of lading <sup>73</sup> or by an endorsement exempting the endorser from responsibility for the genuineness of an

accompanying bill of lading.74 With respect to certainty of time of payment, the Board ruled that drafts payable before a specified maturity date after 5 days' notice were negotiable; 75 that a draft "payable on arrival of car" was not negotiable; 76 and that a note providing for extensions of time should not be approved because of conflicting authorities as to the negotiability of such a note.77 As to certainty of amount, the Board ruled that a bill payable with collection charges is not negotiable 78 unless it is so drawn as to show that no collection charges are to be included unless the bill is dishonored at maturity; 70 but that negotiability is not affected by a provision for interest at a specified rate after maturity if payment is delayed. Fo However, because of conflicting court decisions, the Board in 1918 disapproved of trade acceptances that provided for a fixed discount if paid at a certain time before maturity.81

# ELIMINATION OF THE REOUIREMENT

When Regulation A was amended in 1942 to remove the negotiability requirement with respect to notes evidencing guaranteed V loans, the Board noted that the requirement of negotiability "was not a requirement of the Federal Reserve Act but had been placed in Regulation A as a means of protecting the Federal Reserve Banks against certain legal disadvantages of nonnegotiable paper." <sup>82</sup> In April 1970, the Board broke with tradition and eliminated the negotiability requirement from the regulation. <sup>83</sup>

This action was taken because of the belief that, while negotiability of paper afforded the Reserve Banks certain protection against loss in the event of default, most loans were being made in the form of advances on the notes of member banks themselves and the Reserve Bank could therefore proceed directly against the member bank in the event of default; thus, the importance of negotiability was diminished. In any event, it was felt that negotiability does not improve the underlying quality of the paper offered as security and that the Reserve Banks should not be precluded from accepting perfectly sound and otherwise eligible paper as

security for advances at the regular discount rate merely because it did not meet all of the technical requirements for negotiability. It was understood, however, that elimination of the regulatory requirement would not preclude a Reserve Bank in individual cases from declining to accept nonnegotiable paper for discount or as collateral for advances.



# Discount of Commercial Paper

# MEANING OF "COMMERCIAL PAPER"

#### INTENT OF THE ORIGINAL ACT

The principal objective of the discount provisions of the original Federal Reserve Act—to establish a market for commercial paper—was clearly reflected in the provision of section 13 of the Act that authorized the Reserve Banks to "discount" for their member banks "notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes." This chapter relates to discounting of what has generally been referred to as "commercial paper." Since agricultural paper has been accorded special treatment by the law, it will be considered separately.

Despite frequent statements of their purpose to create a market for commercial paper, the framers of the original Act were obviously not clear, except in a very general way, as to what was meant by commercial paper. They were agreed that it meant paper arising out of "actual commercial transactions"; that it meant paper

For NOTES AND REFERENCES, see pp. 251-53.

drawn, or the proceeds of which were to be used, for "agricultural, industrial, or commercial purposes"; that it included paper secured by "staple agricultural products"; and that it did not include paper drawn for the purpose of trading in stocks and bonds. They were also agreed that it meant "liquid" paper and paper with short maturities. All of these points of agreement were written into the law. The framers, however, made no further effort to define commercial paper; instead, they left to the Federal Reserve Board the authority and responsibility for making a more specific determination of the character of paper eligible for discount.

The report of the House Banking and Currency Committee stated: 1

\* \* \* In view of the great difficulty of defining "commercial paper," the actual definition of the same has been left to the Federal reserve board in order that it may adjust the definition to the practices prevailing in different parts of the country in regard to the transaction of business and the making of paper. \* \* \*

During the debates, Senator Weeks declared: 2

We asked a dozen or fifteen banking men to give us a definition which could limit the kind of paper which we wanted to cover by this definition of commercial paper, and no one of them did it. I do not know just exactly how the reserve board will finally conclude to define it, but I assume they will in some form, so that there will be no question about what eligible paper is.

Perhaps the best effort to explain the meaning of commercial paper was made by Mr. Phelan in the House. After noting that it must be short-time paper, he stated: <sup>3</sup>

\* \* \* Just what constitutes commercial paper it is impossible to define closely or strictly. The whole spirit of the bill and this section is, however, that the funds of the reserve banks shall be applied to the activities of business; first, because the funds of the reserve banks consist in large part of public money and of reserves; and, second, because the funds of commercial banks, both from a scientific banking and a practical standpoint, should be applied to commercial purposes. The whole spirit of the bill is that the funds of the reserve banks should be applied to the activities of business, commerce, and agriculture. It is impossible to define in a specific way just what notes and bills shall be eligible for rediscount. It is clearly defined in the bill, however, that the funds of reserve banks shall not be diverted from the channels of production and distribution. In order that there might be a broad and adaptable construction put upon the terms contained in section 14 [section 13 in the Act as passed], discretion as to their interpretation, in accordance with the spirit of the bill, is given the Federal reserve board. It is reasonable to believe that this board will exercise its discretion with wisdom and prudence.

There were a few members of Congress, such as Mr. Wingo, who questioned the desirability of allowing the Federal Reserve Board to determine what classes of paper should be eligible for discount. The majority, however, appeared to agree with Senator Weeks who stated that Congress, having required that paper arise from a commercial transaction, should "leave

it to the reserve board to make rules and regulations which will define the kind of paper which shall be accepted." 5

#### REGULATORY DEFINITION

The Federal Reserve Banks first opened their doors for business on November 16, 1914. Previously, the Board had decided that since it was not possible to formulate in advance a complete set of regulations to govern the operations of the Reserve Banks, it would "confine itself in the beginning to those matters which were deemed absolutely essential to setting the banks in motion upon a basis of reasonable efficiency." 6 The matter of discounting commercial paper came first. In its first Annual Report to Congress, the Board stated that it had felt "that the regulations relating to discount operations and commercial paper in general were fundamental and that they should be prepared and issued at once." 7 Accordingly, in a letter sent to the Reserve Banks on November 10, 1914,8 the Board outlined its views as to initial discount policy and transmitted five separate though brief regulations relating to the rediscounting of notes and bills and bankers' acceptances.

In its circular letter to the Reserve Banks, the Board referred to the uncertain effects of the war in Europe (in which the United States was not yet involved) and stated that the function of the Federal Reserve-Banks was of a twofold character: (1) They should extend credit facilities, particularly where the prevailing abnormal conditions had created emergencies demanding prompt accommodation; and (2) they should protect the gold holdings of the country in order that such holdings might remain adequate to meet demands made upon them. "While credit facilities should be liberally extended in some parts of the country," said the Board, "it would appear advisable to proceed with caution in districts not in need of immediate relief and to await the effect of the release of reserves and of the changes which the credit mechanism of the country is about to experience before establishing a definite discount policy."

The Board expressed the belief that it would be inadvisable to place a narrow or restrictive interpretation upon the character of paper eligible for discount. It did, however, prescribe three basic principles for the guidance of Federal Reserve Banks and member banks: (1) No bill should be discounted if its proceeds were to be applied to permanent investment; (2) maturities should be well distributed; and (3) bills should be "essentially self-liquidating." In explanation of the self-liquidating principle, the Board stated that discounted paper "should represent in every case some distinct step or stage in the productive or distributive process the progression of goods from producer to consumer. The more nearly these steps approach the final consumer the smaller will be the amount involved in each transaction as represented by the bill, and the more automatically self-liquidating will be its character."

The Board, in this first pronouncement on the subject of discounting, also called attention to the fact that single-name paper does not, like double-name paper, show on its face the character of the transactions out of which it arose. For this reason, the Board felt that it was incumbent upon each Reserve Bank "to insist that the character of the business and the general status of the concern supplying such paper should be carefully examined in order that the discounting bank may be certain that no such single-name paper has been issued for purposes excluded by the act, such as investments of a permanent or speculative nature."

As to procedure, the Board's circular letter stated that while it was not deemed essential that a statement of condition be attached to each bill, it was thought advisable that, after January 15, 1915, no paper should be discounted unless it bore on its face evidence that it was eligible for discount; and a rubber stamp for this purpose was suggested.

Appended to the Board's circular of November 10, 1914, was the Board's Regulation No. 2, which set forth in general the requirements to which all paper offered for discount must conform. Among other things, it was required that the paper offered "shall be in the form of notes, drafts, or bills of exchange arising out of commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial pur-

poses, or the proceeds of which have been used or are to be used for such purposes." Without attempting to elaborate further on the statutory language, the Board's regulation stated only that, under the law, paper drawn for the purpose of trading in stocks and bonds—other than Government bonds—or drawn merely for investment purposes was excluded from eligibility.

An effort to define more specifically the character of paper eligible for discount was made by the Board when, on January 25, 1915, it issued a new regulation, designated as Regulation B, relating to commercial paper. This regulation stated that, in order to be eligible, a bill must be one "the proceeds of which have been used or are to be used in producing, purchasing, carrying, or marketing goods in one or more of the steps of the process of production, manufacture, and distribution."

A year and a half later, in 1916, the Board issued a new series of its regulations. Regulation B was changed to cover open market purchases. Discount operations were covered by a revised Regulation A.11 It embraced not only discounts of commercial paper but also all other kinds of discounts under section 13 of the Federal Reserve Act, including discounts of agricultural paper, commodity paper, and bankers' acceptances that had previously been dealt with in separate regulations. The new regulation, however, made no substantial change in the general definition of commercial paper. It followed the language of the 1915 Regulation B already quoted except that, in referring to the production, purchasing, carrying, or marketing of goods, it defined the word "goods" in a footnote as including "goods, wares, merchandise, or agricultural products, including live stock."

The regulatory statement as to the general character of paper eligible for discount remained unchanged until 1920 when two changes were made in Regulation A. It was then provided that the proceeds of the paper must be used "in the first instance" for the purposes described, and it was expressly stated that eligible paper included paper the proceeds of which were used "for the purpose of carrying or trading in bonds or notes of the United States." 12

Two further changes were made in 1923.13

For the first time in the regulation itself, it was required that the paper be negotiable. In addition, it was provided that the name of a party to the underlying transaction should appear upon the paper "as maker, drawer, acceptor, or indorser." This requirement was eliminated when Regulation A was revised in 1937.14 The 1937 revision also eliminated a provision excluding paper the proceeds of which were used to finance third parties and expanded the definition of eligible paper to include paper the proceeds of which were used "in meeting current operating expenses of a commercial, agricultural or industrial business." As has been noted earlier, the negotiability requirement was removed in 1970.

Further changes of a liberalizing nature were made by the 1973 revision of Regulation A. In the first place, paper the proceeds of which are used for the "purchase of services" as well as for the purchase of goods was made eligible for discount. Of greater significance, this revision eliminated the long-standing prohibition against the discounting of paper the proceeds of which were used for permanent or fixed investments and provided only that the proceeds must not be used "merely for the purpose of investment, speculation, or dealing in stocks, bonds, or other such securities, except direct obligations of the United States." This important change will be discussed in more detail later in this chapter.

#### COMMERCIAL PURPOSE

The Board's regulatory definition of commercial paper, as indicated earlier, has been phrased in broad and general language. The meaning of the term can be better understood by considering particular instances in which the Board by interpretation has determined whether the paper offered for discount was actually drawn for a commercial purpose.

At an early date, the Board in a published statement <sup>15</sup> pointed out the distinction between (1) paper issued or drawn for a commercial or agricultural purpose and (2) paper the proceeds of which have been or are to be used for such purposes. As to the first, a note given by the buyer of goods to the seller is a

note issued or drawn for a commercial purpose, since "the purchase and sale of goods of any character is a commercial transaction from the standpoint of the seller," <sup>16</sup> and the note is eligible for discount as commercial paper, even though the goods may be in the nature of permanent or fixed investments. However, if the note is not given in a purchase-and-sale transaction, then the test of eligibility is the purpose for which the proceeds of the note are to be used.

In any case, it is the purpose of the original negotiation of the note that determines its eligibility. For example, a note given to a farmer in payment for grain purchased for resale is commercial paper even though the farmer subsequently discounts the note at his bank and uses the proceeds for an agricultural purpose, since the purpose of the original negotiation of the note was to finance the purchase and sale of goods, a commercial transaction.<sup>17</sup>

The above principles may be illustrated by additional particular cases. For example, notes given by dealers in payment for mules and cattle are commercial rather than agricultural paper.18 Similarly, the note of an irrigation company the proceeds of which are used for payroll and other current purposes in connection with the distribution of water to farmers constitutes commercial paper.19 When a railroad company, in order to purchase supplies, accepted the draft of the seller, the Board ruled that if the draft were discounted by the seller or a third party with a member bank, it would be eligible for rediscount with a Federal Reserve Bank; but if the railroad itself discounted the draft with its own bank, there would be a direct loan to the railroad and the draft would be eligible for rediscount only if the proceeds were used for a commercial purpose.20

It seems probable that the drafters of the original Federal Reserve Act contemplated that commercial paper would include only paper growing out of business transactions and would not embrace ordinary day-to-day purchases of goods and services by individuals for their own use. In 1937, however, the Board took the position that the purchase of goods, such as an automobile or a radio, for the use of the purchaser himself constitutes a commercial trans-

action. The eligibility of such consumer paper will be specifically considered in a later section of this chapter.

# SELF-LIQUIDATING NATURE

A basic concept underlying the discount provisions of the Federal Reserve Act was that commercial paper admitted to discount should be self-liquidating paper. In a published statement, the Board recognized this concept. It stated that paper eligible for discount was limited to "liquid" paper, "that is, paper which is issued or drawn under such circumstances that in the normal course of business there will automatically come into existence a fund available to liquidate each piece of paper, that fund being the final proceeds of the transaction out of which the paper arose." <sup>21</sup>

As an illustration, if the notes of a public service corporation will not be liquidated within a short time out of current assets accruing through ordinary earnings and the borrowing is really for capital purposes, such notes are ineligible; but, if the notes are given for supplies necessary to enable the corporation to sell services to the public for which the public will pay within 30 or 60 days, the notes are eligible for discount.<sup>22</sup>

In order to assure liquidity, the Board took the position that at least one of the parties to the commercial transaction out of which the paper arises should be obligated as maker, drawer, acceptor, or endorser.<sup>23</sup> Unless the proceeds will ultimately come into the hands of a person who is liable as a party to the paper, there is no assurance that the proceeds of the commercial transaction will be used to liquidate the paper. By the same token, the Board ruled that an equitable participation in a note could not be discounted because it did not represent a legal claim against the maker of the note.<sup>24</sup>

# EFFECT OF COLLATERAL SECURITY

In 1915, in its first comprehensive regulation regarding discounts of commercial paper, the Board stated that "the pledge of goods as security for a bill is not prohibited." <sup>25</sup> A more positive statement was made in the next revision of the regulation in 1916, in which it was provided that paper otherwise eligible "may be secured by the pledge of goods or collateral." <sup>26</sup> In 1920 the regulation made it clear that discounted paper could be secured by "collateral of any nature, including paper, which is ineligible for rediscount." <sup>27</sup>

The Board emphasized in a number of interpretations that eligibility of paper for discount does not depend upon whether it is secured or upon the character of any collateral security, but depends upon the purpose for which the paper is drawn or its proceeds used.<sup>28</sup> Thus, a note drawn for commercial purposes and otherwise eligible for discount is not rendered ineligible because it is secured by a mortgage on real estate.<sup>29</sup>

At the same time, it was recognized that the character of the collateral could have a material bearing upon the acceptability of the paper and its desirability as an investment.<sup>30</sup> The Board at an early date upheld the right of a Reserve Bank to refuse to discount paper not adequately secured.<sup>31</sup> The courts have judicially confirmed the authority of a Federal Reserve Bank to require additional collateral, including collateral that would not itself be eligible for discount.<sup>32</sup>

Perhaps because the question had been raised in the course of litigation, the Board in its 1937 revision of Regulation A expressly authorized the Reserve Banks to require such additional or marginal collateral as they might deem advisable or necessary for their protection.33 However, the regulation stated that a Federal Reserve Bank would be expected to consider the general effects that its action in requiring additional collateral might have on the position of the member bank involved, on its depositors, and on the community, and that in general a Reserve Bank should limit the amount of collateral it required "to the minimum consistent with safety." Moreover, if the additional collateral exceeded 25 per cent of the amount of an advance, the Reserve Bank was required to explain the circumstances to the Board. This latter requirement, however, was eliminated when the regulation was again revised in 1955. The regulation as revised in 1973 provides merely that, in making loans, a Federal Reserve Bank shall require only such amount of collateral as it deems necessary or advisable.

#### EVIDENCE OF ELIGIBILITY

In order to provide evidence of the eligibility of paper offered for discount, the Board in its first regulation on the subject provided that, until January 15, 1915, a Federal Reserve Bank might accept a statement from an officer of the applying bank, but that after that date every bill offered for discount should state on its face that it was eligible for discount and should refer to the number of the credit file in the possession of the member bank, which in turn would contain evidence of eligibility and also full information as to the financial responsibility of the borrower.34 Later, however, it was felt that member banks needed more time to familiarize themselves with the requirements of the law, and the Board, therefore, permitted the Reserve Banks to rely on a statement from an officer of the applying member bank until July 15, 1915.35

After that date, member banks were required to certify in their applications for discount that the paper offered by them was issued for one of the purposes mentioned in the statute. Also it was recommended that a member bank maintain a credit file containing statements of the financial condition of borrowers. If such statements were not on file, the Federal Reserve Bank was required to satisfy itself as to the eligibility of the paper offered for discount, and member banks were expected to use such statement forms or identifying stamps as the Reserve Banks might prescribe.<sup>36</sup>

When the regulation was next revised in 1916,<sup>37</sup> it included separate provisions regarding evidence of eligibility for promissory notes, drafts and bills, and bankers' acceptances. For notes, the regulation provided that the Reserve Bank must be satisfied as to eligibility by reference to the note or otherwise; that compliance with the prohibition against discounting paper for fixed-investment purposes might be evidenced by a statement showing a reasonable excess of quick assets over current liabilities; that the member bank should certify whether the note had been discounted for a depositor or

another member bank or purchased from a nondepositor; that the bank should also certify whether a financial statement of the borrower was on file; that such statements must be on file with respect to notes purchased from sources other than a depositor or a member bank; but that the Reserve Board could waive such statements if the note was secured by a warehouse, terminal, or similar receipt, or if the aggregate of obligations of the borrower rediscounted at the Reserve Bank were less than 10 per cent of the member bank's capital and not in excess of \$5,000. With regard to drafts and bills, the 1916 regulation required only that the Reserve Bank should take necessary steps to satisfy itself as to eligibility, unless the draft or bill presented prima facie evidence thereof or bore a stamp or certificate showing that it was a trade acceptance.

These detailed requirements were repeated in substance in the 1920 revision of Regulation A,<sup>38</sup> except that the Reserve Banks were expressly authorized to require financial statements in all cases; bills, drafts, and trade acceptances were required to be drawn so as to evidence "the character of the underlying transaction" or, if they were not so drawn, eligibility might be evidenced by a stamp or certificate. In 1928 the provisions were expanded to require financial statements from any corporations with which the borrower was "closely affiliated." <sup>39</sup>

In the general revision of the regulation in 1937, the provisions relating to evidence of eligibility were considerably simplified. As changed at that time and as carried forward in the 1955 revision, Regulation A provided that a Federal Reserve Bank should satisfy itself concerning the eligibility of any paper offered for discount; that compliance with the fixed-investment restriction might be evidenced by a statement showing the borrower's financial worth and a reasonable excess of quick assets over current liabilities; and that a Reserve Bank might require financial statements of the parties to the paper discounted and of any corporations affiliated with such parties and any other information which the Reserve Bank deemed necessary.40 In the general revision of Regulation A adopted in 1973, all of these provisions were eliminated and replaced by a statement that a Reserve Bank shall require such information as it deems necessary to insure that paper tendered as collateral or for discount is acceptable and meets any pertinent eligibility requirements.

# CHANGE IN CONCEPT AS TO ELIGIBILITY

Much that has been said in this section regarding the eligibility of paper for discount is now ancient history. The original Federal Reserve Act was based on the concept that Reserve Bank loans should be made only on a short-term basis and on paper that was selfliquidating in character. This concept has sometimes been referred to as the "real-bills doctrine." Related to that concept was the assumption that the pledging of such paper by the Reserve Banks as security for the issuance of Federal Reserve notes would serve as a basis for an elastic currency; it was expected that the volume of such currency would expand and contract directly in response to the varying credit needs of the economy, as reflected by the volume of short-term borrowings by commercial and agricultural enterprises. concepts, however, have long been proved obsolete. Congress itself has recognized the fact by authorizing the Reserve Banks to make advances to member banks not only on the security of eligible paper but also on the security of obligations of the United States; moreover, Congress has provided for the issuance of Federal Reserve notes on the security both of eligible paper and of Government obligations and, in 1968, on the security of Special Drawing Rights certificates.

In view of these changes, the Board of Governors in 1963 recommended to Congress that all of the technical eligibility requirements of the law be repealed and that the Reserve Banks be authorized to make advances to member banks on any satisfactory security at the regular discount rate.41 This proposal has been repeated by the Board in subsequent years but has not been enacted. Nevertheless, it is clear that the Board by interpretations of the law and by amendments to its Regulation A has deliberately departed from the original concept regarding the eligibility of paper as a basis for extension of Federal Reserve loans. As an example, the elimination of the prohibition on the discounting of permanent- or fixed-investment paper, reflected in the 1973 general revision of Regulation A, is a distinct departure from the principle that eligible paper must be self-liquidating.

#### TRADE ACCEPTANCES

# SEPARATE CLASSIFICATION FOR RATE PURPOSES

Two classes of commercial paper were singled out by the Board in the early years of the System as deserving preferential treatment from the point of view of discount rates. One was trade acceptances; the other was commodity paper. In order to distinguish them for rate purposes, the Board at first issued separate regulations relating to these classes of paper.

The Federal Reserve Act itself made no mention of trade acceptances.<sup>12</sup> A bill does not cease to be a bill, however, merely because it is

accepted; and, if otherwise eligible, such an accepted bill growing out of a commercial transaction is eligible for discount.<sup>43</sup>

On July 15, 1915, the Board issued a circular <sup>44</sup> stating that it was ready to approve a discount rate for trade acceptances "somewhat lower than that applicable to other commercial paper." The Board felt that this action might "assist in developing a class of 'double-name' paper, which has shown itself in so many countries a desirable form of investment and an important factor in modern commercial banking systems." The circular was accompanied by a

regulation <sup>45</sup> defining the term "trade acceptance," and requiring that any such acceptance be endorsed by a member bank, have a maturity of not more than 90 days at the time of discount, and be accepted by the purchaser of goods sold to him by the drawer of the bill.

In 1916 a provision specifically relating to the discounting of trade acceptances was incorporated in the Board's general regulation relating to discounts, and the term "trade acceptance" was there defined simply as "a draft or bill of exchange drawn by the seller on the purchaser of goods sold and accepted by such purchaser." <sup>40</sup> This definition was carried into subsequent revisions of Regulation A until 1937 when specific reference to trade acceptances was dropped.

While for a few years the discount rate set for trade acceptances was lower than the rate on other commercial paper, it became generally the same as that for commercial paper by 1920, and in May 1927 the practice of fixing a separate rate for trade acceptances was discontinued.

#### NATURE OF TRANSACTION

As previously indicated, the Board's 1916 regulations defined a trade acceptance as a draft or bill drawn by the seller on the purchaser of goods and accepted by the purchaser. This meant that the underlying transaction must involve a sale of goods.

To constitute a sale, it is necessary that there be a transfer of title. Thus, there is no trade acceptance when a draft is drawn by a supplier of building materials and accepted by the purchaser-a building contractor-if the contractor, under his building contract, does not acquire title to the materials furnished or to the building as it is being erected.47 Similarly, goods sold under a conditional sales contract could not be made the basis for a trade acceptance.48 However, if a lumber company had sold lumber to a sales corporation controlled by the lumber company, the Board held that the transaction was a sale upon which a trade acceptance might be based, provided the sales corporation was not merely an agent of the lumber company formed to evade the law.49

As to what constituted goods for this pur-

pose, the Board followed a liberal position. It held that a draft drawn by a publisher on the purchaser of advertising space and accepted by the latter was a trade acceptance on the ground that the advertising space was goods. Likewise, it held that an accepted draft for the price of electrical goods including their installation 11 and a draft given in payment for gas sold by a gas-producing company 12 were eligible trade acceptances. The Board refused, however, to consider a draft drawn in payment for an insurance premium 13 or drawn in payment for labor alone 14 as covering sales of goods.

As long as there is an actual sale of goods, it does not matter whether the purchaser intends to resell the goods or to use them for his own purposes. The Board held, therefore, that a bill drawn by a dealer on his customer to finance the sale of goods to the customer was a proper trade acceptance, even though the bill was drawn after the purchaser had failed to remit promptly on an open account. But, the Board felt that the use of a trade acceptance as a means of liquidating an otherwise slow account was contrary to the primary purpose of the trade-acceptance movement and that such acceptances should not be encouraged.<sup>25</sup>

#### **FORM**

In 1918 the Board had suggested the use of certain standard forms of trade acceptances.56 In March 1927 the Supreme Court of the State of Texas held that a trade acceptance was rendered nonnegotiable by a statement therein that "the obligation of the acceptor hereof arises out of the purchase of goods from the drawer, maturity being in conformity with the original terms of purchase." 57 This clause, the court ruled, imported into the terms of the instrument an obligation arising from a collateral transaction and thus destroyed the instrument's negotiability. As a result of this decision, the Board suggested in a published statement that the clause be changed in the prevailing standard form to provide only that the transaction giving rise to the instrument was "the purchase of goods by the acceptor from the drawer." 58 Since that time no further statements have been issued by the Board with regard to the form of trade acceptances.

# COMMODITY PAPER

As in the case of trade acceptances and for similar reasons, the Board in 1915 concluded that so-called commodity paper should be encouraged by preferential discount rates for such paper. The Board expected that "this new class of paper with its special rates will prove of particular efficacy in meeting the seasonal demands for credit facilities in the crop-producing districts." <sup>59</sup>

To distinguish such paper for rate purposes, the Board issued a separate regulation relating to commodity paper.<sup>60</sup> It defined the term "commodity paper" as "a note, draft, or bill of exchange secured by warehouse terminal receipts, or shipping documents covering approved and readily marketable, nonperishable staples properly insured." It provided that such paper, in order to be eligible for discount at the special rate, not only should comply with

all the requirements of the Board's general regulation relating to discounts but also should be paper on which the rate of interest or discount, including commission charged the maker, did not exceed 6 per cent. In addition, it had to comply with any requirements prescribed by the Federal Reserve Bank as to warehouse receipts, shipping documents, and insurance.

Substantially similar provisions regarding commodity paper were incorporated in the Board's comprehensive revision of Regulation A in 1916 61 and were repeated in a revision of the regulation in 1917.62 By that time, however, the discount rate on such paper had become the same as the regular rate on other commercial paper; consequently, when the regulation was next revised in 1920 no special provisions with respect to commodity paper were included.

### PERMANENT- OR FIXED-INVESTMENT PAPER

#### **EXCLUSION FROM DISCOUNT**

The original Federal Reserve Act expressly provided that paper eligible for discount should not include paper "covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States." This provision of the law has never been changed.

In its first circular on the subject of discounts in November 1914, the Board stated as the first guiding principle that no bill should be admitted to rediscount if the proceeds had been or were to be applied to permanent investment. The Board explained in the accompanying regulation that the Act excluded paper covering merely investments and that, since any funds employed in agriculture, commerce, or industry

are quasi-investments, the emphasis was to be laid on the word "merely." From this point of view, the regulation stated, there should be excluded all paper whose proceeds were used in permanent or fixed investments of any kind, including investments in land, plant, machinery, permanent improvements, or transactions of a similar nature.<sup>63</sup>

This characterization of permanent investments was spelled out in the Board's 1915 regulation regarding discounts of commercial paper.<sup>61</sup> The regulation provided that no bill would be eligible if its proceeds were used:

For permanent or fixed investments of any kind, such as land, buildings, machinery (including therein additions, alterations, or other permanent improvements, except such as are properly to be regarded as costs of operation). \* \* \*

In 1920 the provision was expanded to exclude paper whose proceeds were used not only for fixed investments, such as land, buildings, or machinery, but "for any other capital purpose." <sup>65</sup> In 1937 this language was modified to refer to any other "fixed" capital purpose. <sup>66</sup> In this amended form the provision was continued in the 1955 revision of Regulation A. <sup>67</sup>

#### EVIDENCE OF COMPLIANCE

The regulatory exclusion of permanent- or fixed-investment paper was accompanied by a provision to the effect that compliance of discounted paper in this respect might be indicated by a statement of the borrower that evidences "a reasonable excess of quick assets over current liabilities." The absence of such a statement, however, did not necessarily render the paper ineligible for discount; the test, of course, was whether the proceeds were actually used for permanent- or fixed-investment purposes.<sup>68</sup>

In this connection the Board ruled that a note given by the buyer to the seller of goods in payment therefor would be eligible in the hands of the seller for discount as commercial paper, even though the goods sold were in the nature of a permanent investment. However, if the proceeds of a note were to be used by the maker to purchase articles constituting permanent investments, the note would be regarded as ineligible. To

# MEANING OF PERMANENT INVESTMENTS

As to what constituted permanent or fixed investments, it was clear that land and buildings fell in the prohibited category, but the status of machinery and equipment was not always clear. On the one hand, the Board held that tractors used in agricultural operations 71 and agricultural implements that wear out rapidly 72 were not to be considered permanent or fixed investments. On the other hand, the prohibition was held applicable to notes given by farmers for the purchase of silos; 73 notes executed by a company furnishing motor transportation to provide funds for the purchase of motor

trucks; <sup>71</sup> notes of a parent corporation the proceeds of which were used to purchase automobiles for subsidiary "drive-it-yourself" companies; <sup>76</sup> and a note the proceeds of which were used by the owner of property for developing or building. <sup>76</sup>

With respect to machinery, the Board in 1938 held that machinery that was purchased by a manufacturing company and that was expected to last over a period of years or indefinitely would constitute a permanent or fixed investment, but that there might be machinery of a kind that, like agricultural tractors, would wear out rapidly and would need to be replaced within a comparatively short time.<sup>77</sup> In other words, the question depended upon the type of machinery involved, as well as on other facts and circumstances of the particular case.

# REMOVAL OF EXCLUSION OF PERMANENT-INVESTMENT PAPER

Despite the fact that Regulation A since the early years of the System had prohibited the discounting of paper drawn for permanent or fixed investments, the Board in 1973 adopted a general revision of the regulation that omitted this prohibition.<sup>78</sup>

The original exclusion of permanent-investment paper from eligibility for discount clearly reflected the then-prevailing theory that all discounted paper should be self-liquidating, that is, the real-bills theory. Actually, however, the statute itself does not expressly and specifically prohibit the discounting of paper representing borrowings for fixed- or permanentinvestment purposes. It provides that the Reserve Banks may discount paper arising out of actual commercial transactions and that the Board shall have the right to define the character of paper eligible for discount. The only statutory limitation is that no such definition by the Board shall include paper covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States. As noted earlier, the Board has held that any purchase-and-sale transaction, regardless of the

nature of the goods involved, is a commercial transaction. In this sense, the purchase of machinery or of a building for a home is a commercial transaction. Literally, the statute seems designed only to exclude paper covering merely investments, that is, paper representing borrowings primarily for the purpose of making a profit, such as realizing appreciation of capital or return in the form of interest or dividends.

Repeal of the permanent-investment prohibition in Regulation A does not make all mortgage notes or notes given for the purchase of machinery eligible for discount. Such notes will still have to comply with the maturity requirements of the law and therefore are not eligible for discount (or as collateral for advances) until they are within 90 days of maturity. Moreover, the paper is not eligible if the property is purchased merely for investment—for example, for later sale at a profit.

This change in the regulation, however, has had an important liberalizing effect because notes drawn to pay for permanent or fixed investments may now be regarded as representing borrowings for an eligible purpose. As noted elsewhere in this study, the Board has taken the position that finance paper is eligible for discount if the proceeds are to be re-lent to others for eligible purposes irrespective of the maturity of such loans. Thus, in 1965 the Board took the position that the note of a finance company is eligible for discount if the proceeds are to be used by the finance company to finance the purchase of consumer goods or "for other

purposes which are eligible within the meaning of the Federal Reserve Act" and that, if there is any question as to whether the proceeds are to be used for such an eligible purpose, a financial statement of the finance company "reflecting an excess of notes receivable which appear eligible for rediscount (without regard to maturity)" over total current liabilities of the company may be taken as an indication of eligibility.<sup>79</sup>

Following the principle of that Board ruling, the note of a finance company or of a savings and loan association that might be acquired by a member bank would be eligible for discount or as collateral for a Reserve Bank advance if that note itself had a maturity of not more than 90 days and if the proceeds were to be used to make loans for permanent or fixed investments, such as the construction of a home or the purchase of machinery. In addition, repeal of the regulatory prohibition makes it possible, in emergency circumstances, for a Federal Reserve Bank to extend direct credit to a home mortgage lender subject to certain limitations prescribed in the law. That possibility will be referred to again in connection with the discussion of extension of Federal Reserve loans to nonmember banks and nonbanking enterprises.

One of the desirable side effects of the repeal of the regulatory prohibition on the discounting of permanent-investment paper is removal of the need for technical interpretations as to what constitutes a permanent investment, such as those described earlier.

# PAPER DRAWN FOR SPECULATIVE PURPOSES

The statutory prohibition against the discount of paper covering "merely" investments obviously excludes paper drawn only for speculative purposes. In its 1915 discount regulation, the Board provided that no bill should be eligible for discount if its proceeds were used "for investments of a merely speculative character,

whether made in goods or otherwise." <sup>50</sup> In 1916 the language was slightly changed to prohibit the discount of any paper "the proceeds of which have been used or are to be used for investments of a purely speculative character"; <sup>81</sup> and the same language (with "transactions" substituted for "investments") was

included in the 1955 revision of Regulation A.<sup>52</sup> The present regulation requires that the proceeds must not be used "merely for the purpose of investment, speculation, or dealing in stocks, bonds, or other such securities, except direct obligations of the United States."

For example, it is customary for agricultural products to be carried for a time in order to accomplish orderly marketing, but the situation is different if there is a "mere speculative withholding from the market, at a time when there

is a normal demand, in the hope ultimately of obtaining a higher price"; and drafts drawn to finance the growers of crops for such a purpose cannot be considered as drawn for an agricultural purpose. So On the other hand, when a manufacturer of pig iron gave his note, secured by pig iron already manufactured but held pending delivery under contract for sale, the note was held eligible for discount because the sale had been made and the carrying of the material was not for speculative purposes. 11

### PAPER DRAWN FOR TRADING IN STOCKS AND BONDS

The law specifically excludes from discount any paper issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, with an exception, however, in favor of bonds and notes of the Government of the United States. In its earliest discount regulation, 55 the Board observed that this provision required no comment.

A provision excluding paper drawn for carrying or trading in stocks and bonds has appeared in all revisions of Regulation A. Since 1930, however, the regulation has made it clear that the exception for Government bonds and notes applies only to direct obligations of the United States, that is, bonds, notes, Treasury bills, and certificates of indebtedness.<sup>80</sup>

In 1918 the War Finance Corporation Act <sup>87</sup> authorized the Reserve Banks to discount paper secured by obligations of the War Finance Corporation. The Board ruled that paper drawn

for trading in bonds and notes of that Corporation was eligible for discount,<sup>88</sup> and in the 1924 revision of Regulation A <sup>89</sup> specific provisions were included with respect to this matter. These provisions were eliminated in 1928 when they were no longer necessary.

Obviously, the reason why the Reserve Banks were prohibited from extending credit on stocks and bonds was that the Banks were intended to assist commercial banking and not investment banking. Paper eligible for discount was confined to self-liquidating paper arising out of commercial rather than investment transactions.<sup>20</sup>

The exception for Government obligations has been liberally construed.<sup>91</sup> For a time, indeed, the Board permitted the discount of notes of nonmember banks drawn for carrying or trading in such obligations, provided the notes were endorsed by a member bank.<sup>92</sup>

#### FINANCE PAPER

# ORIGINAL EXCLUSION FROM DISCOUNT

Generally speaking, "finance paper" is paper the proceeds of which are loaned by the obligor to some other borrower. For many years the Board took the position that such paper was not commercial paper and was therefore not eligible for discount by the Federal Reserve Banks, even though the loan made by the borrower to a third party was itself for a commercial purpose.<sup>93</sup>

Following this position, the Board ruled that the notes of cotton factors or cold storage companies were ineligible for discount when the proceeds were to be used by such factors or companies for the purpose of making loans to their customers.<sup>94</sup> The same principle was applied to paper of finance or credit companies <sup>95</sup> and to notes of Federal land banks and joint-stock land banks the proceeds of which were loaned to third persons for agricultural purposes.<sup>96</sup>

In 1920 the principle was incorporated in Regulation A. It was expressly provided that the Reserve Banks could not discount paper the proceeds of which were used "for the purpose of lending to some other borrower." <sup>97</sup>

#### MODIFICATION BY STATUTE

In two respects the Board's position regarding finance paper was modified by statute in 1923. The Agricultural Credits Act of that year specifically amended section 13 of the Federal Reserve Act to provide that the paper of factors "issued as such making advances exclusively to producers of staple agricultural products in their raw state shall be eligible for such discount." 18 The same statute added to the Federal Reserve Act a new section 13a that, among other things, made eligible for discount paper of cooperative marketing associations the proceeds of which were used for advances by such associations to their members for agricultural purposes. In the light of these changes in the

law, Regulation A was amended in 1923 to except agricultural factors' paper and paper of cooperative marketing associations from the prohibition against the discount of finance paper.<sup>99</sup>

As to other kinds of finance paper, the Board continued after 1923 to exclude such paper from discount. Thus, it held that notes of a warehouse company engaged in a finance business used to finance its current operating expenses <sup>100</sup> and notes of an insurance agency to finance the carrying of accounts covering premiums due on insurance sold by it <sup>101</sup> were not eligible for discount.

### REVERSAL OF BOARD'S POSITION

In 1937, however, the Board reversed its position with regard to the eligibility of finance paper. As part of a comprehensive revision of Regulation A, the provision excluding finance paper was eliminated. The Board explained that elimination of the provision would render eligible for discount "a large amount of paper of commission merchants and finance companies, including paper drawn to finance installment sales of a commercial character." 102

Following this changed policy, the Board made it clear that if the proceeds of paper were advanced to some other borrower, the paper would be eligible for discount provided the proceeds were ultimately used by such other borrower for a commercial, agricultural, or industrial purpose.103 Thus, a note given to a bank or a finance company the proceeds of which are to be used by the maker to purchase goods for his own use is eligible paper; in holding to that effect, the Board pointed out that, from a legal standpoint, there is no difference between the discounting of a note in the hands of the seller and a direct lending by a bank or finance company to the purchaser, since in either case the purpose is to finance "the final step in the distribution of goods, the sale to the consumer." 104

In a 1965 ruling the Board reaffirmed its position that notes of finance companies were eligible for discount if they conformed to the maturity requirement of the law and if the proceeds were used to finance the purchase of consumer goods or for other purposes eligible under the Federal Reserve Act. Recognizing that it is sometimes difficult to determine the purposes for which individuals borrow from finance companies, the Board prescribed a formula that could be used in case of question: If a financial statement of the finance company reflects an excess of notes receivable that appear eligible for discount, without regard to maturity, over the total current liabilities of the finance company, this could be taken as an indication that the note of the finance company is eligible for discount.105

This interpretation was clarified and liberalized in certain respects in 1972. The 1965 formula for determining the eligibility of finance company notes had referred to a financial statement of the company reflecting an excess of notes receivable that appear eligible for rediscount "over total current liabilities (i.e., liabilities maturing within one year)." This definition of "current liabilities" was changed to

refer to "notes due within one year" in order to exclude a company's liabilities for such things as salaries and taxes.

In some instances, finance companies make what are known as direct consumer loans to individuals when the purpose for which the proceeds are to be used cannot easily be determined. In its 1972 interpretation the Board stated that when information is lacking as to whether such loans will be used for eligible purposes, it could be assumed that 50 per cent of such loans would be "notes receivable which appear eligible for rediscount."

The Board also stated that the language just quoted should be regarded as including notes given for the purchase of mobile homes that are acquired by a finance company from a dealer-seller of such homes. Previously, questions had been raised as to whether such notes fell within the prohibition against the discounting of notes drawn for permanent investments. Finally, it was made clear that the principles of the Board's position with respect to finance company paper were applicable to the notes of a finance company engaged in making loans for business and agricultural purposes as well as for consumer loans.<sup>106</sup>

### CONSUMER PAPER

Soon after the 1937 revision of Regulation A, when it first took the position that finance paper was eligible for discount, the Board issued an interpretation in which it made clear that a borrowing for the purpose of making a purchase of goods is a borrowing for a commercial purpose whether the borrower intends to use the goods himself or to resell them, since in such a case the proceeds are used to finance a sale—a commercial transaction. Whatever may have been the intent of the framers of the original Act with regard to limiting commercial loans to ordinary business loans, this ruling of the Board definitely reflected the view that consumer paper is to be regarded as eligible

for discount. For example, the Board's ruling referred to the eligibility of a note given to a member bank by a householder who is to use the proceeds to purchase household equipment, such as radios or furniture.

If the purchase of a radio by an individual constitutes eligible consumer paper, it is difficult to see why a note the proceeds of which are used for the purchase of services, such as medical services or travel advice, should not also be considered a note given for a commercial purpose. In the general revision of Regulation A adopted by the Board in 1973, a new provision specifically makes such paper eligible for discount.

# CONSTRUCTION PAPER

The National Housing Act of 1934 contained, along with provisions for the insurance of certain housing mortgages, an amendment to section 24 of the Federal Reserve Act that provided that loans made to finance the construction of residential or farm buildings and with maturities not exceeding 6 months should not be considered as real estate loans subject to the restrictions of that section on real estate loans made by national banks, but should be classified as "ordinary commercial loans." 108 In addition, the amendment provided that notes representing such loans should be eligible for discount as commercial paper if they were accompanied by a valid and binding agreement -entered into by an individual, partnership, association, or corporation acceptable to the discounting bank-to advance the full amount of the loan upon completion of the building.

Although not entirely clear, it may be assumed that the condition requiring an agreement by a third party to advance the full amount of the loan at maturity was intended not only to afford protection to the lending bank but also to make the paper self-liquidating, in keeping with the general concept that all discounted commercial paper should be self-liquidating in nature.

In 1955, section 24 was amended to extend the permissible maturity of residential and farm construction loans from 6 months to 9 months. 109 The reason given for this liberalizing change was that the prescribed 6-month period had proved to be unrealistically short in some cases, and it was expected that the increase to 9 months might "serve to increase the availability of funds for the financing of short-term residential and farm construction work." 110

In 1959 these provisions were further liberalized to provide that loans made to finance the construction of industrial or commercial buildings and with maturities of not more than 18 months should not be considered real estate loans subject to the limitations of section 24, if

accompanied by an agreement by a financially responsible lender to advance the full amount of the bank's loan upon completion of the building. By successive amendments to section 24, the maximum maturity of construction loans that are exempted from the limitations on real estate loans by national banks has been increased from time to time. At present any such loans, if they have maturities of not more than 60 months—whether for the construction of industrial or commercial buildings or for the construction of residential or farm buildings—are not regarded as real estate loans within the meaning of that section but as ordinary commercial loans.

In view of this liberalization of the provisions of section 24, it might be assumed that all such construction loans, being commercial in nature, should be regarded as eligible for discount under section 13 of the Federal Reserve Act. This assumption is negatived, however, by the fact that section 24 provides specifically that loans for the construction of residential or farm buildings with maturities of not more than 9 months shall be eligible for discount as commercial paper within the terms of the second paragraph of section 13 but makes no similar provision with respect to loans for the construction of industrial or commercial buildings.

The eligibility of residential and farm construction paper for discount by the Reserve Banks was specifically recognized in the Board's 1937 revision of Regulation A.<sup>112</sup> The regulation required that such paper (1) represent a loan to finance the construction of a residential or farm building, whether or not secured by real estate; (2) be endorsed by the member bank; (3) be accompanied by an agreement by a person acceptable to the Reserve Bank to advance the full amount of the loan upon completion of construction; and (4) mature not more than 6 months from the date the loan was made and not more than 90 days from the date of discount. These provisions were re-

peated without change in the January 1955 revision of the regulation.<sup>113</sup> The regulation was not changed to reflect the 1955 statutory increase in the permissible maturity of residential and farm construction paper from 6 months to 9 months until 1973, at which time the correction was made in the general revision of the regulation.

As indicated, the Board's regulation requires that a residential or farm construction loan not only must comply with the maturity requirement specified in section 24 but also must have a maturity of not more than 90 days at the time of discount. It is by no means clear that this latter requirement is made necessary by the law. When the original provisions for construction loans were added to section 24 in 1934, the

report of the House Banking and Currency Committee stated that the Federal Reserve Act was being amended to permit national banks to make such temporary loans with maturities of not more than 6 months and to make "such temporary paper . . . eligible for discount as commercial paper at the Federal Reserve Banks." 114 In view of this statement, it may be argued that—since the intent of Congress was to make such paper eligible for discount if it had a maturity at the time of discount not in excess of that prescribed in section 24—to superimpose a further requirement that the paper have a maturity of not more than 90 days at the time of discount would render unnecessary and meaningless the limitation on original maturity.

# **Agricultural Credits**

### THE ORIGINAL ACT

Granted that the primary objective of the discount provisions of the original Federal Reserve Act was the establishment of a market for commercial paper, an important secondary objective was to provide a new source of credit for agricultural purposes. In a separate section the Act authorized national banks for the first time to make loans on farm lands. In the discount provisions of section 13, agricultural paper was given special prominence in a phrase that described commercial paper as paper issued for agricultural, industrial, or commercial purposes (a confusing description since distinctions have been made between commercial and agricultural paper). Moreover, the Act actually gave preferential treatment to agricultural paper, at least with respect to maturity limitations.

Clearly the framers felt that the Act would provide substantial benefits to the agricultural interests of the country. In his opening statement on the floor of the House, Mr. Glass

For NOTES AND REFERENCES, see pp. 253-54.

called particular attention to those provisions of the bill that would bear upon "the farmer and his welfare." <sup>1</sup> Other Congressmen strongly endorsed the discount provisions as promising great aid to agriculture.<sup>2</sup> They felt that the paper of farmers was fully as good as so-called commercial paper,<sup>3</sup> even though agricultural paper might have longer maturities.<sup>4</sup>

It was recognized that agricultural loans normally were made for a period corresponding to the crop season and that, consequently, the 90-day maturity limitation generally prescribed for paper eligible for discount would not be appropriate for such loans. The reasons for which agricultural paper was allowed a maximum maturity of 6 months have been discussed in detail in Chapter 3 of this study; and the maturity requirements for such paper will be considered further in a later section of the present chapter.

Although, as has been noted, the original Act specifically included paper issued for agricultural purposes in the description of paper eligible for discount, it contained an additional provision expressly stating that nothing in the Act should be construed as prohibiting paper secured by staple agricultural products from being eligible for discount. This seemingly unnecessary provision apparently resulted from a feeling in some quarters that, without this provision, paper drawn to finance the carrying of

agricultural products pending a higher price might be regarded as paper drawn for speculative purposes and therefore ineligible for discount. Despite this provision, it appears that the Board in 1922, as indicated in the previous chapter, concluded that such paper would be of a speculative nature and not eligible for discount as agricultural paper.

### **AGRICULTURAL CREDITS ACT OF 1923**

#### **BACKGROUND**

Proposals for a long-range system of farm credits reached legislative fruition in the enactment of the Federal Farm Loan Act in 1916.6 Following the pattern of the Federal Reserve System, the Federal Farm Loan Act set up 12 regional Federal land banks and provided for the voluntary formation of joint-stock land banks and national farm loan associations. The land banks were authorized to make farm mortgage loans with maturities of not less than 5 and not more than 40 years. The whole system was placed under the supervision of a Federal Farm Loan Board. No change was made in the discounting authority of the Federal Reserve Banks, but both the Reserve Banks and member banks of the Federal Reserve System were specifically authorized to buy and sell farm loan bonds issued by the land banks.7

During World War I, farmers had little or no financial problems. In 1920, however, when deflation set in, farm prices dropped; and the need for additional agricultural credit became acute.<sup>5</sup>

In 1921 the War Finance Corporation was revived, with authority, among other things, to provide loans for agricultural purposes. That Corporation made a large volume of loans to farmers, livestock companies, and cooperative marketing associations. However, it was only an emergency agency, and there was a growing sentiment in favor of a more permanent system of farm credits to meet the intermediate credit

needs of the farmer—loans with maturities shorter than the 5-year minimum maturity permitted by the Farm Loan Act and yet longer than the 6-month maximum maturity prescribed for the discount of agricultural paper by the Federal Reserve Banks. The growth of this sentiment led to the enactment of the Agricultural Credits Act of 1923.10

The chief advocates of the new farm credit legislation in Congress were Senators Lenroot and Capper, and Chairman McFadden of the House Banking and Currency Committee. Aside from Congress, the principal impetus probably came from Eugene Meyer, at that time Managing Director of the War Finance Corporation and later Governor of the Federal Reserve Board. Actually, Meyer felt strongly that the best way to help the agricultural interests was to induce more country banks to become members of the Federal Reserve System.11 However, he urged the enactment of the farm credit bill as a means of meeting the problems and difficulties that had come to the attention of the War Finance Corporation in connection with agricultural credits.12

#### GENERAL PROVISIONS

The Agricultural Credits Act set up 12 Federal intermediate credit banks with authority to make agricultural and livestock loans with maturities of from 6 months to 3 years. It provided also for the voluntary organization of national

agricultural credit corporations that, under regulations of the Comptroller of the Currency, were authorized to make loans on agricultural paper with a maturity of not more than 6 months and on livestock paper with a maturity of up to 3 years; a further provision authorized member banks of the Federal Reserve System to purchase stock in these corporations. Such was the new machinery provided by the statute. In addition, certain amendments were made to the existing farm credit provisions of the Federal Farm Loan Act and to the discount provisions of the Federal Reserve Act; the latter are of particular interest here.

# AMENDMENTS TO FEDERAL RESERVE ACT

The general objective of the 1923 amendments to the Federal Reserve Act was to make eligible for discount certain types of agricultural paper that previously had not been eligible, either because of the maturity limitations or because of other limitations of the law as they had been interpreted by the Board. The maturity requirements were liberalized both for agricultural paper in general and for bankers' acceptances based on agricultural transactions. Sight or demand drafts drawn to finance domestic shipments of agricultural products were made eligible for discount, as were drafts of factors drawn to finance producers of staple agricultural products. A new section-13awas added to the Federal Reserve Act dealing specifically with the discounting of agricultural paper for Federal intermediate credit banks and cooperative marketing associations. As stated by Senator Capper, who sponsored the bill in the Senate, the purpose of these provisions was "to make such changes in the rules of eligibility governing agricultural paper as seem necessary to fit the actual requirements of the farmer." 13

In the opinion of Eugene Meyer, the amendments to the discount provisions of the Federal Reserve Act were the most important in the bill.<sup>14</sup> His statement before the House Banking and Currency Committee regarding adjustment of the Federal Reserve System to meet changing conditions is worthy of quotation here because

of its applicability not only to the agricultural credit functions of the System but also to the System's functions in general: 15

\* \* \* The adjustments contemplated are in line with the experience of the last few years, and their purpose is merely to adapt the Federal reserve system, so far as agriculture is concerned, to changed conditions. Those who object to adjusting the eligibility rules of the system to the time required for the orderly marketing of agricultural products under present conditions seem to fear that the soundness of the system may be jeopardized. But the system suffers from friends as well as from foes. Those who defend its every act and policy and who stand for the immutability of its present law and regulations may be as harmful as those who are extreme in their denunciation of the part played by it in the collapse of commodity markets and prices. The true friends of the Federal reserve system are those who are willing to see its machinery adjusted along sound lines to meet changing conditions, both in this country and abroad.

Shortly after the enactment of the Agricultural Credits Act of 1923, the Board in a published statement reviewed and explained the increased farm credit facilities provided by that act. In general, the Board said that it had "so construed and administered the law as to improve, in the highest possible degree, the credit standing and economic position of the agricultural interests, placing at their disposal, through its discounts for member banks and its openmarket operations, the vast resources of the Federal reserve system to the fullest extent permitted by the law and by the principles of sound banking." <sup>16</sup>

Since 1923 Congress has enacted numerous statutes to provide further credit assistance to agriculture, including, among others, the Farm Credit Acts of 1933 and 1937, the Federal Farm Mortgage Corporation Act of 1934, and the Farm Credit Act of 1971. However, no substantial changes in the authority of the Federal Reserve Banks to discount agricultural paper have been made since the liberalizing amendments made by the Agricultural Credits Act of 1923. Amendments to the law authorizing advances by the Reserve Banks to member

banks on the security of obligations of Federal intermediate credit banks and other Federally established organizations to provide agricultural credit will be discussed later.

As discussed in Chapter 3, discounts of agricultural paper are subject to the general limitations relating to endorsement and to the amount

of paper of one borrower that may be discounted for any member bank. Before discussing the one important difference between agricultural and commercial paper—the more liberal maturity requirements applicable to agricultural paper—it is necessary to consider the nature of agricultural paper.

### NATURE OF AGRICULTURAL PAPER

#### REGULATORY DESCRIPTION

The Federal Reserve Act itself did not undertake to define agricultural paper or agricultural purposes, although it was clear that paper based on livestock was intended to be covered by these terms. More specific description was left to the discretion of the Federal Reserve Board.

In 1915, in a separate regulation pertaining to agricultural paper,17 the Board stated merely that paper issued or drawn for agricultural purposes or based on livestock meant paper the proceeds of which had been used or were to be used for agricultural purposes, "including the breeding, raising, fattening, or marketing of live stock." After the passage of the Agricultural Credits Act of 1923, the Board in a revised regulation 18 more particularly referred to paper drawn for, or the proceeds of which were to be used for, "the production of agricultural products, the marketing of agricultural products by the growers thereof, or the carrying of agricultural products by the growers thereof pending orderly marketing, and the breeding, raising, fattening, or marketing of live stock." The same language was used in the 1955 revision of Regulation A.19 Paper of cooperative marketing associations was specifically declared to constitute agricultural paper if it met certain requirements. Otherwise, the Board has never attempted by regulation to describe agricultural paper in any detail, and the revision adopted in 1973 omits even the general description of such paper indicated above.

# DISTINGUISHED FROM COMMERCIAL PAPER

In the early days of the System, the Board found it necessary to issue a number of interpretations distinguishing agricultural paper from commercial paper, in view of the more liberal maturity requirements applicable to the former type of paper. In general, these interpretations are still in effect.

The basic test is whether the commodity for the purchase of which a note is given will actually be used for agricultural purposes. Even though the commodity itself is of an agricultural nature, the note is not considered agricultural paper if the purchaser does not intend to use it for an agricultural purpose.20 Hence, purchase of such a commodity merely for resale is not sufficient; 21 in such a case the paper must be treated as commercial rather than agricultural paper.22 However, as long as the commodity is actually to be used for an agricultural purpose by the purchaser, the note given by him may be considered agricultural paper, whether discounted by the maker or by the seller-endorser.23 Thus, the Board ruled that notes given for commercial fertilizer,24 tractors used in agricultural operations,25 agricultural implements,26 and the draining and tilling of farm land 27 may be considered agricultural paper.

Livestock paper—that is, paper to finance the breeding, raising, fattening, and marketing of livestock—has always been regarded as agricultural paper.<sup>28</sup> One of the principal purposes of the Agricultural Credits Act of 1923 was to provide needed credit to breeders of livestock. For this purpose, the Board held that cows, horses, and mules are livestock.<sup>29</sup> However, notes given by dealers in cattle and mules are

commercial rather than agricultural paper,<sup>30</sup> and the notes of a packing company given for the purchase of livestock to be slaughtered are not notes "based on live stock" within the meaning of the law.<sup>31</sup>

### **MATURITY**

The original Federal Reserve Act allowed a maximum maturity of 6 months for agricultural paper, as contrasted with the 90-day maturity requirement applicable to all other types of paper. This allowance was made with no intent to single out agricultural paper for special favor but simply in recognition of the fact that the marketing of farm crops and livestock normally requires a longer period of financing than ordinary commercial transactions. The considerations that led the framers of the original Act to prescribe a more liberal maturity requirement for agricultural paper than for commercial paper have been noted in Chapter 3.

Even a 6-month maturity limitation soon proved to be inadequate, and the Agricultural Credits Act of 1923 increased the maturity permitted for agricultural paper to 9 months.

Apparently this further liberalization was prompted largely by the contention of representatives of livestock associations that the then-existing 6-month limitation was not adequate to provide assistance to breeders, as distinguished from raisers, of livestock.<sup>32</sup> The Senate Banking and Currency Committee felt that the longer period of maturity "would be helpful and was in some cases necessary," and that such a lengthening of the maturity of agricultural paper would in no way impair the liquid character

essential to Federal Reserve Bank discounts.<sup>33</sup> Congress agreed with those "in control of the Federal reserve system" that paper having a maturity of more than 9 months should not be eligible for discount because the paper rediscounted by the Reserve Banks "must be self-liquidating." <sup>34</sup> As a safeguard, the Senate Banking and Currency Committee inserted a new provision prohibiting the use of paper with maturities greater than 6 months as security for Federal Reserve notes, unless the paper was secured by warehouse receipts or security documents or chattel mortgages on livestock.<sup>35</sup>

In addition to increasing the maximum maturity prescribed for the discount of agricultural paper, the Agricultural Credits Act of 1923 increased the maturity prescribed by section 13 of the Federal Reserve Act for the discount of bankers' acceptances from 90 days to 6 months when the acceptances were for agricultural purposes and were secured by title documents covering readily marketable staples. The Federal Reserve Board had previously ruled that agricultural acceptances with maturities of up to 6 months could be purchased by the Federal Reserve Banks in the open market, and Congress felt that there was no reason "why such acceptances should not be given the full benefit of the rediscount privilege." 36

# AMOUNT LIMITATIONS

The longer maturity permitted for agricultural paper was a departure from the orthodox doctrine that only short-term paper should be eligible for discount, and Congress agreed to this departure only with a qualification. To prevent the discounting of long-term agricultural paper in excessive amounts, the original Federal Reserve Act provided that discounts of such paper should be limited to a percentage of the capital of the discounting Federal Reserve Bank, "to be ascertained and fixed by the Federal Reserve Board."

Pursuant to this provision, the Board by regulation limited the aggregate amount of agricultural paper with a maturity of more than 3 months and less than 6 months that each Federal Reserve Bank might discount to 25 per cent of the Reserve Bank's paid-in capital.<sup>37</sup> At the same time the Board indicated that, in those districts in which 6-month paper was particularly required to carry through agricultural operations, the 25 per cent limit would be increased upon request of the Reserve Banks.<sup>38</sup>

In 1916 Congress sought to make the statutory limitation more liberal by requiring it to be based on a percentage of the assets, rather than of the capital, of the discounting Federal Reserve Bank.39 Still later, the Agricultural Credits Act of 1923 authorized the Board by regulation to limit the amount of paper with a maturity ranging from 3 to 6 months and from 6 to 9 months that might be rediscounted by a Reserve Bank. Pursuant to these changes in the law, the Board in its 1923 revision of Regulation A provided that there should be no amount limitation on the discount of paper with a maturity of more than 3 months and less than 6 months, but that the aggregate amount of discounted agricultural paper with a maturity of between 6 and 9 months should not exceed 10 per cent of the total assets of a Federal Reserve Bank. 40 Although the authority for such limitations is still in the law, the limit fixed by the Board in 1923 was omitted from Regulation A in 1937, and no amount limitation is now in force.

One should bear in mind, however, that agricultural paper continues to be subject to the same limitations on the amount of paper of any one borrower that may be discounted for a member bank as those that are applicable to the discounting of other types of paper.

# SIGHT DRAFTS

Drafts payable at sight or on demand do not, of course, have any fixed maturity, and it is possible that they may not actually be presented for payment within 90 days, or even within 6 or 9 months. For this reason, the Board in 1917 ruled that demand paper was not eligible for discount. It was the custom, however, for many member banks during crop-moving periods to discount large volumes of sight drafts secured by bills of lading covering the shipment of wheat, cotton, or other agricultural products;

these drafts, although having no fixed maturity, were usually paid with promptness and were considered a liquid and desirable form of paper. Accordingly, the Board recommended to Congress that the law be amended to make such drafts eligible for rediscount by the Reserve Banks under certain conditions.<sup>42</sup>

Such an amendment was made by the Agricultural Credits Act of 1923.<sup>43</sup> It extended the discount privilege to bills of exchange payable at sight or on demand if drawn to finance the

domestic shipment of "nonperishable, readily marketable staple agricultural products" and if secured by bills of lading or other shipping documents conveying or securing title to such staples. The act contained the provision, however, that all such bills should be forwarded promptly for collection and that demand for payment should be made with reasonable promptness after the arrival of the staples at their destination; and no such bill could be held by or for the account of a Federal Reserve Bank for more than 90 days. In discounting such sight bills, the Reserve Banks were authorized to compute the interest to be deducted on the basis of the estimated life of the bill and to adjust the discount after payment of the bill to conform to its actual life. In 1928, the provision was expanded to permit the discounting of sight bills covering nonagricultural as well as agricultural staples and covering the exportation as well as the domestic shipment of such staples.44

In its 1923 revision of Regulation A, the Board followed in general the language of the law with respect to discounts of sight or demand bills, 45 and the regulatory provisions on this subject remained substantially the same until 1973.46 These provisions, however, became unnecessary in 1966 when the Board ruled that all demand notes met the maturity requirements of the law and therefore were eligible for discount if they met other eligibility requirements.47 In the light of this fact, the general revision of Regulation A adopted by the Board in 1973 omitted the special regulatory provision regarding demand drafts.

In 1923, when the special authority for the discount of sight or demand paper still had significance, the Board stated that it did not deem it advisable to formulate a comprehensive definition of the term "readily marketable nonperishable staple" and that the Reserve Banks should exercise their discretion in the matter.48 In specific instances, however, the Board held that cottonseed should be,49 and cottonseed oil should not be,50 considered readily marketable staples for this purpose. As has been noted, the statutory provisions were changed in 1928 to cover nonagricultural as well as agricultural staples. When Regulation A was revised in 1937, it carried a footnote stating that, within the meaning of the regulation, a readily marketable staple meant "an article of commerce, agriculture, or industry of such uses as to make it the subject of constant dealings in ready markets with such frequent quotations of price as to make (a) the price easily and definitely ascertainable and (b) the staple itself easy to realize upon by sale at any time." 51 This definition followed a similar definition that had previously been adopted by the Board for the purpose of determining the eligibility of bankers' acceptances growing out of the storage of readily marketable staples. The scope of the term will be considered further in the following chapter relating to the discounting of bankers' acceptances. The definition was omitted in the revision of Regulation A adopted in 1973 since, as previously indicated, that revision did not include any provision relating specifically to the eligibility of sight or demand drafts.

# FACTORS' PAPER

At the time of the hearings on the Agricultural Credits Act of 1923, Governor Eugene Meyer pointed out that, in addition to sight bills, there was another class of agricultural paper that had theretofore been ineligible for discount because of rulings of the Federal Reserve Board. The Board had held that finance paper

the proceeds of which were to be loaned to third persons was not eligible for discount. Based on this theory, the paper of cotton factors, who carried the cotton for their customers until it was sold, could not be offered for discount.<sup>52</sup> Governor Meyer felt that this was a "hairsplitting" distinction.<sup>53</sup>

Congress apparently agreed with Governor Meyer. The Agricultural Credits Act of 1923 amended section 13 of the Federal Reserve Act to provide expressly that nothing in the latter should be construed to prevent "the notes, drafts, and bills of exchange of factors issued as such making advances exclusively to producers of staple agricultural products in their raw state" from being eligible for discount. A paraphrase of this provision was incorporated in the Board's 1923 revision of Regulation A,<sup>54</sup> and a similar provision appeared in the 1955 regulation.<sup>55</sup> It was omitted, however, from the revision of the regulation adopted in 1973.

This provision related only to factors' paper drawn to finance producers of agricultural products in their raw state. Thus, the Board held that if the proceeds of a cold-storage company's notes were to be used for making advances to producers of eggs and poultry, the notes would be eligible for discount, but that butter is not an agricultural product in its raw state and that consequently notes covering advances to those engaged in the commercial production of butter from cream purchased from others would not be eligible for discount.<sup>56</sup>

Some years later, as has been noted in Chapter 4, the Board reversed its previous position regarding the eligibility of finance paper for discount. Since 1937, not only agricultural factors' paper but any paper the proceeds of which are to be loaned to third persons has been eligible for discount if the proceeds are ultimately to be used for commercial, agricultural, or industrial purposes. Consequently, the general revision of the regulation adopted by the Board in 1973 does not include any provision relating specifically to factors' paper.

# PAPER OF COOPERATIVE MARKETING ASSOCIATIONS

By 1923 cooperative marketing associations had assumed considerable importance as agencies for enabling farmers to market their crops to better advantage.<sup>57</sup> Normally such associations were nonstock organizations whose membership consisted of the producers of the particular crop that the organization was designed to market and to which the members delivered their crops for sale. The commodities were pooled according to grade, and after all of a particular pool had been sold by the association the proceeds were distributed pro rata to the producers who had contributed to that pool.<sup>58</sup>

In a number of rulings prior to 1923 <sup>59</sup> the Board had held that in some circumstances notes of cooperative marketing associations were eligible for discount as agricultural paper, but that in other circumstances such notes were not eligible for discount or were eligible only as commercial paper and therefore must have a maturity of not more than 90 days. For example, the Board had held that notes of an association engaged in packing and marketing

products that it had not grown, the proceeds of which were used to pay current expenses and to purchase supplies, were eligible for discount only as commercial paper.<sup>60</sup>

The Agricultural Credits Act of 1923 recognized the essentially agricultural nature of cooperative marketing associations and, as stated by Eugene Meyer, "swept away" technical distinctions based on the legal form in which their paper was issued.61 A new section-13aadded to the Federal Reserve Act provided that notes, drafts, and bills of exchange issued or drawn by such associations should be "deemed" to have been issued or drawn for an agricultural purpose if their proceeds were (1) advanced to their members for an agricultural purpose, (2) used to make payments to members for agricultural products delivered to the associations, or (3) used to meet expenditures incurred in connection with grading, packing, preparing for market, or marketing of any agricultural products handled by the associations for their members.

After the enactment of the Agricultural Credits Act of 1923, the Board published a revised statement of general principles regarding the discount of paper of cooperative marketing associations.62 Among other things, this statement made it clear that the following types of paper would be eligible for discount as agricultural paper: growers' drafts accepted by the associations and covering deliveries of crops, if the proceeds were used by the growers for agricultural purposes; growers' paper used to finance the carrying of their products for a reasonable period incident to orderly marketing; and paper of the associations to finance the packing and marketing of the products of their members, to pay for products purchased from their members, or to make advances to their members for agricultural purposes.

In a revision of its Regulation A, the Board followed the language of the amended law as to the eligibility of paper of cooperative marketing associations for discount; however, the regulation provided that such paper would not be eligible if the proceeds were used to defray expenses of organizing the association, or to acquire warehouses, or to purchase or improve real estate or other fixed or permanent investments.<sup>63</sup> The 1973 revision of Regulation A omits the paragraph dealing specifically with paper of cooperative marketing associations, but such paper is referred to as constituting agricultural paper for purposes of discount.

# DISCOUNTS FOR FEDERAL INTERMEDIATE CREDIT BANKS

As noted at the beginning of this chapter, the Agricultural Credits Act of 1923 set up a system of Federal intermediate credit banks to make loans to farmers with maturities intermediate between the short-term credit available through the Federal Reserve Banks and the long-term credit obtainable from the Federal land banks. The intermediate credit banks were authorized to discount agricultural and livestock paper for State and national banks, agricultural credit corporations, livestock loan companies, and cooperative marketing associations, and to make direct loans to cooperative marketing associations. The maturity of all such discounts and advances was limited to a minimum of 6 months and to a maximum of 3 years.

In turn, the Federal intermediate credit banks were permitted to rediscount their paper with the Reserve Banks on the same basis on which agricultural paper in general could be offered for discount to the Reserve Banks. Thus, to be eligible for discount, such paper had to be endorsed by the intermediate credit bank and had to have a maturity at the time of discount of not more than 9 months, exclusive of days of grace. In addition, the Federal Reserve

Board had the right to limit the amount of paper with maturities of 3 to 6 months and of 6 to 9 months that might be rediscounted by a Federal Reserve Bank. Furthermore, the new law specifically provided that no Reserve Bank should rediscount for a Federal intermediate credit bank any note bearing the endorsement of a nonmember State bank that was eligible for membership in the Federal Reserve System. This was the first instance in which the discount facilities of the Federal Reserve Banks were made available to any but member banks of the Federal Reserve System.

In addition to authority to discount paper for the intermediate credit banks, the Agricultural Credits Act of 1923 gave the Reserve Banks authority to buy and sell debentures and other such obligations issued by the Federal intermediate credit banks or by the national agricultural credit corporations provided for in the same Act, but only subject to the same limitations as those applicable to the purchase and sale of farm loan bonds. Farm loan bonds, under the Farm Loan Act of 1916, could be bought and sold by the Reserve Banks to the same extent as State, county, and municipal

bonds could be purchased pursuant to section 14(b) of the Federal Reserve Act, and that section prescribed a maturity limitation of 6 months at the date of purchase. Finally, it may be noted that the Agricultural Credits Act added to section 14 of the Federal Reserve Act a new provision authorizing the Reserve Banks to purchase and sell in the open market acceptances of the intermediate credit banks and the national agricultural corporations whenever the Federal Reserve Board should declare "that the public interest so requires." All of these provisions relate to purchases by the Reserve Banks rather than to the discounting and lending functions of the Banks; they are mentioned here to indicate the extent to which Congress in 1923 provided for the use of the Federal Reserve System in facilitating the operations of Federal intermediate credit banks and in furthering extensions of agricultural credit.

Discounts for the intermediate credit banks were made subject to regulations and limitations to be prescribed by the Federal Reserve Board. In its 1923 revision of Regulation A,64 the Board required each Federal Reserve Bank, in discounting paper for any intermediate credit bank, to "give preference to the demands of its own member banks" and to have "due regard to the probable future needs of its own member banks." In addition, a Federal Reserve Bank was prohibited from discounting such paper whenever its own reserves were less than 50 per cent of its aggregate liabilities for deposits and Federal Reserve notes in circulation,65 and the total amount discounted by all Federal Reserve Banks at any one time for any one intermediate credit bank was limited to the amount of the capital and surplus of such intermediate credit bank.

In 1928 both of these amount limitations were made less rigid by an amendment to the regulation allowing them to be exceeded "with the permission of the Board." <sup>66</sup> In the 1937 general revision of Regulation A, <sup>67</sup> the limitation on the aggregate amount of discounts by all Reserve Banks for any one intermediate credit bank was omitted altogether. In 1955 the other limitation was also omitted, primarily because the reserves of all Federal Reserve Banks had for some time been less than 50

per cent of their deposit and note liabilities and the Board's permission would therefore be necessary in all cases. It was specifically provided that all discounts for intermediate credit banks should be made only with the permission of the Board.<sup>68</sup> The 1973 revision of Regulation A drastically condensed the section regarding discounts for intermediate credit banks but without any change in substance.

In the meantime Congress amended the law to provide the Federal intermediate credit banks with additional facilities for "acquiring funds through the Federal reserve system." 69 The Act of May 19, 1932,70 authorized the use of intermediate credit bank debentures as collateral for advances by the Reserve Banks to member banks. In addition, it amended section 13a of the Federal Reserve Act to permit the Reserve Banks to discount for the intermediate credit banks notes payable to such banks and endorsed by them if the notes had maturities of not more than 9 months and were secured by paper eligible for discount by the Reserve Banks. The purpose of the added authority to discount notes payable to the intermediate credit banks was simply to permit the discounting of paper representing direct advances made by such banks to agricultural associations and other financial institutions. As explained by Chairman Steagall of the House Banking and Currency Committee, it was "a piece of lost machinery in the intermediate credit banks" that the committee was attempting to supply.

In practice, the Reserve Banks do not now discount paper of Federal intermediate credit banks. However, under present law the Reserve Banks are authorized, with the permission of the Board, to discount for any Federal intermediate credit bank (1) paper meeting the regulatory definition of agricultural paper and (2) notes payable to such intermediate credit bank that represent loans made by it and that are secured by any paper eligible for discount by the Reserve Banks. In either case, the paper must be endorsed by the intermediate credit bank, must have a maturity of not more than 9 months at the time of discount, and must not bear the endorsement of a nonmember State bank. No amount limitation is prescribed.



# Bankers' Acceptances

### GENERAL CONSIDERATIONS

#### **PURPOSES**

In authorizing extensions of Federal Reserve credit on commercial and agricultural paper, the original Federal Reserve Act sought to provide a broader market for well-known existing types of paper. In contrast, the provisions of the Act with respect to bankers' acceptances had as their objective the development of a market for what was then considered a new type of commercial paper in the United States, and it is clear that their underlying purpose was to stimulate U.S. foreign trade.

The unimportant role of U.S. banks in the financing of foreign trade had been deplored by the National Monetary Commission in its 1912 report. When the House Banking and Currency Committee reported the Glass bill on the Federal Reserve in 1913, it stated that in the opinion of expert bankers the "acceptance form of loan," which was very common in Europe, could "be applied in the United States to excellent advantage." To remedy the situation, it

For NOTES AND REFERENCES, see pp. 254-57.

was proposed to give national banks express authority to accept drafts and bills of exchange and, in addition, to authorize the Federal Reserve Banks to discount such acceptances, subject in both cases to limitations on maturity and amount.

The major purpose of these provisions was to permit the financing of foreign business through U.S. markets rather than through foreign markets, particularly the London market. Mr. Phelan said: 3

Taken in connection with the permission to establish foreign branches it means that our importers and our exporters shall no longer be dependent upon London, and that they shall be freed from the annual tribute which they have been required to pay London bankers.

This purpose was more fully explained by Senator Swanson: 4

\* \* \* This country, having no system of acceptances in vogue by banks, has been compelled to resort to the foreign system in order to conduct our foreign business. All of our transactions in exportation and importation of goods is thus conducted in foreign money centers. The bankers and their customers in this country have to pay immense sums annually for this accommodation. The reserve banks, by being permitted to rediscount the acceptances of member banks, will soon do this class of business to the great benefit of the banks and their customers, and result in the saving of many millions of dollars annually. \* \* \*

The greater marketability of paper accepted by well-known banks was emphasized by Senator Weeks in referring to the acceptance provisions of the bill: <sup>5</sup>

\* \* \* If the merchant made a promissory note, he might find it necessary to pay 5 per cent for that money; but if he draws on a well-known bank or a well-known banker, he may be able to sell his paper on a 4 per cent basis. \* \* \*

For that reason, we undoubtedly will see a lower interest rate to every man who has a broad credit as a result of this system. That is the kind of paper that will not only go in our own reserve banks and be available as a basis for circulation, but it is the kind of paper that will give our business men a world-wide credit.

With the financing of foreign trade in mind, the Glass bill authorized national banks to accept, and the Federal Reserve Banks to discount, only acceptances based upon the importation or exportation of goods. Mr. Glass remarked during the debates in the House that this limitation had "been complained of by many of those who believe that its extension to domestic operations would be highly advantageous to industry." 6 Indeed, the Senate was opposed to the limitation; both the Owen bill and the Hitchcock bill would have covered acceptances growing out of domestic as well as foreign transactions. In the conference on the bill, however, the House conferees prevailed and the reference to domestic shipments was omitted.

On the very day on which the Act was finally approved, Senator Bristow asked why the reference had been cut out and why the dealer in foreign merchandise should be "given an advantage over the dealer in domestic merchandise on exactly the same kind of paper." Senator Owen replied that he had yielded with "very great reluctance" on this point, but that the House conferees had demanded its omission on the ground "that small banks were apt to abuse the right of selling their credit in the way of acceptances by accepting domestic bills in default of any accommodation they could extend at the time because of their then resources." It was not until 1916 that the acceptance provisions were broadened to cover domestic transactions. How this came about will be discussed later.

# EARLY ENCOURAGEMENT BY THE BOARD

Recognizing the novelty of acceptances, the Federal Reserve Board proceeded cautiously after the enactment of the original Federal Reserve Act. In issuing its first comprehensive regulation on the subject, the Board in April 1915 observed: 8

\* \* The acceptance is still in its infancy in the field of American banking. How rapid its development will be can not be foretold; but the development itself is certain. Opportunity is given by the Federal reserve act to assist the movement in this new direction; the present regulations are to be regarded as a first step and will be extended as circumstances and a reasonable regard for the other uses and needs of the credit facilities of the Federal reserve system may warrant.

At the same time, the Board called attention to the highly desirable character of bankers' acceptances and stated that they would be discounted at a preferential rate, as follows: "

The acceptance is the standard form of paper in the world discount market and both on this account and because of its acknowledged liquidity universally commands a preferential rate. By reason of its being readily marketable it is widely regarded as a most desirable paper in the secondary reserves of banks and will help to provide an effective substitute for the "call loan."

In the fall of 1915, when the Board amended its regulations to relax provisions prohibiting the renewal of acceptances, the Board declared: 10

It has been the aim of the Board to do everything in its power to create for the American acceptance, that is, dollar exchange [not to be confused with dollar exchange acceptances authorized the following year], a dominating position in the world market.

\* \* \* In widening somewhat the facilities of Federal reserve banks in dealing with American bankers' acceptances, the Board is attempting to give the member banks a larger opportunity for developing their sphere of usefulness in this respect.

By the latter part of 1916, the System's policy of encouraging bankers' acceptances began to show results. The Board was able to say: 11

There can be but little doubt that the law permitting national banks to accept drafts based upon foreign-trade transactions has been a most helpful factor in the recent movement of our foreign trade. Dollar acceptances [still not to be confused with dollar exchange acceptances] are now becoming known in almost all parts of the world, and are bound to prove a most powerful instrument in promoting and facilitating the commercial relations between this country and our foreign markets, where commercial credit has to be extended by our exporters desirous to enter these markets in competition with European houses. \* \*

The movement to encourage an acceptance market continued despite the intervention of World War I. In its *Annual Report* to Congress for 1919, the Board, after noting that there was not in this country any broad acceptance market such as existed in London, went on to say: 12

\* \* \* The development of such a market is necessarily a slow process and the burden of its support has fallen during the year 1919, as in previous years, upon the Federal Reserve Banks. This condition will doubtless continue until banks generally begin to invest funds temporarily idle in acceptances and until this method of employing funds appeals to the private investor. \* \*

In the following year, the Board reported to Congress that "appreciable progress" had been made in the development of a market for bankers' acceptances and that the Federal Reserve Banks continued to be "the greatest influences" in that market.<sup>13</sup>

These statements by the Board are significant as indicating the attitude of the System toward bankers' acceptances during the earlier years. The System's policy of encouragement was reflected in preferential discount rates. At the same time, the novelty of acceptances in U.S. banking was evidenced by the numerous rulings and interpretations issued by the Board during those years. In fact, a major part of the interpretations of the Board published in the Federal Reserve Bulletin before 1924 related to bankers' acceptances.

After 1923, however, the emphasis placed on bankers' acceptances gradually diminished. Since then, there has been no change in the law on this subject. No change has been made in the Board's Regulation C relating to the making of acceptances by member banks (see Appendix C) since 1946, and provisions of Regulation A regarding the discounting of acceptances by the Reserve Banks were drastically condensed in the 1973 revision of that regulation. Only in recent years has interest in bankers' acceptances revived, with some evidence of resurgence in the acceptance market.<sup>14</sup>

#### **DEFINITION**

An excellent nontechnical definition of a banker's acceptance is set forth in the following excerpt from an article that appeared in a 1955 issue of the Federal Reserve *Bulletin*, to which, incidentally, the reader is referred for a good summary of the development of bankers' acceptances in the United States: 15

A banker's acceptance is a time bill of exchange (frequently called a time draft) drawn on and accepted by a banking institution. By accepting the draft the bank signifies its commitment to pay the face amount at maturity to anyone who presents it for payment at that time. In this way the bank provides its name and credit and enables its

customer, who pays a commission to the accepting bank for this accommodation, to secure financing readily and at a reasonable interest cost. For investors, bankers' acceptances represent short-term private paper with a maximum degree of safety and liquidity, comparable to that enjoyed by Treasury bills.

Bankers' acceptances have been utilized in the United States and abroad in part to finance domestic transactions but primarily in transactions related to international trade. Buyers and sellers engaged in foreign transactions are apt to be less well known to each other and the shipping time is longer than is usually the case in domestic transactions.

Somewhat more legal in nature was the definition stated by the Board in its 1915 regulations. There the term "acceptance" was defined as: <sup>16</sup>

\* \* \* a draft or bill of exchange drawn to order, having a definite maturity, and payable in dollars, in the United States, the obligation to pay which has been accepted by an acknowledgement written or stamped and signed across the face of the instrument by the party on whom it is drawn; such agreement to be to the effect that the acceptor will pay at maturity according to the tenor of such draft or bill without qualifying conditions.

In a separate place, the regulation provided that an acceptance, in order to be eligible for discount, must have been made by "a member bank, nonmember bank, trust company, or by some private banking firm, person, company, or corporation engaged in the business of accepting or discounting." If it met these requirements, the acceptance was to be considered a "banker's" acceptance.<sup>17</sup>

The definition was simplified in the Board's 1916 revision of Regulation A. There the term "banker's acceptance" was defined simply as "a draft or bill of exchange of which the acceptor is a bank or trust company, or a firm, person, company, or corporation engaged in the business of granting bankers' acceptance credits." 18

Four years later the definition was changed to make it clear that an eligible acceptance could be payable either in the United States or abroad and either in dollars or in some other money.<sup>19</sup> This was a reversal of the position taken by the Board in 1915 that the instrument must be one payable in dollars in the United States

The Board's present Regulation A, as drastically revised in 1973, omits any definition of a banker's acceptance.

In construing its earlier regulatory definition, the Board made it clear that an acceptance must be made by the party upon which it is drawn. For example, a draft drawn upon a land company but accepted by a bank cannot properly be considered a banker's acceptance.<sup>20</sup>

It should be noted, however, that the definition did not require that the acceptor be a bank. If the acceptor was in the habit of carrying on some acceptance business, its acceptances qualified as bankers' acceptances.<sup>21</sup> In pursuance of the policy of developing a U.S. acceptance business, the Board in 1918 announced that acceptances of "acceptance corporations" should be considered on the same basis as those of prime private bankers and should not be discriminated against.<sup>22</sup>

# ACCEPTANCE AUTHORITY OF MEMBER BANKS

It seems reasonably clear that the framers of the original Federal Reserve Act assumed that national banks lacked authority to accept time drafts. The House committee report stated that the acceptance business was "a new form of business heretofore forbidden to national banks." <sup>23</sup> Mr. Phelan observed in the House that "under our national banking laws national banks are not permitted to accept drafts or bills of exchange." <sup>24</sup> In the Senate, Senator Swanson declared that the bill would "open up a new field of business for our national banks." <sup>25</sup>

Following enactment of the original Act, the Federal Reserve Board on several occasions expressed the view that national banks had no acceptance powers prior to 1913, 26 and it appears that the Comptroller of the Currency took the same position for many years. In 1963, however, the Comptroller sharply reversed that position and ruled that national banks were not limited by the Federal Reserve Act as to the

kinds of acceptances they might make in financing credit transactions; this ruling was based largely on the ground that the making of acceptances constituted an essential part of the general banking powers authorized in the National Bank Act.<sup>27</sup>

Although the provisions of the original Federal Reserve Act were in terms of authorizing any member bank to make acceptances of the kinds therein described, they were obviously not intended to confer any new authority upon State member banks since State banks derive their powers from State law, Nevertheless, the provisions could reasonably have been interpreted as limiting State member banks, as well as national banks, to the types of acceptances described in the Act. Although the Act expressly provided that State banks joining the System should retain their charter and statutory rights as State banks, this reservation was made subject to the provisions of the Federal Reserve Act. In the form in which the bills passed both Houses of Congress, the acceptance provisions referred only to national banks; but the conference committee changed the words "national bank" to "member bank." Although no explanation was given for this change, it seems likely that it was intended to limit State member banks, as well as national banks, to the making of acceptances of the kinds specified.

Despite these considerations, the Board's General Counsel in 1923 stated that the Board had "always taken the position that a State bank becoming a member of the Federal reserve system is not limited as to the character of acceptances which it may make by the permissive provisions of section 13." 28 At the same time, that opinion stated that the quantitative limitations of the Act with respect to bankers' acceptances—limitations on the amount of acceptances for any one customer and on the aggregate amount of acceptances—were applicable to State member banks as well as to national banks.

On the assumption that the provisions of section 13 of the Federal Reserve Act limiting the kinds and amounts of acceptances that could be made by member banks applied at least to national banks, if not to State member banks, the Board since 1917 has had outstanding its

Regulation C, regarding the making of bankers' acceptances, in addition to Regulation A, governing the discounting of acceptances by the Reserve Banks. If national banks and State member banks are governed only by the amount limitations of the law and not by the qualitative limitations, it is questionable whether Regulation C continues to serve any useful purpose.

# DISCOUNTING AUTHORITY OF FEDERAL RESERVE BANKS

Whatever may be the situation as to the authority of national banks or of State member banks to make acceptances, the Federal Reserve Banks are authorized by section 13 of the Federal Reserve Act to discount only bankers' acceptances of the kinds thereinafter described.29 Consequently, in order for any acceptance to be eligible for discount, it must meet all the requirements of the seventh or the twelfth paragraph of section 13 with respect to the acceptance authority of member banks, those as to kind as well as those as to maturity and amount. In addition, it must also meet two special requirements for discount by the Reserve Bank, First, it must have a maturity at the time of discount not less than that specified by the statute, and this requirement as to maturity for discount purposes must be carefully distinguished from the maturity requirements prescribed as a condition to the authority of member banks to make acceptances. Second, it must be endorsed "by at least one member bank." Until 1916, an acceptance had to comply with separate limitations as to amount, different from those imposed on the discounting authority of member banks; however, these limitations are no longer prescribed.

Requirements as to kind, maturity, and amount will be treated in subsequent sections of this chapter. The requirement as to endorsement may appropriately be considered here in connection with the general nature of the Reserve Banks' discounting authority.

As to discounts of other types of paper, the law authorized a Federal Reserve Bank to discount the paper if endorsed by any of "its" member banks. An acceptance, however, was required by the law only to be endorsed by "at least one member bank." Noting the difference, the Board in 1915 held that it was immaterial whether the offering member bank was located in the district of the Reserve Bank making the discount or in some other district; in other words, a Reserve Bank could discount bankers' acceptances for any member bank wherever located.30 This inconsistency prevailed until 1937 when, in revising Regulation A, the Board provided that a banker's acceptance could be discounted by a Federal Reserve Bank only for one of "its member banks," though the regulation still, rather ambiguously, required the acceptance to bear the endorsement of "a member bank." 31 The present regulation authorizes a Reserve Bank to discount for a member bank, which must, of course, be one of its own members, bankers' acceptances endorsed by "the member bank." Thus, despite the discrepancy in the law, a Reserve Bank now may discount acceptances only for its own member banks.

The Board's discount regulations have always included a provision to the effect that a Federal Reserve Bank must satisfy itself as to the eligibility of any paper offered for discount. In the case of bankers' acceptances, however, a special provision as to evidence of eligibility was once considered necessary. As amended in

1916. Regulation A specifically provided that if the bill did not itself evidence the character of the underlying transaction, evidence of the eligibility of a banker's acceptance might consist of a stamp or certificate affixed by the acceptor in a form satisfactory to the Reserve Bank.32 In 1937, a footnote was inserted in the regulation requiring the accepting bank to obtain "substantiating evidence" as to the eligibility of the underlying transaction in the case of acceptances based on import or export transactions, but this requirement was omitted in 1955, presumably as unnecessary. No provisions regarding evidence of eligibility of bankers' acceptances are included in the revision of the regulation adopted in 1973.

Even if legally eligible for discount, a banker's acceptance, like any other kind of eligible paper, does not have to be discounted by the Reserve Bank to which it is offered for discount. The discount authority of the Reserve Banks is not mandatory but discretionary. Thus, in an early ruling the Board held that a draft drawn by an American exporter upon a foreign buyer and accepted by the buyer may be technically eligible for discount, but that the Reserve Bank may nevertheless, in its discretion, decline to discount such an acceptance on the ground that it is not a desirable investment.<sup>33</sup>

### IMPORTATION AND EXPORTATION OF GOODS

# CONNECTION WITH IMPORT OR EXPORT

The original Federal Reserve Act authorized member banks to make, and Federal Reserve Banks to discount, only one type of banker's acceptance: acceptances "growing out of the importation or exportation of goods." As has been indicated, the framers of the Act thought of the acceptance mechanism chiefly as a means of financing foreign trade, hoping that the acceptance authority, along with the authority given national banks to establish foreign

branches, would serve to improve the position of the United States in the world market.

Aside from the rather vague requirement that acceptances should grow out of import or export transactions, the law made no attempt to describe or limit the kinds of transactions that might give rise to eligible acceptances. In its first regulation on the subject the Board required only an indication (on the face of the acceptance) that the proceeds "were used or are to be used in connection with a transaction involving the importation or exportation of goods." 34 In 1915, becoming a little more

specific, the Board changed the regulation to require the draft to be drawn either by a commercial, industrial, or agricultural concern "directly connected" with the shipment of goods involved or by a banker; in the latter event the "goods" were required to be "clearly specified" in the agreement with the acceptor. If the acceptor were not a member bank, it had to agree to furnish the Reserve Bank, on request, with information as to the nature of the transaction.35 In 1916, however, the language of the regulation was again changed, this time to require that an accepted bill, to be eligible for discount, "must have been drawn under a credit opened for the purpose of conducting, or settling accounts resulting from," one of the three types of transactions described in the statute.36

The obvious intent of these early regulations was to insure that a banker's acceptance had some close and direct connection with an import or export transaction in order for it to be considered as growing out of such a transaction. In a number of early rulings, the Board sought to answer the recurring question of how close and direct the connection ought to be.

Thus, the mere fact that a draft was secured by an acceptance based on an import or export transaction was held by the Board not to be sufficient to make the draft itself eligible for discount.37 Similarly, the Board ruled that an acceptance was too remotely related to an import or export transaction if the draft was drawn by a domestic seller of raw materials on a domestic manufacturer who had a contract to export the manufactured products; 38 or if the draft was drawn by a foreign manufacturer on a domestic bank to finance the manufacture of goods to be shipped later to the United States; 39 or if the acceptance was intended to finance foreign retailers in selling goods exported from the United States.40

On the other hand, if it were clear that the draft was actually drawn to finance an export transaction, the Board held that the acceptance of the draft would be eligible for discount even though the goods had not yet been actually shipped <sup>41</sup> or even though there had been a delay in shipment.<sup>42</sup> As a matter of fact, the Board went so far as to hold that, if there had

been a bona fide contract for the export of goods, drafts drawn to finance such export continued to be eligible throughout their life as drafts growing out of an export transaction even though, because of freight rates and shipping conditions, the goods were never actually shipped abroad.<sup>43</sup>

Thus, although the Board adopted a liberal view with respect to acceptances made prior to shipments, it was more conservative, at least at first, with respect to acceptances made after the shipment was completed. In 1917, it ruled that after goods had been imported and they were lying on the docks, any new transaction would be simply a domestic transaction.44 Similarly, in 1926, the Board held that a national bank could not legally accept drafts after the underlying import or export transactions were completed. 45 In the following year, however, the Board concluded that these and other previous rulings were unnecessarily strict interpretations of the law and that the statute was susceptible of "a more liberal interpretation which would facilitate the financing of our foreign trade." It ruled, therefore, that acceptances might properly be considered as growing out of the importation or exportation of goods if they were drawn to finance the sale and distribution on usual credit terms of imported or exported goods into the channels of trade, whether or not the bills were accepted after the physical importation or exportation had been completed.46 This ruling opened up a broader field for the use of bankers' acceptances than had previously existed.47

# CONTRACT AND SHIPPING DOCUMENTS

The two things that normally afford the best evidence that a banker's acceptance grows out of an import or export transaction are the existence of a contract for the shipment of goods and the documents relating to their shipment.

At an early date the Board held that the accepted draft must have been drawn by, or at the instance of, a person with a contract to export or import goods. However, if the goods had been actually shipped and shipping documents were attached to the draft at the time of

its acceptance, the existence of a contract for export was not essential.<sup>49</sup>

In a 1918 ruling the Board announced certain principles to be applied in determining whether an acceptance grew out of an export transaction in the case of a dealer who was engaged in the purchase of the same kind of goods for both export and domestic use. The agreement between such a dealer and the accepting bank was required to show (1) that the dealer had a contract for the export of the goods, (2) that the amount of the drafts would not exceed the amount involved in the export transaction, and (3) that the proceeds of the drafts would be used in connection with the export transaction. In addition, it was required that the proceeds of the sale be applied in payment of the acceptance, unless the dealer had placed the bank in funds to meet it at maturity or had secured the acceptance in the manner required for domestic acceptances, that is, by shipping documents, warehouse receipts, or similar documents securing title to readily marketable staples.50

This ruling, however, was superseded 2 years later when the Board, in its 1920 revision of Regulation A, undertook to specify the circumstances that must be present for an acceptance to be considered as growing out of the importation or exportation of goods.51 The regulation stated that it was not necessary that shipping documents be attached or that the drafts cover "specific goods" 52 in existence at the time of acceptance. But the regulation required either (1) that shipping documents be attached when the draft was presented for acceptance, or (2) if the goods had not been shipped, that there be a contract for their import or export within a specified and reasonable time and that the customer agree to furnish the accepting bank in due course with shipping documents covering the goods or with exchange arising out of the transaction being financed.

These requirements, as interpreted by the Board, meant that it was no longer sufficient, as had been indicated in the 1918 ruling, for the acceptance to be secured by documents covering goods not intended for export; a dealer engaged in both domestic and foreign transactions was now required to furnish the accepting bank with shipping documents cover-

ing the goods to be exported if the acceptance was to be eligible as one growing out of an export transaction.<sup>53</sup> The regulatory provision permitting the dealer to furnish exchange arising out of the transaction was meant as an alternative to the furnishing of shipping documents only in the case of import transactions.

When the regulation was next revised in 1922, the detailed provisions of the 1920 regulation with respect to the alternative necessity for either a contract or shipping documents, as well as the other requirements as to import and export transactions, were omitted. The Board stated, however, that their elimination was only for simplification and that the Board was not reversing or modifying any of its previous rulings regarding acceptances growing out of the importation or exportation of goods insofar as they had been interpretative of the law or had laid down broad general principles, which "as a result of long experience in the field of international banking, [were] recognized as essential in the proper conduct of the acceptance business." 51 Apparently, the Board felt that a regulatory statement of these general principles was no longer necessary. It observed:

Those American banking institutions which have large demands for acceptance credits in foreign transactions have by this time had considerable experience in this field, and the former detailed regulations are no longer thought necessary. Moreover, it is believed that the general advancement of foreign trade, with the resulting benefit to the agricultural and commercial interests which are largely dependent upon foreign markets, can be furthered most effectually at the present time by the substitution of this simpler regulation applicable to acceptances in export and import transactions.

Since 1922, neither Regulation A nor Regulation C has contained any provisions describing or limiting the import and export transactions that may be made the basis for bankers' acceptances, except that, until 1955, Regulation A continued to carry the general requirement that an acceptance should be drawn under a credit opened for the purpose of conducting or settling accounts resulting from one of the three types of transactions described in the law.

#### GEOGRAPHIC COVERAGE

Soon after the enactment of the original Act question arose as to what was meant geographically by the phrase "importation or exportation of goods." In 1915 the Board's General Counsel expressed the view that it covered not only shipments of goods between the United States and foreign countries but also shipments between two foreign countries and shipments between the United States and Puerto Rico, the Canal Zone, or the Philippines. 55 However, because Hawaii was then an integrated territory and subject to all laws of the United States, he held that shipments between the United States and Hawaii were domestic shipments and could not, therefore, be regarded as shipments involving the importation or exportation of goods. This, of course, was before the law was changed

to authorize acceptances based upon domestic shipment of goods. (It was also, of course, long before Hawaii became a State.)

When Regulation A was revised after the amendments made by the Act of September 7. 1916, it specifically covered acceptances arising out of transactions involving shipments between the United States and any foreign country. between the United States and any of its "dependencies or insular possessions," or between foreign countries.56 In 1923 the regulation included mention of an additional category of shipments-those between dependencies or insular possessions and foreign countries.57 The same four categories of shipments are covered by the Board's regulations today, although since February 15, 1955, they have been specifically described not in Regulation A but in Regulation C, governing acceptances by member banks.58

### DOMESTIC SHIPMENTS

# EXTENSION OF LAW TO COVER DOMESTIC SHIPMENTS

The original Federal Reserve Act, as has been noted, contained no authority for the making or discounting of bankers' acceptances covering domestic shipments of goods. Some members of Congress could see no good reason for authorizing foreign but not domestic acceptances, but the majority apparently felt that, in view of the novelty of the acceptance device in this country, acceptances against domestic shipments might be abused by the smaller banks. By 1916, however, sentiment had changed. The statute was amended to authorize member banks to accept drafts or bills "which grow out of transactions involving the domestic shipment of goods provided shipping documents conveying or securing title are attached at the time of acceptance." 59

The amendment had been recommended by the Board in its 1915 Annual Report 60 as follows:

The acceptance system, provision for which is made in foreign trade operations by the Federal Reserve Act, should be extended to the domestic trade in so far as relates to documentary acceptances secured by shipping documents or warehouse receipts, covering readily marketable commodities or against the pledge of goods actually sold.

There can be but little question of the safety of such acceptances, and their use will tend to equalize interest rates the country over and help to broaden the discount market.

In explaining the purpose of the amendment in Congress, Senator Owen stated: 61

The purpose of that is to permit a limited use of domestic acceptances where those acceptances are covered by documents conveying or securing title to readily marketable staples, and then confining it further, so that the bank may not make acceptances to over 10 per cent of its paid up and unimpaired capital stock to any particular individual, company, firm, or corporation.\* \* \*

The amount limitation referred to by the Senator will be discussed at a later point. His statement is significant here because it reflects a feeling of caution in extending the law to permit banks to make acceptances in domestic transactions.

### PURPOSE OF FINANCING

Promptly after the 1916 amendment to the law authorizing domestic acceptances, the Board revised its Regulation A to cover bankers' acceptances under the new authority. 42 However, the revised regulation did no more than paraphrase the requirements of the statute that such acceptances must grow out of the domestic shipment of goods and that shipping documents must be attached at the time of acceptance.

In some early rulings the Board took the position that, in order to be eligible, the accepted draft must have been drawn solely for the purpose of financing the shipment and that if the effect was merely a straight loan to the drawer, even though secured by bills of lading, the draft could not be eligible for acceptance. <sup>63</sup> In other rulings the Board similarly held that acceptances covering financing for a period longer than the period of shipment were actually designed to provide working capital and so were not eligible. <sup>64</sup>

In 1929, however, the Board held that when a 90-day bill was accepted by a bank and the proceeds were used to pay a sight draft accompanied by a bill of lading covering a shipment of staples, the acceptance was eligible for discount even though 90 days were not required for completion of the shipment, provided the maturity was consistent with the "usual and customary" credit time prevailing in the particular business. The Board stated that this ruling superseded, to the extent of any inconsistencies, previous rulings regarding the use of acceptances to furnish working capital.

### SHIPPING DOCUMENTS

As a condition both to the acceptance by member banks of drafts growing out of domestic shipments and to the discounting of such acceptances by the Federal Reserve Banks, the law requires that shipping documents "conveying or securing title" shall be "attached at the time of acceptance." In applying this condition, the Board has held that the term "shipping documents" includes either an order bill of lading or a straight bill of lading, even though the protection afforded by a straight bill is not absolute; but that freight receipts or mere copies of original bills of lading are not sufficient.66

Since the law requires attachment of shipping documents at the time of acceptance, a draft cannot be accepted before the bills of lading covering a shipment have been issued. But physical attachment is not necessary; it suffices if the documents are in the possession of the accepting bank or its agent at the time of acceptance. But

Although shipping documents are necessary at the time of acceptance, they need not, and normally would not, be retained by the accepting bank throughout the life of the acceptance. Obviously, such documents must be surrendered in order for the customer to consummate the transaction involved. However, the Board once pointed out that when the documents have to be released after acceptance, banking prudence requires that the accepting bank should protect itself by obtaining either a trust receipt or an agreement that the proceeds of the sale will be deposited with the bank when they become available. To

#### GEOGRAPHIC LIMITATION

The 1916 amendment authorizing acceptances growing out of the domestic shipment of goods did not define what was meant by a domestic shipment, nor did the Board by regulation or ruling undertake to define the term prior to 1946. Presumably it was understood that domestic was simply the opposite of foreign and that the amendment referred to shipments within the United States. This was confirmed in the Board's 1946 revision of Regulation C, when previous language referring to domestic shipments was changed to refer to the "shipment of goods within the United States," 71

### STORAGE OF STAPLES

### PURPOSE OF TRANSACTION

When the law was amended in 1916 to authorize acceptances growing out of the domestic shipment of goods, an additional type of acceptance was also authorized, namely, acceptances "which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples." The purpose of this third class of commercial banker's acceptance was to facilitate the carrying of goods held in storage pending sale, shipment, or distribution into the process of manufacture.

If the draft, even though secured by a ware-house receipt, was actually drawn to carry goods for speculative purposes or for an indefinite period of time without any purpose to sell, ship, or manufacture within a reasonable time, it was not eligible for acceptance; such a draft was regarded by the Board as merely a cloak to evade the limitations of the law on the amount which a national or a State member bank could lawfully lend to one person.<sup>72</sup>

By the same token, if the real purpose of a proposed acceptance credit based on the storage of cotton at a mill was to provide the mill with working capital rather than to finance the sale of the cotton by a cotton broker to the mill or temporary storage thereof pending sale, such an acceptance was considered improper.<sup>73</sup> Similarly, drafts drawn to finance a manufacturer pending the manufacture and ultimate sale of the goods as a finished product were held ineligible for acceptance because the drafts, although accompanied by warehouse receipts, were not drawn to carry the goods covered by such receipts pending a reasonably immediate sale or distribution.<sup>74</sup>

# WAREHOUSE RECEIPTS AND OTHER SECURITY

The statute requires that an acceptance covering the storage of readily marketable staples be "secured at the time of acceptance by a

warehouse receipt or other such document conveying or securing title" to such staples. By regulation and interpretation the Board has laid down certain conditions as to the form of the security for such acceptances, the independence of the warehouseman from the borrower, and the substitution and release of the security.

As to what constitutes a warehouse receipt or other such document, the Board by regulation in 1920 provided that the security for the staples involved must take the form of a "warehouse, terminal, or other similar receipt, conveying security title to such staples, issued by a party independent of the customer." <sup>75</sup> For this purpose, chattel mortgages on cattle were not considered security similar to a warehouse receipt. <sup>76</sup> However, a receipt issued by the custodian of buildings in which the staples were stored could be treated as a warehouse receipt. <sup>77</sup>

The principal regulatory requirement was that the warehouse receipt be issued by a party completely independent of the borrower; otherwise the receipt would not effectively convey or secure title to the staples. This meant that the borrower should not be in a position to exercise any control over the goods stored and should not have access to the premises,78 except access solely for the purpose of inspecting the goods. 79 If these conditions were met, the staples could be stored on property owned by the customer if they were turned over, under a bona fide lease, to an independent warehouseman.80 However, in a case in which the custodians and representatives of the warehouse company were former employees of the lessor-borrower who expected to be reemployed by the latter at the close of the storage season, the Board held that the requirement as to independence of the warehouseman was not fulfilled.81 Similarly, if the warehouse company was organized by the customer, it must not have been simply a subterfuge to evade this requirement of the regulation.82

In 1928 Regulation A was amended to make

it clear that a warehouse receipt covering the storage of readily marketable staples could be issued "by a grain elevator or warehouse company duly bonded and licensed and regularly inspected by State or Federal authorities with whom all receipts for such staples and all transfers thereof are registered and without whose consent no staples may be withdrawn." 83

Under the statute, bankers' acceptances secured by warehouse receipts covering the storage of staples are required to be so secured only at the time of acceptance, except that if such acceptances or any other kinds of acceptances are made by a member bank for one customer up to an amount exceeding 10 per cent of the bank's capital stock and surplus, the acceptance must remain secured throughout its life. In other words, the law does not require that acceptances within the 10 per cent limitation must remain secured, either with respect to the acceptance authority of member banks or the discounting authority of Federal Reserve Banks. By regulation, however, the Board provided that acceptances to finance the storage of staples, in order to be eligible for discount, must continue to be secured throughout the life of the acceptance by some form of security in addition to the customer's general credit, whether or not the acceptance exceeded 10 per cent of the member bank's capital and surplus.84 This requirement was first included in Regulation A in 1920.85 If the goods were withdrawn from storage before maturity, the regulation permitted the substitution of a trust receipt or other similar document covering the goods, provided the substitution was conditioned on a reasonably prompt liquidation of the credit. To insure compliance, the regulation provided that, when the original documents were released, it should be required either (1) that the proceeds be applied within a specified time to the liquidation of the acceptance credit, or (2) that a new document similar to the original be substituted in a specified time.

### PLACE OF STORAGE

At an early date the Board ruled that acceptances secured by the storage of staples were eligible for discount even though the staples were stored in a warehouse in a foreign country. Such acceptances involved drafts that were payable in dollars in the United States and that were drawn abroad and accepted by U.S. banks.<sup>86</sup> In 1928 the eligibility for discount of acceptances covering the foreign storage of staples was expressly recognized by an amendment to Regulation A that inserted after the word "storage" the words "in the United States or in any foreign country." <sup>87</sup>

# MEANING OF "READILY MARKETABLE STAPLES"

Shortly after the law was amended in 1916 to authorize acceptances secured by the storage of staples, the Board ruled that the term "staples" included manufactured goods as well as raw materials, provided the goods were non-perishable and had a wide ready market.<sup>88</sup>

Three years later the Board defined the term "readily marketable staple" as follows: \*9

A readily marketable staple may be defined as an article of commerce, agriculture, or industry of such uses as to make it the subject of constant dealings in ready markets with such frequent quotations of prices as to make (a) the price easily and definitely ascertainable and (b) the staple itself easy to realize upon by sale at any time.

At the same time the Board suggested that, as a matter of prudence and protection, banks should not consider as eligible any staple that is so perishable as to raise doubts as to whether its value as security can be maintained at least for the life of the draft drawn against it.

The definition just quoted was incorporated in Regulation A in 1920 and, surviving the years without any change in language, it is still set forth in a footnote in Regulation C; however, it was omitted in the 1973 revision of Regulation A.

In particular instances, the Board ruled that readily marketable staples included cattle, 90 coal, 91 cotton and cotton yarns, 92 cottonseed, 93 flour, 94 potatoes, 95 sugar in bond, 90 and wool. 97 In other cases, it held that the term did not include automobiles and automobile parts and tires 98 or whiskey or sacramental wine in bond. 99

### DOLLAR EXCHANGE

#### NATURE AND PURPOSE

In 1916 Paul M. Warburg, a member of the Federal Reserve Board, made a trip to South America. Upon his return, he wrote a letter to Senator Robert L. Owen, then Chairman of the Senate Banking and Currency Committee, recommending that U.S. banks be given authority to accept drafts drawn by foreign bankers to furnish "dollar exchange." 100 Mr. Warburg stated that his attention had been drawn to the fact that the means of payment employed by the South American merchant, when settling his obligations in Europe or in the United States, was generally not by check but by "the old established usage—a three months' draft on foreign bankers, primarily British bankers." Mr. Warburg then went on to say:

\* \* \* If dollar exchange is to be used as freely as sterling exchange, the foreign bankers in these South American countries must be in a position to draw a three months' draft on American bankers as easily as they can draw it on British bankers.\* \* \*

. . . . .

I am fully conscious of the fact that a draft of this kind, if permitted, might be classified as closely approaching or being a species of the finance draft; but to the extent as above outlined I think this draft has to be sanctioned in order to place our banks on a par with the British banks and other foreign banks operating in South and Central America.

If Congress will trust the Federal Reserve Board to supervise these transactions and keep them within proper bounds, I believe that an amendment as here proposed would remove a great handicap now burdening the American banks, while any abuse of these facilities could be stopped at any time by the Federal Reserve Board.

Congress followed Mr. Warburg's recommendations. The Act of September 7, 1916—the same act that authorized acceptances against domestic shipments and storage of staples—

added to section 13 of the Federal Reserve Act a new paragraph authorizing member banks to accept drafts or bills of exchange drawn upon them for the purpose of furnishing dollar exchange, subject to certain limitations. It was required that the drafts or bills must have not more than 3 months' sight to run at time of acceptance. It was required that they be drawn, under regulations prescribed by the Board, by banks or bankers in foreign countries or dependencies or insular possessions of the United States for the purpose of furnishing dollar exchange "as required by the usages of trade" in the respective foreign countries, dependencies, or insular possessions. The amendment further provided that such drafts and bills might be acquired by Federal Reserve Banks in such amounts and subject to such regulations, restrictions, and limitations as might be prescribed by the Board. Specific limitations were placed upon the amount of dollar-exchange drafts that could be accepted by member banks.

In explaining the new type of acceptance in Congress, Senator Owen said: 101

At present exchange passing from the Argentine to the United States passes through London by sterling exchange. By this [amendment] it is proposed to permit these exchanges to be expressed in dollars, so as in that way to establish a direct communication between the South American and other foreign countries and the United States, and to make it unnecessary, in transmitting credits, to transmit them through London in sterling exchange or through other European countries in terms of money of the foreign country through which the exchanges are transmitted. The purpose is to establish the dollar exchange, so as to make the United States a financial center for the transaction of foreign business, and to make this country what it is destined to be-the financial center of the world.

Soon after the passage of the 1916 amendment, the Board noted that the custom among foreign bankers of selling 3-month drafts in preference to checks had originated in countries "where the mail connections were irregular and the foreign-exchange market was a limited one, and where it would have been difficult for the drawing banker to be certain that he could find a cover against the checks drawn by him in time to forward it by the same mail, whereas, in drawing a three months' draft, he would feel assured of being able to forward remittances before his obligation fell due." <sup>102</sup> In areas where these conditions did not exist, the Board felt that dollar-exchange acceptances were not justified.

As observed by Mr. Warburg, dollar-exchange drafts are in the nature of "finance" drafts. Unlike the so-called commercial acceptances discussed in previous sections of this chapter, dollar-exchange acceptances are not directly based on underlying commercial transactions. The Board, however, has carefully sought to limit the use of these acceptances to the particular species of finance transaction covered by the statute. It has held, for example, that they may not be used merely for the purpose of benefiting from the fact that dollar exchange is at a premium in the country where the drafts are drawn. 103 In its 1946 revision of Regulation C, the Board prescribed the following "purpose" limitation: 104

Any such dollar exchange draft or bill must be drawn and accepted in good faith for the purpose of furnishing dollar exchange as required by the usages of trade in the country, dependency, or insular possession in which the draft or bill is drawn. Drafts or bills drawn merely because dollar exchange is at a premium in the place where drawn or for any speculative purpose or drafts or bills commonly referred to as "finance bills" (i.e., which are not drawn primarily to furnish dollar exchange) will not be deemed to meet the requirements of this section.

In furtherance of this limitation as to purpose, the regulation also provided that the aggregate of drafts or bills accepted by a member bank for any one foreign bank or banker should not exceed an amount which the member bank would expect the foreign bank or banker to liquidate through the proceeds of export documentary bills or from other

sources "reasonably available to such foreign bank or banker arising in the normal course of trade." 105

The principal usefulness of dollar-exchange acceptances arose from the fact that in some foreign countries exports of goods were subject to seasonal variations. This form of acceptance enabled banks in such countries to provide dollars to their customers to finance imports from the United States during seasonally low export periods, such acceptances to be repaid with dollars acquired out of the proceeds of later exports. Despite their usefulness for this purpose, however, dollar-exchange acceptances never constituted a very large proportion of the total amount of acceptances made by member banks under the Federal Reserve Act.

# PERMISSION TO ACCEPT DOLLAR-EXCHANGE DRAFTS

The statute does not specifically provide that a member bank must obtain the Board's permission before accepting dollar-exchange drafts or that such drafts may be accepted only when drawn by bankers in countries designated by the Board. The law does provide, however, that dollar-exchange drafts must be "drawn under regulations to be prescribed" by the Board. Pursuant to this provision, the Board by regulation has required that a member bank must have the Board's prior permission before it accepts any dollar-exchange drafts and also that a member bank may accept such drafts only for bankers in those foreign countries that have been expressly designated by the Board.

The Board's first regulation on this subject was issued in September 1916 as Regulation C.<sup>107</sup> It provided simply that any member bank desiring to accept drafts drawn by foreign banks or bankers should apply to the Board for such authority, setting forth the usages of trade in the respective countries in which such banks or bankers were located; that, if the Board determined that the usages of trade required, the Board would so notify the applying bank and publish in the Federal Reserve Bulletin the names of the countries approved for this purpose; but that the Board reserved the right

to modify, or, on 90 days' notice, to revoke either its approval as to the particular member bank or its approval as to any foreign country.

In its contemporaneous revision of Regulation A,<sup>108</sup> the Board stated that the Federal Reserve Banks were authorized to discount for member banks dollar-exchange acceptances made in accordance with Regulation C.

The provisions of Regulation C as first issued, treating together the authority of member banks to accept dollar-exchange drafts and their authority to accept for bankers in specified foreign countries, continued unchanged until 1946. When the regulation was revised in that year, the two authorities were separated.

As to the authority of member banks to make dollar-exchange acceptances, the 1946 Regulation C provided, and continues to provide, that a member bank must file with the Board, through the Federal Reserve Bank of its district, an application for permission to accept dollar-exchange drafts. The application need not be in any particular form, but it must show "the present and anticipated need" for the authority requested. The Board reserves the right to rescind any such permission after not less than 90 days' notice in writing to the bank affected.

### **DESIGNATED COUNTRIES**

Since the law permitted dollar-exchange acceptances only with respect to those countries in which such acceptances were required by the usages of trade, the Board felt it necessary to assume the responsibility for determining what particular countries met this requirement. As already noted, in its first regulation on the subject the Board required any member bank applying for permission to accept dollar-exchange drafts to set forth the usages of trade in the countries for which it desired to accept such drafts, and the Board stated that it would publish in the Federal Reserve Bulletin the names of the countries approved by it for this purpose.

Late in 1916 the Board published examples of letters written by it to member banks approving and declining to approve certain foreign countries as eligible for dollar-exchange

drafts. 110 It quoted a letter declining to approve England and France for this purpose, because it appeared that there was "no difficulty in securing in London or Paris cable transfers or checks on the United States." At the same time, it indicated that it had given approval to the acceptance of dollar-exchange drafts for banks or bankers in Puerto Rico, Santo Domingo, Costa Rica, Peru, Chile, Brazil, Venezuela, Argentina, and Bolivia, In 1918, Colombia, Ecuador, Nicaragua, Uruguay, and Trinidad were added to the list.111 In 1920, the following countries were also added: British Guiana, British Honduras, Cuba, Dutch Guiana, French Guiana, Honduras, Panama, Paraguay, and San Salvador.112 Up to this time, only South and Central American countries (plus Cuba) had been included in the list. In 1921, however, the Board designated Australia, New Zealand, and "other Australasian dependencies." 113 Finally, in 1922, the list was expanded to include the French West Indies, Guatemala, and the Dutch East Indies.114 No countries have been added to the list since 1922. Also, no countries have been removed from the list, although the reference to Santo Domingo now refers to Haiti.

It should be noted that member banks that have been authorized to accept dollar-exchange drafts with respect to countries designated by the Board at the time the authority was granted also have authority to accept such drafts for countries subsequently designated by the Board without the necessity for any further permission from the Board.<sup>115</sup>

As revised in 1946, Regulation C provided <sup>116</sup> that member banks having authority to accept dollar-exchange drafts might accept such drafts only with respect to the countries specified in the list published by the Board, but that a member bank desiring to accept for bankers in countries not specified in such list might request the Board to add such countries to the list upon a showing that the furnishing of dollar exchange was required by the usages of trade. The regulation also noted that the Board might at any time, after 90 days' published notice, remove the name of any country from such list.

As has been observed, no countries have been added to or removed from the list since 1922. Extensive changes have taken place since that time in the usages of trade in foreign countries affecting dollar exchange; and unless the law is construed as authorizing dollar-exchange acceptances for purposes broader than those envisaged by Mr. Warburg after his 1916 trip to South America, one may question whether many—or any—of the countries designated by the Board before 1922 as justifying dollar-exchange drafts actually warrant that designation under present conditions.

# QUESTION REGARDING PRESENT LEGAL AUTHORITY

An interesting technical question has been raised as to whether the twelfth paragraph of section 13 of the Federal Reserve Act—the paragraph authorizing dollar-exchange acceptances—is still an effective part of the law.

In 1952, when the U.S. Code was revised under the auspices of the House Judiciary Committee, the revision omitted the dollarexchange paragraph that had previously been carried in section 373 of Title 12. A note by the codifier stated that the provisions of this section had been added to section 5202 of the Revised Statutes by the Act of September 7, 1916, but had been omitted in the further amendment made to section 5202 by the Act of April 5, 1918. For the same reasons, the codifier also omitted the eleventh paragraph of section 13 of the Federal Reserve Act, relating to the right of national banks to act as insurance agents and real estate loan brokers, which had previously been carried as section 92 of Title 12.

Apparently, the basis for the codifier's omission of these provisions was as follows:

Section 13 of the original Federal Reserve Act had amended section 5202 of the Revised Statutes, which limited the aggregate indebtedness of national banks, by adding an exception with respect to liabilities incurred under the Federal Reserve Act; the amended section 5202 had been set forth in full in section 13 of the Federal Reserve Act, although without quotation marks.

The Act of September 7, 1916, amended section 13 of the Federal Reserve Act and, in

doing so, set forth the amended section in full. However, instead of quoting the entire section within a single set of quotation marks, the amending act closed the quotation at the end of what is now the eighth paragraph of section 13. The ninth paragraph, beginning without quotation marks, then quoted section 5202 of the Revised Statutes as it had been amended by the original Federal Reserve Act and continued the quotation until the end of the revised section 13, thus making it appear that the tenth, eleventh, and twelfth paragraphs of section 13 were a part of section 5202. Those paragraphs related, respectively, to the authority of the Federal Reserve Board to regulate discounts by the Federal Reserve Banks, the authority of national banks to act as insurance agents and real estate loan brokers, and the authority of member banks to accept dollarexchange drafts. None of these paragraphs, of course, had any relation to the matter covered by section 5202 of the Revised Statuteslimitations on aggregate liabilities of national banks.

Two years later the War Finance Corporation Act of April 5, 1918, rewrote section 5202 in order to except liabilities incurred under that act from the limitation on the aggregate indebtedness of national banks. The rewritten section-naturally enough-did not include the material contained in the tenth, eleventh, and twelfth paragraphs of section 13 of the Federal Reserve Act. Nevertheless, because of the peculiar placement of quotation marks in the 1916 amendment, the codifier of the 1952 U.S. Code concluded that the eleventh and twelfth paragraphs of section 13 had been repealed by the 1918 revision of section 5202. Rather inconsistently, he did not conclude that the tenth paragraph of section 13 had also been repealed.

When the matter came to the attention of the Board in 1954, Chairman Martin wrote a letter to the House Judiciary Committee in which, for reasons set forth in an enclosed memorandum, 117 he expressed the view that the omitted paragraphs were still effective law and suggested that their erroneous omission be corrected. However, no action was taken for this purpose.

In January 1958 when the proposed Financial Institutions Act was being considered by the House Banking and Currency Committee, Mr. Patman charged that a provision of the bill that purported to amend the eleventh paragraph of section 13 of the Federal Reserve Act, regarding the authority of national banks to act as insurance agents, was misleading and, indeed, was a reflection on the integrity of the whole bill, because that paragraph had in fact been "repealed 40 years ago." <sup>118</sup> This led to a heated debate that partially contributed to the death of the entire bill in the House committee.

The debate evoked legal memoranda in support of the continued legal effectiveness of the eleventh paragraph of section 13 and, necessarily, also of the twelfth paragraph relating to dollar-exchange acceptances. The record of the hearing contained such memoranda prepared by counsel for the advisory committee of bankers that had assisted the Senate Banking and Currency Committee in its consideration of the bill and by the general counsel to the House Banking and Currency Committee. The record also included a letter from the Comptroller of the Currency in support of

the validity of the eleventh paragraph, and the Comptroller's letter appended the memorandum that had been submitted by the Board in 1954.<sup>120</sup> A memorandum from the Legislative Reference Section of the Library of Congress, submitted by Mr. Patman himself, lent support to the validity of the questioned provisions of the law, although it expressed no definite opinion.<sup>121</sup>

When the U.S. Code was revised in 1958, the codifier again omitted both section 373 and section 92 of Title 12. They were omitted again in the 1970 edition of the U.S. Code.

As was pointed out in the legal memoranda previously mentioned, repeal of these provisions was clearly not intended by the 1918 amendment; court decisions since 1918 have assumed that both provisions continued in effect; and both the Comptroller of the Currency and the Board have acted for over 40 years on the assumption that the provisions are still in force. For these reasons, it seems abundantly clear that the codifier's omission of the provisions from the U.S. Code (which, after all, is only presumed to be the law) was an error arising from a too literal regard for quotation marks.

### **MATURITIES**

# ACCEPTANCES BY MEMBER BANKS

With respect to both maturities and amounts, the law makes a distinction between commercial bankers' acceptances and dollar-exchange acceptances and also between the authority of member banks to accept and the authority of Reserve Banks to discount.

With respect to the acceptance authority of member banks, the original Federal Reserve Act provided that such banks might accept drafts or bills of exchange growing out of the importation or exportation of goods only if the drafts or bills had "not more than six months' sight to run." When additional authority for the acceptance of drafts and bills based on domestic shipments of goods and the storage of staples was granted in 1916, this maturity limitation was not changed, except to exclude days of grace from the prescribed 6-month period. The limitation remains the same today: Commercial acceptances by member banks may not have a maturity at the time of acceptance of more than 6 months, not counting days of grace.

In its regulations on the subject, the Board has merely restated the maturity requirement of the law.<sup>122</sup> In some of its early rulings, however, the Board took the position that certain

kinds of acceptances, particularly those covering domestic shipments of goods, should be even more restricted as to maturity than required by the law. Thus, it held that a draft drawn solely to finance a shipment of goods should not have a maturity greater than that approximating the period required for the shipment.123 However, if the draft were drawn to finance the subsequent sale as well as the shipment of the goods, the Board held that the maturity of the acceptance need not be limited to the period of the shipment.121 In a 1929 ruling, the Board took the more liberal position that, even if the shipment itself covered only a relatively short time, the draft drawn to finance it was eligible for acceptance if it had a maturity consistent with the usual and customary credit time prevailing in the particular business.125

With respect to the acceptance of dollar-exchange drafts by member banks, the law fixes a maximum maturity only half as long as that fixed for commercial acceptances. As has been noted, the practice of South American bankers that had been observed by Mr. Warburg in 1916 was to draw 3-month drafts; presumably, it was this practice that led Congress to provide that member banks should accept only dollar-exchange drafts that have "not more than three months' sight to run, exclusive of days of grace."

The Board's regulations have never imposed any additional limitations on the maturity of dollar-exchange acceptances, nor has the Board published any interpretations relating to this limitation.

# DISCOUNT BY FEDERAL RESERVE BANKS

As distinguished from the 6-month maturity requirement imposed by the original Federal Reserve Act upon the authority of member banks to accept drafts growing out of the importation or exportation of goods, the Act authorized the Federal Reserve Banks to discount such acceptances only if they had "a maturity at the time of discount of not more than three months." When in 1916 member

banks were also authorized to accept drafts based on domestic shipments of goods and the storage of staples, their eligibility for discount was made subject to the same maturity requirement, although the requirement was slightly changed at that time to refer to 3 months' "sight, exclusive of days of grace." The Agricultural Credits Act of 1923, for reasons noted in a previous chapter, liberalized the maturity requirement as to agricultural acceptances by permitting such acceptances, if secured by warehouse receipts or other such security documents, to have a maturity at the time of discount of not more than 6 months. Otherwise, no changes have been made in the provisions of the original Federal Reserve Act on this point. To be eligible for discount, all bankers' acceptances-dollar exchange as well as commercial—must have a maturity of not more than 90 days at the time of discount, except that agricultural acceptances may have maturities of up to 6 months.

Although the Board has never undertaken to limit further by regulation the maturity limitations placed by the statute on the acceptance authority of member banks, it has done so with respect to the maturity fixed by the law for the discounting of bankers' acceptances. In its 1920 revision of Regulation A, the Board stated that although acceptances might legally be discounted with maturities of up to 3 months, nevertheless a Reserve Bank might decline to rediscount any acceptance if its maturity "is in excess of the usual or customary period of credit required to finance the underlying transaction or \* \* \* is in excess of that period reasonably necessary to finance such transactions." 126 As has been seen, the same principle was applied by the Board, though in published rulings rather than regulations, to the maturity of drafts covering domestic shipments of goods that were eligible for acceptance by member banks.127

With respect to the discounting of acceptances based on the storage of readily marketable staples, the Board's Regulation A, as revised in 1920, stated that since the purpose of such acceptances is to permit their temporary holding pending sale, shipment, or distribution, no such acceptance offered for discount should have a maturity "in excess of the time ordinarily necessary to effect a reasonably prompt sale, shipment, or distribution into the process of manufacture or consumption."

These rules adopted in 1920 were still to be found, unchanged, in the 1955 revision of Regulation A,<sup>128</sup> but they were climinated in the 1973 revision of the regulation.

#### RENEWALS

Despite the statutory limitations on maturity, nothing in the discount provisions of the Federal Reserve Act precludes the renewal of a draft accepted by a member bank. However, the draft must be such as to be eligible for acceptance at the time of renewal. Thus, in certain early rulings the Board held that if a draft drawn to finance an importation or exportation of goods were renewed after the completion of the shipment, the renewal draft could not be said to grow out of an import or export transaction and, if eligible for acceptance at all, it would have to be as a draft based on a domestic storage transaction.129 Similarly, a draft originally secured by warehouse receipts or bills of lading that were later released could not, upon its renewal, be eligible for acceptance unless the renewal draft complied at the time of renewal with the requirements of the Board's regulations.130

In one of its earliest regulations on the subject, the Board specifically provided that a bill to finance an import or export transaction "must not be drawn or renewed after the goods have been surrendered to the purchaser or consignee." 131 A few months later, however, the Board amended this provision to make it slightly more liberal: An exception was added to permit renewal after surrender of the goods "for such reasonable period as may have been agreed upon at the time of the opening of the credit as a condition incidental to the importation or exportation involved, provided that the bill must not contain or be subject to any condition whereby the holder thereof is obligated to renew the same at maturity." 132 In a

press statement at the time the Board declared: 133

This broadening of the conditions upon which acceptances are based is intended to comply with existing mercantile customs, and to permit the development of the business more freely than at present, particularly through the use of drafts drawn in American currency.\* \*

Notwithstanding this seeming liberalization of its attitude toward renewals after the surrender of the goods, the Board in 1919 held generally that a renewal draft should not be accepted if at that time the period required for the completion of the transaction out of which the original draft arose had elapsed. This ruling was incorporated in the Board's 1920 revision of Regulation A as follows:

\* \* \* no renewal draft whether or not contracted for in advance, can be eligible if at the time of its acceptance the period required for the conclusion of the transaction out of which the original draft was drawn shall have elapsed.

Although this statement regarding renewals was eliminated when the regulation was next revised in 1922, the Board indicated that no change in its previous rulings was intended.

In 1927, however, a much more liberal position was reflected in a published interpretation in which the Board held that bankers' acceptances could properly be considered as growing out of transactions involving the importation or exportation of goods when drawn to finance the sale and distribution of imported or exported goods into the channels of trade, whether or not the bills were accepted after the physical importation or exportation had been completed.<sup>136</sup>

A member bank may not unconditionally agree in advance to accept a renewal draft,<sup>137</sup> nor may a Federal Reserve Bank agree in advance to discount renewal acceptances.<sup>138</sup> Eligibility for acceptance in the one case and for discount in the other must depend upon the circumstances existing at the time of the renewal.

### AMOUNT LIMITATIONS

# ACCEPTANCE BY MEMBER BANKS

As in the case of the maturity limitations, distinctions must be made (1) between limitations on the amount of drafts that a member bank may accept and on the amount of acceptances that a Federal Reserve Bank may discount, and (2) between so-called commercial acceptances and dollar-exchange acceptances. In addition, a third distinction must be drawn between acceptances for one customer and aggregate acceptances for all customers.

Beginning with the limitations on the acceptance authority of member banks, it is in order first to consider the limitations on the amount of commercial drafts that a member bank may accept for one customer. No such limitations were contained in the original Act. By the Act of September 7, 1916, however, section 13 of the Federal Reserve Act was amended to provide that no member bank should accept, whether in a foreign or a domestic transaction, for any one person, company, firm, or corporation in an amount equal at any one time in the aggregate to more than 10 per cent of the bank's capital stock and surplus, unless the bank was secured "either by attached documents or by some other actual security growing out of the same transaction as the acceptance." 139 This limitation has never been modified and is still in effect.

In construing the limitation, the Board in an early ruling held that the "person" to which it referred was the person who had entered into an agreement with the member bank to protect it against loss and to whom the bank had lent its credit in the form of an acceptance, whether or not such person was the drawer of the draft or some other customer of the bank.<sup>140</sup>

In another early ruling the Board made it plain that the limitation did not prohibit a member bank from accepting drafts in an amount greater than 10 per cent for one person; it meant only that, if for more than 10 per cent,

the bank must hold some "actual security" as to the excess.<sup>111</sup> Within the 10 per cent limitation, the bank could properly rely on the customer's general credit.

The term "actual security" was interpreted as including shipping documents and warehouse receipts, 112 and also a trade acceptance accepted by the drawee, 113 Moreover, there was nothing to prevent the release of the original security for the acceptance provided that, if the acceptance were in excess of the 10 per cent limitation, there was a substitution of some other actual security growing out of the same transaction, such as warehouse receipts 144 or new drafts with bills of lading covering the same goods. 115

In this connection, an oft-recurring question was one that related to the circumstances under which a trust receipt might be regarded as actual security. In several published rulings the Board established the principle that a trust receipt was adequate only if it did not permit the purchaser to retain control of the goods.116 This principle was incorporated in the Board's 1920 revision of Regulation C. It was specifically provided that a trust receipt that permitted the customer to have access to, or control over, the goods involved would not be considered actual security for purposes of the 10 per cent limitation, but that a bill-of-lading draft would constitute actual security even after the documents had been released, provided the draft was accepted by the drawee upon or before the surrender of the documents.117 The present Regulation C 148 contains a substantially similar provision to the effect that the member bank shall be and remain secured as to the excess over 10 per cent of its capital stock 149 and surplus by attached documents or other actual security and that a trust receipt permitting the customer to have access to or control over the goods will not be considered actual security for this purpose.

In addition to a limitation on acceptances for any one customer, the framers of the original Federal Reserve Act felt that a limitation on the aggregate amount of drafts that a member bank might accept was also desirable. The Act specifically provided that no member bank should accept bills in an amount equal at any time in the aggregate to more than one-half the bank's paid-up capital stock and surplus.

Apparently, however, it was soon found that more leeway was needed. By an amendment of March 3, 1915,<sup>150</sup> an exception was added to permit a member bank to accept up to as much as 100 per cent of its capital stock and surplus if granted such authority by the Federal Reserve Board under regulations applicable to all member banks regardless of capital stock and surplus.

Acting under this amendment to the law, the Board issued a new regulation <sup>151</sup> by which it authorized any member bank to accept up to 100 per cent of its capital stock and surplus under the following conditions: (1) The bank was required to have an unimpaired surplus of not less than 20 per cent of its paid-in capital; (2) it was required to file a formal application with the Federal Reserve Bank of its district that would report to the Board on the standing of the applicant; and (3) any such application had to be approved by the Board, such approval to be subject to rescission on 90 days' notice.

When the law was amended in 1916 to authorize acceptances growing out of domestic shipments of goods and the storage of readily marketable staples, the provision authorizing 100 per cent acceptances with the authority of the Board was omitted, apparently through inadvertence. In its *Annual Report* to Congress for 1916, the Board recommended an amendment "to restore the provision which was by error stricken from the Act in the amendments of September 7, 1916, thus restoring to national banks, with the approval of the Federal Reserve Board, the right to accept up to 100 per cent of their capital and surplus in transactions involving imports and exports." <sup>152</sup>

In accordance with the Board's recommendation, the provision was restored by the Act of June 21, 1917,<sup>153</sup> but with a new proviso to the effect that the aggregate of acceptances growing out of domestic transactions should in no event exceed 50 per cent of a member bank's capital stock and surplus. In other words, while the Board might authorize a member bank to accept drafts, both domestic and foreign, in an aggregate amount of more than 50 per cent, it could not in any case permit the bank to accept more than 50 per cent in domestic transactions.<sup>154</sup>

After the provision for 100 per cent acceptance authority was restored, the Board, in its 1917 revision of Regulation C, again provided that any bank might apply for such authority if it had surplus equal to at least 20 per cent of its capital; but in this revision the Federal Reserve Bank with which the application was filed was required to report to the Board not only as to the standing of the applicant bank but also as to whether business and banking conditions prevailing in its district warranted the granting of the application.<sup>155</sup>

These regulatory provisions regarding the 100 per cent acceptance authority remained substantially unchanged until 1946. When Regulation C was revised in that year, the requirement that the applicant's surplus be at least 20 per cent of its capital was omitted. The revised regulation also omitted the specific provisions for reports by the Federal Reserve Bank. However, a new provision stated that while the application need not be in any particular form, it must show "the present and anticipated need of the applicant bank for the authority requested." 156 The regulation continued, as in the past, to reserve to the Board the right to rescind any such authority after not less than 90 days' notice in writing. As might naturally have been expected, only a relatively few of the larger banks of the country have felt it necessary to obtain the Board's permission to accept drafts amounting in the aggregate to more than half their capital and surplus.

Two additional points should also be noted. First, a member bank's own acceptances purchased by it before maturity are not to be counted in determining the aggregate amount of acceptances outstanding, since by purchasing them the bank's obligation as to such acceptances is cancelled.<sup>157</sup> Second, when a member bank accepts commercial drafts or bills at the request of another member bank that agrees to put the accepting bank in funds to meet such acceptances at maturity, drafts and bills so accepted must be considered as acceptance liabili-

ties of both the accepting bank and the requesting bank for purposes of the aggregate-amount limitations of the law and the Board's regulations.<sup>158</sup>

The authority granted member banks to accept drafts drawn for the purpose of furnishing dollar exchange, like their authority to accept commercial drafts, is subject to limitations both as to the amount that may be accepted for one customer and as to the aggregate amount for all customers. Moreover, these limitations are separate and distinct from, and not to be included in, the amount limitations prescribed as to commercial acceptances.<sup>159</sup>

Under the law, no member bank may accept dollar-exchange drafts for any one bank in an amount greater in the aggregate than 10 per cent of the accepting bank's paid-up and unimpaired capital and surplus, unless the draft is accompanied by documents "conveying or securing title or by some other adequate security." 160 In its Regulation C, the Board has made it clear that the limitation refers to drafts drawn by foreign bankers as well as by foreign banks and that only the excess over the 10 per cent limit must remain secured by security documents. 161

As has been noted in connection with dollarexchange acceptances in general, the Board by regulation has prescribed an additional limitation on the amount of such acceptances that may be made for any one foreign bank or banker, but its primary purpose is to insure that the drafts accepted are actually for the purpose of furnishing dollar exchange. It requires that the aggregate of drafts and bills accepted for any foreign bank or banker shall not exceed an amount that the accepting member bank would expect the foreign bank or banker to liquidate through the proceeds of documentary bills or other sources reasonably available to the foreign bank or banker arising in the normal course of trade.182

The aggregate amount of dollar-exchange drafts that a member bank accepts and has outstanding at any one time, as distinguished from the amount accepted for any one foreign bank, may not exceed 50 per cent of the bank's capital and surplus. This limit cannot be exceeded, as may be done in the case of the

limitation on the aggregate amount of commercial acceptances, with the authority of the Board. Moreover, the limitation on the aggregate amount of dollar-exchange acceptances is separate and distinct from the aggregate limitation placed by the law on commercial acceptances.

As in the case of commercial acceptances, dollar-exchange drafts accepted by one member bank at the request of another must be considered as part of the acceptance liabilities of each of such member banks for purposes of the amount limitations on the making of dollar-exchange acceptances.<sup>163</sup>

# DISCOUNT BY FEDERAL RESERVE BANKS

Like all other paper discounted by the Federal Reserve Banks, bankers' acceptances must comply with the general requirement that the aggregate amount of paper rediscounted for any member bank upon which any one person is liable as maker, acceptor, endorser, drawer, or guarantor shall not exceed the amount for which one person may become liable to a national bank under section 5200 of the Revised Statutes. This means that a draft accepted by a member bank for a particular customer cannot be eligible for discount with the Reserve Bank if the total amount of acceptances made for that customer and then outstanding exceeds 10 per cent of the member bank's capital and surplus, unless, as may well be the case, the situation is one that falls within one of the various exceptions to section 5200 of the Revised Statutes.

In addition to this general requirement, the Board by regulation made it a condition to the discount of a banker's acceptance that drafts accepted by a member bank for any one customer in excess of 10 per cent of the capital and surplus of the accepting bank must remain actually secured throughout the life of the acceptance. This requirement was, of course, comparable to the limitation imposed by the law and the Board's Regulation C on the amount of drafts that a member bank might accept for one customer. Supplementing this requirement, Regulation A provided in a foot-

note that, in the case of acceptances in excess of the 10 per cent limitation, such acceptances must be secured by shipping documents, warehouse receipts, or some other actual security growing out of the same transaction as the acceptance, such as documentary drafts, trade acceptances, terminal receipts, or trust receipts. If trust receipts were the security for the draft, they were required to be such as to provide an effective and lawful lien in favor of the accepting bank and they could not be considered actual security if they permitted the customer to have access to or control over the goods.

Apart from these limitations on the amount of acceptances that may be discounted for one customer, neither the law nor Regulation A imposes any limitations on the amount of acceptances—whether commercial or dollar exchange—that may be discounted by the Federal Reserve Banks. Even the limitations with respect to acceptances for one customer were omitted from the revision of the regulation adopted in 1973. In the case of dollar-exchange drafts, the statute provides that they "may be acquired by Federal Reserve Banks in such amounts \* \* \* as may be prescribed by the Board"; but the Board has never exercised this authority.

It should be noted, however, that the original Federal Reserve Act limited the aggregate amount of acceptances that a Federal Reserve Bank might discount for any one member bank (as distinguished from any one customer of a member bank) to one-half the capital stock and surplus of the member bank. By an amendment of March 3, 1915, this limitation was liberalized to permit the discount of acceptances for a member bank, with the authority of the Board,

of up to 100 per cent of the member bank's capital stock and surplus. Pursuant to this provision, the Board by regulation gave the Reserve Banks blanket authority to discount acceptances for a member bank up to the amount of its capital stock and surplus. 166

At the same time—in 1915—the Board provided that bills accepted by any private banker and rediscounted by a Federal Reserve Bank should not exceed 5 per cent of the paid-in capital stock of the discounting Reserve Bank, unless the acceptances were secured by a lien on the goods or transfer of title thereto, and that in no event should the aggregate amount of acceptances of any private banker to be rediscounted by a Reserve Bank's paid-in capital stock. Later in the same year these specified limits on discounts of acceptances of private bankers were omitted, leaving the percentages to be fixed from time to time by the Board.<sup>167</sup>

When section 13 of the Act was amended by the Act of September 7, 1916, the provision limiting the amount of acceptances that might be discounted for any member bank was omitted. Subsequent regulations of the Board omitted the limitations on the discounting of acceptances of private bankers. Consequently, the only remaining amount restrictions on the discounting of acceptances—as distinguished from those imposed on the acceptance powers of member banks-were those that in general precluded the discounting of paper accepted by a member bank for one borrower in excess of 10 per cent of such bank's capital and surplus unless the excess remained actually secured throughout the life of the acceptance. As has been noted, these restrictions were not included in the 1973 revision of Regulation A.

## LETTERS OF CREDIT AND SYNDICATE CREDITS

Although a member bank may not unconditionally agree in advance to renew outstanding acceptances, it may enter into an agreement

with a customer to accept his drafts over a specified period of time, provided they are eligible at the time of acceptance.<sup>168</sup> The trans-

action may take the form of a commercial letter of credit issued by a bank for its customer under which the bank agrees to honor drafts that may be drawn under the letter.<sup>169</sup>

Because commercial letters of credit may frequently be used to finance import or export transactions and because large city banks are better known abroad than small interior banks, it sometimes happens that an interior bank will appoint a large city bank as its agent for the issuance of a letter of credit and the acceptance of drafts drawn thereunder. While a national bank is without authority to guarantee letters of credit, the Board in 1921 held that under such an arrangement an interior national bank could agree unconditionally to reimburse its agent for any moneys put out by it or to put the agent bank in funds to meet maturing acceptances under such a letter of credit.<sup>170</sup>

Drafts accepted by the agent bank, under an arrangement of the kind just described, at the request of another member bank must be regarded as acceptance liabilities of both the accepting bank and the requesting bank for purposes of the aggregate amount limitations discussed in a previous section of this chapter.<sup>171</sup> However, the letter of credit itself, since it is only an agreement to make acceptances, is not subject to the limitation prescribed by section 13 of the Federal Reserve Act on the aggregate amount of acceptances that a member bank may

have outstanding at any one time. 122 Nevertheless, the Board once cautioned member banks to exercise prudence in issuing letters of credit under which acceptances in excess of this limitation might result.

At one time, in the early days of the development of acceptances, the Board apparently became concerned by the growth of "syndicate" acceptance credits providing for the extension of acceptance credits by groups of banks. It felt called upon to publish a statement outlining certain principles that should be followed by accepting banks in their own interests and in order to avoid the necessity for issuing rigid and inflexible regulations on the subject. The Board urged that since acceptance transactions call for direct contact between banks and borrowers, syndicate credits should be avoided. In addition, it stated that the duration of acceptance credits should not normally exceed 1 year and in no case 2 years; that such credits should relate to transactions of a legitimate commercial nature and should not be for the purpose of furnishing working capital; that agreements by bankers to furnish 1-year or 2-year credit at a definite rate of interest to finance themselves should not be countenanced; and that, whenever syndicates were formed to furnish acceptance credits for more than moderate amounts, the Federal Reserve Banks should be consulted.173

# DIMINISHED IMPORTANCE OF ELIGIBILITY REQUIREMENTS

The numerous technical regulatory requirements and Board interpretations with respect to the eligibility of bankers' acceptances for discount by the Reserve Banks are of little significance today for all practical purposes. Briefly, this is because practically all Reserve Bank loans to member banks are now made in the form of advances rather than by the rediscount-

ing of customers' paper held by the member banks and because advances may be made on the security of any paper eligible for purchase by the Reserve Banks under the Federal Reserve Act. Under section 14 of the Act, bankers' acceptances may be purchased by the Reserve Banks even though they are not eligible for discount.

The first paragraph of section 14 authorizes any Reserve Bank to purchase in the open market "cable transfers and bankers' acceptances and bills of exchange of the kinds and maturities by this Act made eligible for rediscount, with or without the indorsement of a member bank." 171 This language was part of the original Act and has never been changed. In 1923 the Board interpreted the language as meaning that a Reserve Bank may purchase a banker's acceptance even though it is not of the kind or maturity made eligible for rediscount. In this connection, the Board said: 175

At first glance, it would appear that only bankers' acceptances of the kinds and maturities made eligible for rediscount could be purchased in the open market, but, upon careful consideration of the language of this section, it will be found that the phrase "of the kinds and maturities by this act made eligible for rediscount" qualifies only "bills of exchange" and does not qualify "bankers' acceptances." Accordingly, bankers' acceptances may, subject to the board's regulations, be eligible for purchase in the open market by Federal reserve banks, even though not of the kinds and maturities made eligible for rediscount. This construction of section 14 has been adopted by the board since 1916, when the board first provided in its regulations that a Federal reserve bank might purchase in the open market bankers' acceptances based upon the domestic storage of goods under contract of sale, even though such acceptances would not be eligible for rediscount by Federal reserve banks \* \* \*.

As will be noted in a later chapter, Congress in 1916 amended section 13 of the Federal Reserve Act to authorize the Reserve Banks to made direct advances to member banks on their own promissory notes for periods of up to 15 days provided such notes were 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." Consequently, following the Board's 1923 ruling that bankers' acceptances were eligible for purchase even though

not eligible for discount, it became permissible for a Reserve Bank to make an advance to a member bank on the security of a banker's acceptance that would have been ineligible for rediscount. In 1933, the law was amended to permit advances to member banks on paper eligible for rediscount or for purchase by the Reserve Banks for periods of up to 90 days.<sup>176</sup>

It is still conceivable, though very unlikely, that a member bank might seek to borrow from its Reserve Bank by offering bankers' acceptances for discount, but it is almost certain that the member bank would apply for an advance on the security of such a banker's acceptance. Consequently, the technical requirements of Regulation A with respect to the discounting of bankers' acceptances would not be applicable.

Despite these considerations, Regulation A continued until 1973 to include detailed provisions, both in the text and in footnotes, regarding requirements for the discounting of bankers' acceptances. Since, for the reasons here indicated, these provisions no longer served any practical purpose, they were replaced in the 1973 general revision of Regulation A by a short paragraph that merely paraphrases, in condensed language, the provisions of section 13 of the Act with respect to commercial bankers' acceptances and dollar-exchange acceptances.

Although section 14 of the Act authorizes the Reserve Banks to purchase in the open market bankers' acceptances that are not eligible for discount, the regulations of the Federal Open Market Committee provide that the Reserve Banks may purchase in the open market only acceptances of the kinds made eligible for purchase under the Board's Regulation B.177 The Board's Regulation B, which has not been changed since 1923, purports to govern open market purchases by the Reserve Banks of bills of exchange, trade acceptances, and bankers' acceptances. One of the requirements of that regulation is that a banker's acceptance eligible for purchase must also be eligible for discount under the Board's Regulation A.178 Consequently, the present technical requirements of

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the law and of Regulation A still have some significance in that they are made applicable, by virtue of the FOMC's regulations, to open market purchases of bankers' acceptances. It is questionable whether, as a matter of policy, such open market purchases of acceptances need to be made subject to such requirements.

In any event, this does not change the fact that, under the law itself, acceptances may be purchased by the Reserve Banks even though not eligible for discount and that, therefore, ineligible acceptances may be taken as collateral security for Reserve Bank advances to member banks.



# Rediscount of World War I Veterans' Notes

It may be a relief now to turn to a minor but interesting development in the lending authority of the Federal Reserve Banks. This development was significant because it represented the first instance in which the Reserve Banks were authorized to extend direct credit accommodations to nonmember commercial banks. This authorization was a result of the need in the early 1920's to provide some means of enabling veterans of World War I to use their military life insurance policies—called adjusted service certificates—as a basis for obtaining loans from banks. In order to induce banks to make such loans, the Reserve Banks were authorized to discount for nonmember as well as member banks the notes of veterans secured by such certificates.

Culminating several years of agitation for a cash bonus or some other payment to veterans, the World War Adjusted Compensation Act of May 19, 1924, represented something of a compromise. It provided for the issuance of adjusted service certificates to all veterans of World War I; these certificates, in effect, were 20-year endowment insurance policies based in

For NOTES AND REFERENCES, see p. 257.

general on years of military service. Each certificate was dated as of the first day of the month in which the veteran's application for the certificate was filed, but in no event could a certificate be dated before January 1, 1925. The face amount of the certificate was payable after 20 years to the veteran or, if he died in the meantime, to his beneficiary.

A means was provided, however, by which the veteran could obtain cash on the basis of his certificate, although not immediately. Section 502(b) of the act authorized any national or State bank, after 2 years from the date of the certificate, to make a loan to a veteran on his own note secured by the certificate in an amount not to exceed 90 per cent of the certificate's current reserve value. The interest rate charged on any such loan was limited to a rate not more than 2 per cent above the discount rate currently charged on 90-day commercial paper by the Federal Reserve Bank of the district. Any bank making such a loan was specifically authorized to transfer the note to any other bank.

The provisions 2 that involved the Federal Reserve Banks were patterned closely after the discount provisions of section 13 of the Federal Reserve Act. Any note representing a loan by a commercial bank to a veteran on his adjusted service certificate, if it were endorsed by a bank and were in compliance with regulations of the Federal Reserve Board, was made eligible for rediscount at the Federal Reserve Bank of the district, whether or not the bank offering the note was a member of the Federal Reserve System and whether or not such bank had made the loan in the first instance or had acquired it from another bank.

To be eligible for rediscount, however, the note was required to have a maturity at the time of discount of not more than 9 months, exclusive of days of grace—a requirement, it should be noted, much more liberal than the maturity required for the discount of commercial paper in general.

The rate of discount charged by a Federal Reserve Bank was required to be the same as that charged by it in discounting 90-day commercial paper for its member banks. The Federal Reserve Board was authorized to permit or require a Federal Reserve Bank to rediscount such veterans' notes for any other Reserve Bank, and in such a case the rate of rediscount was to be fixed by the Board. Again, the law was patterned after provisions of the Federal Reserve Act (discussed later in this study) regarding rediscounts between Federal Reserve Banks.

If a veteran failed to pay a loan obtained on his adjusted service certificate, the bank holding his note could present it to the Director of the Veterans' Bureau and the Director was authorized to pay the bank in full. The certificate would then be restored by the Director to the veteran upon receipt of the amount that had been paid the bank, plus interest.

Since loans could not be made on the certificates until at least 2 years after January 1, 1925, it was not necessary for the Federal Reserve System to take any immediate action. However, on December 9, 1926, the Board issued a regulation governing the rediscount of notes secured by adjusted service certificates. At the same time, in accordance with a request made by the Veterans' Bureau, the Board arranged for the Federal Reserve Banks to furnish

all banks with full information as to the legal requirements for loans on such certificates and for the rediscount of veterans' notes by the Reserve Banks.

The new regulation, designated Regulation M, consisted in large part of a restatement of the requirements of the law. It provided, for example, that to be eligible for discount a veteran's note must (1) arise out of a loan made in conformity with the law on the security of a certificate issued to the maker; (2) be negotiable and have a maturity at the time of discount of not more than 9 months; (3) bear interest at a rate not more than 2 per cent above the discount rate; and (4) be endorsed by the offering bank. The Reserve Bank was required to satisfy itself as to the eligibility of the note for discount. Along with the note, the offering bank was obliged to submit an affidavit to the effect that, in accordance with the law, it had not charged any fee for the loan other than interest and that it had notified the veteran of the fact that the note was being rediscounted.4

Although a Reserve Bank could rediscount such notes for nonmember as well as for member banks, it was permitted by the Board's regulation to rediscount them only for banks located within its district. Moreover, the regulation provided that no rediscount should be made for any nonmember bank unless it furnished such information as the Reserve Bank might request "in order to satisfy itself as to the condition of such bank and the advisability of making the rediscount for it."

In 1928, Regulation M was redesignated Regulation G, but no change was made in its provisions. In 1931, however, the Adjusted Compensation Act was amended to provide that the loan value of an adjusted service certificate should in no event be less than 50 per cent of its face value and that the interest rate on loans on such certificates should in no event exceed 4½ per cent, and Regulation G was amended by the Board to conform to these changes in the law. In 1932 the statute was further amended (1) to reduce the maximum interest rate on bank loans to 3½ per cent, and (2) to permit banks to make loans on the certificates

at any time after the date of their issuance.<sup>8</sup> These modifications were likewise incorporated in a revision of the Board's regulation.<sup>9</sup>

As time passed, discounts of veterans' notes became of less and less importance. By 1939, it appeared that the Federal Reserve Banks held no notes secured by adjusted service certificates and that no such notes had been rediscounted for several years. Moreover, the statute had been amended to authorize payment of such certificates by the Veterans' Administration at the option of the veterans and also to authorize

the Veterans' Administration to make loans on such certificates. Since, for these reasons, it seemed unlikely that the Reserve Banks would be called on in the future to rediscount veterans' notes, the Board on April 6, 1939, decided to repeal its Regulation G relating to this matter.<sup>10</sup> At the same time, however, the Board announced that if it should happen that any application for the discount of such a note should be received, it would be handled in the same manner as if the provisions of Regulation G were still in effect.

## **Advances to Member Banks**

### GENERAL CONSIDERATIONS

# DISTINCTION BETWEEN ADVANCES AND REDISCOUNTS

One of the most interesting chapters in the history of the lending functions of the Federal Reserve Banks is that relating to advances to member banks. For many years, virtually all lending by the Reserve Banks has taken the form of advances rather than discounts. Both discounts and advances are sometimes loosely referred to as discount operations, but the legal and procedural distinctions between the two are clear.

In the case of a discount, credit is given by a Reserve Bank to a member bank on the basis of eligible paper representing loans made by the member bank to its own customers. By eligible paper we mean, of course, commercial or agricultural paper meeting all of the technical requirements that have been discussed in previous chapters. Any such eligible paper that is offered for discount is transferred to the Reserve Bank with the member bank's endorsement. No note is executed by the member bank. The bank

For NOTES AND REFERENCES, see pp. 257-60.

receives in its reserve account at the Reserve Bank credit in the amount of the paper discounted, less the current rate of discount. When the paper approaches maturity, it is returned by the Reserve Bank to the member bank for collection, and at maturity the full amount of the paper is charged to the member bank's reserve account.

An advance is a simpler operation. The member bank merely executes its own note or, under procedures established in 1971, enters into a continuing lending agreement, and pledges as security paper eligible for discount or purchase by the Reserve Banks. Interest on the advance is paid at maturity on an accrual basis. If the advance is not repaid at maturity, the Reserve Bank has a direct claim against the member and does not have to resort to the paper pledged as security unless necessary to satisfy that claim.

# DEVELOPMENT OF AUTHORITY FOR ADVANCES

The original Federal Reserve Act contained no authority for advances to member banks.

In 1916 provision was made for 15-day advances on the notes of member banks secured by Government bonds or by notes, drafts, bills of exchange, or bankers' acceptances eligible for discount or for purchase by the Reserve Banks. It was not until 1932, however, that the real trend toward advances began. The immediate cause was the deteriorated banking situation and the decline in the volume of eligible paper held by member banks. Even those banks that had ample amounts of paper eligible for discount were reluctant to use such paper as a basis for borrowing from the Federal Reserve Banks.

During 1932 and 1933, in an attempt to dispel fear and create an atmosphere of confidence, Congress enacted a series of statutes broadening the credit facilities of the Federal Reserve Banks and making such facilities available not only to member banks but also to nonmember banks and even to nonbanking institutions and individuals. The first step, in 1932, was emergency authority for advances on the security of any satisfactory assets to groups of member banks and to individual member banks in cases in which the member banks had exhausted their eligible paper-although the advances were at higher rates of interest. Subsequently, the Reserve Banks were authorized, in unusual and exigent circumstances, to discount eligible paper for individuals, partnerships, and corporations.

At the time of the banking crisis in March 1933, provision was made for direct advances to individuals, partnerships, and corporations on the security of direct obligations of the United States; nonmember banks were given the privilege, though only for a short time, of borrowing from the Reserve Banks on any satisfactory assets. In June 1933, Congress extended the period for which member banks might obtain direct advances on eligible paper from 15 to 90 days. The Banking Act of 1935 made permanent and more liberal the authority of the Reserve Banks to make advances to member banks on satisfactory security at a rate of interest higher than the regular discount rate.

These statutory amendments in rapid succession over a period of 3 years represented signifi-

cant changes in the concept of the lending functions of the Federal Reserve Banks. For one thing, they involved an extension of the credit facilities of the System to others than member banks. Of more importance, these amendments evidenced a definite departure from the original idea that Federal Reserve credit should be based only on self-liquidating commercial paper that met certain technical requirements as to eligibility; instead, greater emphasis was placed on the soundness of the assets offered as security, whether Government bonds, real estate mortgages, or consumer paper.

Additional liberalizing changes were made in the law in the late 1960's. In 1966 obligations issued or guaranteed by Federal agencies were made eligible for purchase by the Reserve Banks and therefore also eligible as collateral for advances to member banks. In 1968 such agency issues were made eligible as security for advances to individuals, partnerships, and corporations. At the same time, a technical change made eligible as security for advances to member banks not only notes, drafts, bills of exchange, or bankers' acceptances that were eligible for discount or purchase by the Reserve Banks but also any obligations that were eligible for purchase.

It is of interest to note that although discounting operations, as discussed in previous chapters, have involved detailed regulations and numerous rulings on the part of the Board, advances have given rise to relatively few regulations or interpretations. In fact, it was not until 1937 that the Board's Regulation A devoted a separate section to the subject of advances as distinguished from discounts. However, the predominant importance of advances in recent years is indicated by the fact that the revision of the regulation in 1955 for the first time placed the section dealing with advances ahead of the detailed and technical provisions relating to the discount of commercial, agricultural, and industrial paper. The importance of discounting was further downgraded by the revision of Regulation A adopted in 1973. This revision condensed to a minimum the regulatory provisions regarding eligibility of paper for discount, and it provided that a Reserve Bank may discount paper for a member bank if the Reserve Bank "should conclude that a member bank would be better accommodated by the discount of paper than by an advance on the security thereof."

### ORIGINAL AUTHORIZATION

As previously indicated, the original Federal Reserve Act was limited to discounts; it included no provision for advances. In its Annual Report for 1915, the Federal Reserve Board recommended to Congress an amendment to authorize 15-day advances to member banks on their own notes secured either by eligible paper or by Government bonds. The Board stated: 1

In order to enable member banks to obtain prompt and economical accommodations for periods not to exceed fifteen days, the Federal Reserve Banks should be permitted to make advances to member banks against their promissory notes secured by such notes, drafts, bills of exchange, and bankers' acceptances as the law at present permits to be rediscounted or purchased; or against the deposit or pledge of United States Government bonds, the purchase of which is now permitted under the law.

The Board's recommendation was adopted by Congress. The Act of September 7, 1916,2 among other amendments, added a new paragraph to section 13 of the Federal Reserve Act, a paragraph that will frequently be referred to hereinafter as "the eighth paragraph of section 13." It authorized any Federal Reserve Bank to make advances to its member banks on their Promissory notes 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." No such advance could be made for a period exceeding 15 days, and rates for such advances were required to be established by the Reserve Banks, subject to the review and determination of the Federal Reserve Board.

The primary purpose of this amendment, as it had been stated by the Board and as it was later stated by the Senate Banking and Cur-

rency Committee,<sup>3</sup> was "to facilitate the convenience of the transaction and to economize in bookkeeping." On the floor of Congress, Senator Owen referred to it simply as "an administrative detail which makes more convenient the operation of the bank." Many years later, when early drafts of the Banking Act of 1933 were being considered in Congress, the Board similarly stated that member banks borrowed on their 15-day notes "because of the greater convenience both to them and to the Federal reserve bank." <sup>5</sup>

Following the adoption of the 1916 amendment, the Board announced that it did not consider it necessary to promulgate "any special ruling relating to the exercise of the powers conferred" by this amendment.<sup>6</sup> Actually, as previously noted, it developed that the provisions of the law regarding advances, unlike those with respect to discounts, rarely gave rise to the need for rulings by the Board.

### LIMITATION TO PAPER ELIGIBLE FOR PURCHASE UNDER FEDERAL RESERVE ACT

Putting aside for the moment the specific authority for the use of Government bonds as collateral security for advances to member banks, it should be noted that the 1916 amendment required that such advances be 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," [emphasis added] that is, under the Federal Reserve Act. In effect, this meant that all of the classes of paper eligible for discount under that Act, as discussed in previous chapters of this history, and, in addition, all paper eligible for purchase by the Reserve Banks under that Act (with exceptions hereinafter noted) became eligible as collateral for advances.

The restriction of security for advances to paper eligible for discount or purchase under the Federal Reserve Act, however, had the effect of excluding two types of paper. One was notes secured by adjusted service certificates of World War I veterans, since such notes were made eligible for discount by provisions

of the World War Adjusted Compensation Act rather than by provisions of the Federal Reserve Act. The other was farm loan bonds, since the authority of the Reserve Banks to purchase such bonds was contained not in the Federal Reserve Act but in the Farm Loan Act of 1916.

Paper eligible for purchase by the Reserve Banks under the Federal Reserve Act is described in section 14 of that Act. It covers, in the first paragraph of that section, cable transfers, bankers' acceptances, and bills of exchange of the kinds and maturities eligible for discount. As noted in an earlier chapter relating specifically to bankers' acceptances, the Board has ruled that such acceptances are eligible for purchase even though they are not eligible for discount; consequently, any acceptances are eligible as security for Reserve Bank advances to member banks. Section 14 also authorizes the purchase of direct obligations of the United States; obligations fully guaranteed by the United States; obligations issued or guaranteed by any agency of the United States; and obligations issued by States and municipalities in anticipation of the collection of taxes and with maturities of not more than 6 months, which are usually referred to as tax warrants.

### LIMITATION TO PAPER ARISING FROM COMMERCIAL OR AGRICULTURAL TRANSACTIONS

Not all paper made eligible for purchase by the Reserve Banks under the Federal Reserve Act was also eligible as security for Reserve Bank advances until 1968. This was because the Board before 1968 took the position that the reference in the eighth paragraph of section 13, as added in 1916, to "notes, drafts, bills of exchange, \* \* \* eligible \* \* \* for purchase under the Federal Reserve Act" was intended to cover only notes arising out of commercial and agricultural transactions. Consequently, obligations guaranteed by the United States, obligations issued by individual Government agencies, and tax warrants of municipalities, even though expressly eligible for purchase under section 14 of the Federal Reserve Act, were not eligible for use as collateral for advances unless their eligibility for such use was specifically provided

for by Congress. The rationale of the Board's position before 1968 may be summarized as follows.

Read literally, the reference to the use of notes eligible for purchase by the Reserve Banks that is contained in the eighth paragraph of section 13 could be construed as covering any notes, including bonds and debentures, issued by Government agencies that were eligible for purchase under section 14 of the Act. It seems reasonably clear, however, that such a literal construction of the eighth paragraph of section 13 would not have been warranted. In the first place, the legislative history of that paragraph indicates that the word "notes" as used therein was intended to cover only notes arising out of commercial and agricultural transactions of the kind made eligible for discount.

As originally enacted in 1916, this paragraph authorized 15-day advances on the security of (1) notes, drafts, bills of exchange, or bankers' acceptances eligible for discount or purchase, or (2) bonds or notes of the United States. Since bonds and notes of the United States were already eligible for purchase under section 14(b), it would have been unnecessary to mention them separately in section 13 if they were covered by the words "notes \* \* \* eligible \* \* \* for purchase." When the Board in its 1932 Annual Report to Congress recommended that the maximum maturity on advances secured by paper eligible for discount or purchase be increased from 15 to 90 days, it was clear that the Board had in mind only ordinary commercial or agricultural paper. Thus, the Board noted that the Reserve Banks could rediscount "commercial or industrial paper with maturities up to 90 days and agricultural paper with maturities up to 9 months" and argued that an amendment increasing the maturity on advances secured by such paper would not "involve a broadening in the character or class of paper or securities which may be legally acquired by Federal Reserve banks and would not constitute in any respect a departure from the fundamental purposes of the Federal Reserve Act." s

The Emergency Banking Act of March 9, 1933, added a new paragraph to section 13 authorizing 90-day advances to individuals, partnerships, or corporations if secured by

direct obligations of the United States. Under that paragraph, the Board took the position that since member banks are "corporations," advances could be made to such banks on Government obligations with maturities of up to 90 days. This resort to the last paragraph of section 13 as a legal basis for 90-day advances on Government obligations would have been unnecessary if the word "notes" in the eighth paragraph of section 13 were broad enough to include notes of the United States.

Again, in 1934 Congress amended section 14(b) to authorize the purchase of bonds of the Federal Farm Mortgage Corporation and of the Home Owners' Loan Corporation; at the same time it also amended the eighth paragraph of section 13 to make such bonds eligible as security for 15-day advances to member banks. These amendments to section 13 would not have been necessary if such bonds were notes within the meaning of section 13; they would have automatically become eligible as security for 90-day advances to member banks by reason of the fact that they were made eligible for purchase.

It appears that, presumably for the reasons above indicated, the Board adopted the position that notes of a Government agency, even though backed by the credit of the United States and perhaps eligible for purchase under the Federal Reserve Act, would not for that reason alone be eligible as security for advances under section 13. In 1960, the Board ruled that United States Government Insured Merchant Marine Bonds, issued under the Merchant Marine Act of 1936, were not eligible as security for such advances, even though such bonds were in effect fully insured as to principal and interest by the United States. After quoting the provision of section 13 authorizing 90-day advances on paper eligible for discount or purchase, the Board concluded: 9

\* \* \* in the light of the language of the quoted provision, its legislative history, and the language and scope of other provisions of the Federal Reserve Act, that the words "notes, drafts, bills of exchange, or bankers' acceptances" refer only to obligations arising out of commercial or agricultural transactions. Since Merchant Marine Bonds [which

are based on mortgages] are not of this character, they are not eligible as security for advances by Federal Reserve Banks to member banks under the provisions of section 13 of the Federal Reserve Act.

The situation was completely changed in 1968 when Congress, following a recommendation made by the Board, amended the eighth paragraph of section 13 to authorize advances to member banks not only on the security of "notes \* \* \* eligible \* \* \* for purchase" but also on the security of any obligations eligible for purchase under section 14(b) of the Act.10 As a result of this amendment, all of the various obligations made eligible for purchase under section 14(b), including obligations fully guaranteed by the United States, obligations issued or guaranteed by Government agencies, and tax warrants of municipalities, became for the first time eligible for use as collateral for advances to member banks.

In the light of the 1968 amendment to the law, the Board amended Regulation A, effective November 13, 1968, to change the provisions regarding advances to member banks by eliminating a reference to the making of such advances "secured by such notes, drafts, bills of exchange, or bankers' acceptances as are eligible for discount by Federal Reserve Banks under the provisions of this Regulation or for purchase by such banks under the provisions of the Federal Reserve Act" and by substituting for this language a simple statement that "Reserve Banks may make advances to member banks for not more than 90 days if secured by obligations or other paper eligible under the Federal Reserve Act for discount or purchase by Reserve Banks." 11

# ENDORSEMENT OF PLEDGED PAPER

Bills of exchange and bankers' acceptances need not be endorsed by a member bank in order to be eligible for purchase under section 14 of the Federal Reserve Act. Moreover, the general requirement of section 13 that paper offered for rediscount must be endorsed by the offering member bank is not regarded as an essential prerequisite of eligibility as such. For

these reasons, the Board in an early ruling held that eligible paper pledged as security for advances to a member bank did not have to be endorsed by the member bank, provided the paper was negotiable in form.<sup>12</sup> Since then, as mentioned earlier in this study, the negotiability requirement has been eliminated.

### MATURITY OF ADVANCES

Although the Reserve Banks may discount commercial paper having a maturity of up to 90 days at the time of discount and agricultural paper with a maturity of not more than 9 months, the authority for advances, as already noted, was originally limited by the 1916 amendment to periods of not more than 15 days. When that amendment was under consideration in Congress, question was raised as to why the maturity was made so short; 13 but, until 1933, the 15-day limitation continued in effect for advances both on eligible paper and on Government obligations. Although renewals were not encouraged, the Board held that a Federal Reserve Bank could renew the 15-day notes of its member banks as long as it did not obligate itself in advance to make any such renewal.11

In 1932 the Board recommended to Congress that the maturity limitation on advances be increased from 15 to 90 days, pointing out that such a liberalization "would be especially helpful to country banks." 15 In accordance with this proposal, Congress by the Banking Act of 1933 amended the eighth paragraph of section 13 of the Federal Reserve Act to authorize advances to member banks on their secured notes for periods of up to 90 days, but only when the security was paper eligible for rediscount or purchase by the Reserve Banks under the Federal Reserve Act. Advances on Government obligations were still specifically limited to 15 days, even though such obligations were eligible for purchase under section 14 of the Act. As will be noted later, however, another provision of the law, which had been added in March 1933, was construed as authorizing 90-day advances to member banks on their own notes secured by direct obligations of the United States.

Despite the statutory extension of the period for which advances might be made to member banks on the security of eligible paper, such advances have normally been extended for periods of much less than 90 days. The principle that member bank borrowings should ordinarily be only for temporary periods was emphasized when the Board's Regulation A was revised in 1955. In a foreword to the revised regulation, it was stated that "Federal Reserve credit is generally extended on a short-term basis"; and, while the provision relating to advances on eligible paper followed the law in prescribing a maximum maturity of 90 days, a footnote to this provision stated, "However, borrowings by member banks are generally for short periods." 16 This footnote was eliminated in 1968; 17 but the statement remains accurate as a matter of practice except where advances are made to enable member banks to meet seasonal needs and except in unusual or emergency circumstances.

# INCREASE OF SECURITIES LOANS DURING LIFE OF ADVANCE

While Congress during the early 1930's was seeking to instill confidence in the economy by broadening the basis for borrowings from the Reserve Banks, it was at the same time deeply conscious of the fact that the use of bank credit for speculative purposes had been one of the major causes of bank failures. Thus, when the Glass-Steagall bill was being debated in February 1932, an amendment was offered to make any advance to a member bank immediately due and payable if, during the life of the advance, the bank should increase its outstanding loans for the purpose of carrying stocks and bonds. The amendment was defeated only because Senator Glass gave assurance that a provision to that effect was to be included in the omnibus banking bill then pending.19

An early draft of the Glass omnibus banking bill in March 1932 10 included not only a provision for suspending credit to member banks that increased their securities loans but also a requirement that the rate of interest on any 15-day advance to a member bank should be 1 per cent higher than the current discount rate. The Board strongly opposed the suggested penalty rate on advances. It argued that the theory underlying the suggestion, namely, that advances had a more direct connection with speculative activities than rediscounts, was unfounded. It pointed out that if advances "were prohibited or made more expensive, they [member banks] would merely substitute the procedure of rediscounting eligible paper without any change in the use of the proceeds." <sup>20</sup>

At the same time, the Board recommended the inclusion in section 4 of the Federal Reserve Act of a provision requiring the Reserve Banks to keep themselves informed as to the speculative use of bank credit by their member banks and to take such matters into consideration in making discounts and advances. Such a provision, the Board believed, would make unnecessary the proposed provision for making any advance immediately due and payable if the borrowing bank increased its loans to purchase or carry securities.

As it turned out, both provisions were included in the final version of the Banking Act of 1933. The provision added to section 4, as recommended by the Board, will be discussed in a later chapter. The provision added to the eighth paragraph of section 13 was to the effect that if any member bank to which any advance had been made under that paragraph should, during the life of such advance and despite an official warning from the Reserve Bank or the Board, increase its outstanding loans collateraled by securities or loans to members of stock exchanges or dealers in securities for the purpose of purchasing or carrying stocks, bonds, or other investment securities (other than obligations of the United States), such advance should be deemed immediately due and payable. In addition, in any such case the member bank was made ineligible to borrow again from the Reserve Bank under this paragraph for such period as the Federal Reserve Board should determine.

This provision remains unchanged in the law and it has given rise to no legal problems. Following the language of the law, the Board has taken the position that an increase in a member bank's securities loans does not subject it to the penalties prescribed by the provision unless such increase takes place after the issuance of an official warning by the Reserve Bank or the Board.<sup>21</sup> This has been the only published interpretation of the provision.

# ELIMINATION OF APPLICATION FORMS AND PROMISSORY NOTES

In November 1970 the Board approved rather drastic changes in the procedures relating to advances to member banks: (1) elimination of the use of formal applications for advances, and (2) provision for the use of a continuing lending agreement to be entered into by a member bank in lieu of the execution of a traditional promissory note in connection with each borrowing.

The law had never required that member banks file formal application forms in requesting Reserve Bank advances, but Regulation A had included provisions clearly implying the need for such applications. These provisions were climinated by an amendment to the regulation, effective November 23, 1970.<sup>22</sup>

At the same time, the Board amended the regulation to eliminate references to the execution of notes by borrowing member banks. It appeared that the law expressly required a borrowing bank to execute a promissory note. Nevertheless, the Board concluded that the underlying purpose of this requirement-to give a Reserve Bank a direct claim against a borrowing member bank-would be equally served by the execution of a lending agreement under which the bank would be legally obligated to repay all advances made pursuant to the agreement. Moreover, a practice had developed by which overnight advances to member banks were frequently repaid before the receipt by the Reserve Bank of the borrowing bank's promissory note.

These changes in procedure were described by the Board in a press release issued on December 1, 1970, as "designed to simplify and update present practices." They went into effect in February 1971. Since then, continuing lending agreements have been regarded as an acceptable substitute for formal application forms and promissory notes. Such agreements include the essential terms previously included in promissory notes, and a member bank is unconditionally obliged to repay all advances received under such agreements.

# ADVANCES ON DIRECT OBLIGATIONS OF THE UNITED STATES

### **15-DAY ADVANCES**

The eighth paragraph of section 13 of the Federal Reserve Act, as added by the Act of September 7, 1916,23 authorized the Federal Reserve Banks to make advances to member banks on their own notes secured not only by paper eligible for discount or purchase but also by the "deposit or pledge of bonds or notes of the United States." The maturity of such advances was limited to 15 days. By the Banking Act of 1933, this paragraph was amended to permit a maximum maturity of 90 days, instead of 15 days, on advances secured by eligible paper. It did not, however, similarly liberalize the maturity restriction with respect to advances secured by Government obligations. Thus, under this paragraph of section 13, advances on direct obligations of the United States with maturities exceeding 15 days could not be made.

### **90-DAY ADVANCES**

Actually, there was no need for the Banking Act of June 16, 1933, to increase the maturity limitation on advances secured by Government obligations. About 3 months earlier, the Emergency Banking Act of March 9, 1933,<sup>21</sup> had added to section 13 of the Federal Reserve Act a new paragraph (the thirteenth and last paragraph) that had authorized advances with maturities of up to 90 days to individuals, partnerships, and corporations on their promissory notes secured by direct obligations of the

United States. Although the new paragraph did not specifically mention member banks, it was immediately obvious that since member banks were corporations, they could obtain 90-day advances on the security of Government obligations under the provisions of this paragraph.

This was made clear by a change in Regulation A in 1942. Section 2(b), which previously had prescribed a 15-day maturity with respect to advances to member banks on Government obligations, was amended to provide a maximum maturity of 90 days.<sup>23</sup> In a footnote it was explained that although the eighth paragraph of section 13 authorized advances to member banks on Government obligations for periods not exceeding 15 days, the last paragraph of that section authorized advances to any individual, partnership, or corporation on direct obligations of the United States for periods not exceeding 90 days and that the term "corporation" included a member bank.

When the regulation was again revised in February 1955, the 15-day maturity limitation on advances on Government obligations was restored, at least in the text of the regulation. However, it was explained in a footnote that under the last paragraph of section 13 of the Federal Reserve Act, a Federal Reserve Bank had authority to make 90-day advances to individuals, partnerships, and corporations (including member and nonmember banks) on their notes secured by direct obligations of the

United States, but that advances to member banks on the security of such obligations "are normally for short periods of not exceeding fifteen days."

In 1968 the regulation was amended to provide in the text for advances to member banks for periods of up to 90 days when secured either by paper eligible for discount or by paper eligible for purchase by the Reserve Banks, without any specific reference to advances on direct obligations of the United States; at the same time the footnote indicating that advances were normally made for shorter periods was omitted.<sup>27</sup>

# LIMITATION AS TO TYPE OF OBLIGATION

The eighth paragraph of section 13 of the Federal Reserve Act, as added in 1916, referred to advances on bonds or notes of the United States. The Banking Act of 1933 amended this language to refer to bonds, notes, certificates of indebtedness, or Treasury bills of the United States.28 Although the last paragraph of section 13 authorized advances on "direct obligations of the United States," the Board construed this phrase as likewise being limited to bonds, notes, and certificates of indebtedness, and as not including any other types of direct obligations of the United States. Thus, in 1960, the Board held that although the Defense Department was directly liable on certain deed of trust notes, such notes were not direct obligations of the United States within the meaning of the last paragraph of section 13. This position was based on the ground that advances under that paragraph were subject to such limitations, restrictions, and regulations as the

Board may prescribe, and that Regulation A parenthetically defined direct obligations to mean only bonds, notes, Treasury bills, or certificates of indebtedness of the United States.<sup>29</sup>

### ADVANCES AT PAR

In its 1937 revision of Regulation A, the Board included a provision requiring a Federal Reserve Bank to explain to the Board the facts and circumstances of any case in which the amount of an advance on a member bank's note secured by direct obligations of the United States or by obligations fully guaranteed by the United States was less than the face amount of such obligations.30 However, when World War II broke out in Europe, the Board announced that all advances by the Reserve Banks on Government obligations would be made at par,31 and this announcement was repeated in 1941 when the United States entered the war.32 This provision was omitted in the 1955 revision of the regulation because it was considered no longer applicable and because its inclusion might be construed as being inconsistent with the System's announced policy that all advances on Government obligations would be made at par.

For many years commercial banks held large volumes of Government obligations in their portfolios, and by far the greatest part of member bank borrowings from the Reserve Banks during those years was through advances secured by direct obligations of the United States. In recent years, however, the volume of "free" (that is, unpledged) Government obligations held by member banks has declined sharply, and more and more member bank borrowings have been secured by eligible paper.

# ADVANCES ON OBLIGATIONS OF GOVERNMENT AGENCIES

### SUMMARY

Except for bonds of the War Finance Corporation during World War I, 33 only direct obligations of the United States, as distinguished from obligations of U. S. Government agencies, were eligible as security for Reserve Bank advances prior to 1932. After 1932 amend-

ments were made from time to time to the eighth paragraph of section 13 of the Federal Reserve Act for the purpose of specifically making obligations of certain Government agencies eligible as security for advances under that paragraph. In 1968 the paragraph was amended to permit advances to member banks on any obligations eligible for purchase by the Reserve Banks under section 14(b) of the Federal Reserve Act—which include all obligations guaranteed by the United States and obligations issued or guaranteed by agencies of the United States.

# FEDERAL INTERMEDIATE CREDIT BANK OBLIGATIONS

The Agricultural Credits Act of 1923 added to the Federal Reserve Act a new section—13a -which, among other things, authorized the Reserve Banks to discount 'paper for Federal intermediate credit banks and to purchase the debentures and other obligations of such banks. In 1932 Congress apparently felt that the intermediate credit banks needed additional facilities for acquiring funds through the Federal Reserve System; the Act of May 19, 1932,31 endorsed by the Farm Loan Board, the Treasury, and the Federal Reserve Board, was designed to meet these needs. Among other things, that act amended the eighth paragraph of section 13 of the Federal Reserve Act so as to authorize 15-day advances by the Reserve Banks to member banks on their notes secured "by the deposit or pledge of debentures or other such obligations of Federal intermediate credit banks which are eligible for purchase by Federal reserve banks under section 13(a) of the Federal Reserve Act." 35

In recommending the enactment of this provision the House Banking and Currency Committee, after pointing out that intermediate credit bank debentures were already eligible for purchase by the Federal Reserve Banks, stated: <sup>36</sup>

\* \* \* Such an amendment to the Federal reserve act would be of great benefit to the Federal intermediate credit banks because its

immediate effect would be to broaden the market for the collateral trust debentures issued by the banks. These are high-grade investments, and member banks would purchase them in greater volume if they could be used as a basis for temporary credit with the Federal reserve bank in the event of some emergency or need for funds.\*

Significantly, the committee's report went on to say that it was not believed that the debentures would be used for this purpose to any great extent, but that "the fact that they could would be very valuable in the sale of debentures and would greatly facilitate the operations of the Federal intermediate credit banks in extending credit to agriculture." This motive—to make the purchase and holding of the debentures more attractive to banks—has obviously been behind subsequent amendments to the Federal Reserve Act making obligations of other Government agencies eligible as collateral for Federal Reserve advances to member banks

In the course of the debates on the 1932 amendment, Chairman Steagall of the House Banking and Currency Committee argued that debentures of the intermediate credit banks were "as sound and desirable" as the commercial paper that the Reserve Banks were permitted to accept as collateral for advances under the existing law and that the amendment would make the debentures more desirable to member banks and thus "reduce the interest which is paid by farmer borrowers." <sup>37</sup>

One persistent opponent of the amendment was Congressman McFadden. He argued strongly that its enactment would weaken the security behind Federal Reserve notes. His reasons were the same as those he had previously advanced in opposing the Glass-Steagall Act, which a few months before had permitted Government bonds to be used as collateral security for Federal Reserve notes. He insisted that the amendment would "repeal the liquidity provision of the Federal reserve act, the main thing that was the argument for the creation of the Federal reserve act—clasticity." He contended that the amendment was a reversion "to the

Government bond secured circulating medium," and that in this instance the bonds of the intermediate credit system were being substituted for Government bonds.<sup>28</sup>

Despite Mr. McFadden's objections, the amendment was passed. It became a precedent for later enactments authorizing obligations of certain other Government agencies to be used as collateral for advances by the Reserve Banks to their member banks.

The 1932 amendment authorized the pledge of intermediate credit bank obligations as security for 15-day advances to member banks only if they were cligible for purchase by the Reserve Banks under section 13a of the Federal Reserve Act. That section provided for the purchase of such obligations only "to the same extent and subject to the same conditions" as those under which farm loan bonds could be bought by the Reserve Banks. Under the Farm Loan Act of 1916, the Reserve Banks could buy farm loan bonds only to the same extent and subject to the same conditions as they could buy municipal bonds under section 14(b) of the Federal Reserve Act. Under section 14(b) they were authorized to purchase only municipal bonds having maturities of not more than 6 months from the date of purchase. As the result of this rather devious chain of references, only obligations of intermediate credit banks having a maturity of 6 months or less were eligible as security for advances to member banks. This limitation, however, is no longer applicable because section 14(b) of the Federal Reserve Act now authorizes the Reserve Banks to purchase obligations of any agency of the United States—the intermediate credit banks are regarded as agencies of the United States—and the eighth paragraph of section 13 permits any obligations eligible for purchase under section 14(b) to be used as collateral for Reserve Bank advances.

Although section 13a of the Federal Reserve Act refers to the purchase of debentures issued by "a" Federal intermediate credit bank, the law covers not only debentures issued individually by such banks but also consolidated debentures issued by such banks together; <sup>30</sup>

consequently, consolidated debentures, as well as individual debentures, are eligible as security for advances to member banks.

#### FARM LOAN BONDS

The Federal Farm Loan Act of 1916 expressly authorized any Federal Reserve Bank to buy and sell farm loan bonds issued by the Federal farm land banks to the same extent as they were authorized to buy State, county, district, and municipal bonds under section 14(b) of the Federal Reserve Act.40 That section authorized the purchase of such bonds, that is, tax warrants, with maturities of not more than 6 months. Since the new farm loan bonds were eligible for purchase under a statute other than the Federal Reserve Act, they were not eligible as collateral for advances to member banks under the eighth paragraph of section 13 of that Act, Moreover, the Board's General Counsel in 1917 ruled that farm loan bonds could not be regarded as "bonds of the United States" and were therefore not eligible for use as collateral for advances to member banks.41

In the early days of March 1933, drastic steps had been taken to maintain the solvency of the banks of the country. As a further step toward economic recovery, President Roosevelt, in a special message to Congress on March 16, 1933, recommended the enactment of an act "to establish and maintain such a balance between production and consumption of agricultural commodities and such conditions in the marketing of agricultural commodities as will give to such commodities sold by farmers their pre-war purchasing power." <sup>42</sup> This became known as the Agricultural Adjustment Act.

As evidence of the urgency of the measure, the bill was introduced in the House on March 20, reported the same day, passed by the House on March 22, and introduced in the Senate on March 23. Up to that point, it contained nothing with respect to farm credits; it was concerned primarily with the maintenance of the balance between the production and consumption of agricultural commodities. As reported by the

Senate committee, however, the bill was expanded to cover extensions of additional credit through the farm credit system. It included a provision for the issuance by the Federal land banks of a special type of farm loan bonds for a limited period of 2 years in order to enable the land banks to expand their lending facilities. These bonds, limited to an aggregate of \$2 billion, were to be fully guaranteed as to interest by the United States.

To insure the sale of the bonds, Senator Frazier proposed an amendment that would have given them the complete support of the Federal Reserve System: If they were not sold to the public, the Federal Reserve Board would have been required to deliver to the Federal Farm Loan Board an equal amount of Federal Reserve notes. A less drastic step, however, was finally adopted. On April 10, Senator Shipstead introduced an amendment to the bill to make the new farm loan bonds eligible as collateral for advances by Federal Reserve Banks to member banks under section 13 of the Federal Reserve Act. As finally enacted on May 12, the statute 43 amended section 32 of the Federal Farm Loan Act of 1916 to authorize the issuance of the temporary farm loan bonds and further amended the provisions of section 13 of the Federal Reserve Act relating to 15-day advances to member banks so as to permit such advances to be secured "by the deposit or pledge of bonds issued pursuant to the paragraph added to section 32 of the Federal Farm Loan Act, as amended by section 21 of the Emergency Farm Mortgage Act of 1933."

Authority for the use of these bonds as collateral for advances to member banks was short lived, however. In the following month, the Banking Act of 1933 again amended the eighth paragraph of section 13 of the Federal Reserve Act and at that time the provision for the use of farm loan bonds as collateral for 15-day advances was omitted.

Although the Reserve Banks were still authorized to purchase farm loan bonds, that authority was not contained in the Federal Reserve Act itself; consequently, such bonds

did not come within the scope of paper eligible as collateral for advances, that is, paper eligible for discount or purchase under the Federal Reserve Act. However, farm loan bonds have again become eligible as collateral for Federal Reserve advances because they are obligations of the Federal land banks, which are agencies of the United States; the Reserve Banks are authorized under section 14(b) of the Federal Reserve Act to purchase obligations of Government agencies, and section 13 permits the use of any paper eligible for purchase under section 14(b) as collateral for Federal Reserve Bank advances.

### FEDERAL FARM MORTGAGE CORPORATION BONDS

The need for additional farm credit, which the Act of May 12, 1933, had been designed to meet, continued into 1934. Commercial banks still were not satisfying the demand for farm mortgage loans. The Federal Farm Mortgage Corporation Act of January 31, 1934," was intended "to supply funds for continuing on its augmented basis the land-mortgage credit system provided for in the Federal Farm Loan Act and the Emergency Farm Mortgage Act of 1933." 45 It created a new agency, the Federal Farm Mortgage Corporation, with authority to issue bonds guaranteed by the United States. The Federal land banks were permitted to exchange their own consolidated bonds for the Government-guaranteed bonds of the Corporation and thus be in a position to sell the latter and use the proceeds for making additional farm mortgage loans.

To encourage banks to buy the bonds of the new Corporation, the House bill would have amended section 14 of the Federal Reserve Act to authorize the Federal Reserve Banks to buy and sell such bonds. As finally enacted, the statute went further and amended both section 14 and section 13 of the Federal Reserve Act. The Reserve Banks were authorized under section 14 to buy and sell bonds of the Federal Farm Mortgage Corporation having maturities from the date of purchase of not more than

6 months. The eighth paragraph of section 13 was amended to authorize 15-day advances to member banks on their notes secured "by the deposit or pledge of Federal Farm Mortgage Corporation bonds issued under the Federal Farm Mortgage Corporation Act."

This authorization soon lost its significance. By the mid-1950's very few bonds of the Federal Farm Mortgage Corporation were outstanding.16 In recognition of this fact, the Board's 1955 revision of Regulation A, which previously had referred in the text to the use of such bonds as collateral for advances to member banks, merely referred in a footnote to the fact that "such advances may also be made on notes secured by the deposit or pledge of Federal Farm Mortgage Corporation bonds issued under the Federal Farm Mortgage Corporation Act." 17 By an Act of October 4, 1961, Congress amended paragraph 8 of section 13 of the Federal Reserve Act to eliminate the reference to Federal Farm Mortgage Corporation bonds as collateral for Federal Reserve advances to member banks; " and the footnote reference to such bonds in Regulation A was eliminated in 1968.49

# HOME OWNERS' LOAN CORPORATION BONDS

A few months after bonds of the Farm Mortgage Corporation were made eligible as collateral for Federal Reserve advances, bonds of the Home Owners' Loan Corporation (HOLC) were given the same privilege. In addition to making such bonds eligible for purchase by the Federal Reserve Banks, the Act of April 27, 1934, 50 amended the eighth paragraph of section 13 of the Federal Reserve Act to permit 15-day advances to member banks to be secured by "the deposit or pledge of bonds issued under the provisions of subsection (c) of section 4 of the Home Owners' Loan Act of 1933, as amended."

The committee reports gave no specific reason for this amendment. It appeared, however, that the refunding of the previously issued HOLC bonds had been retarded because they

had not been clearly guaranteed as to principal by the United States and, being quoted below par, they had not been acceptable to some mortgagees at face value in exchange for mortgages. To remedy the situation, the new bonds were expressly and fully guaranteed as to principal and interest by the United States.<sup>51</sup> Presumably in order to make them more attractive investments for banks, they were also made available as a basis for Federal Reserve credit.

During the debates, Senator Bulkley stated that this was simply a technical provision designed to put these bonds "on the same basis with United States bonds in this respect.

\* \* \* We are simply conforming to the Federal Reserve Act in giving these bonds a technical privilege, which they ought to have when guaranteed by the Treasury." <sup>52</sup>

In practice, the authority for the use of HOLC bonds as security for section 13 advances to member banks proved to be of little significance. The HOLC was dissolved on February 3, 1954,<sup>53</sup> and none of its bonds are outstanding. The reference carried in the Board's 1937 Regulation A to the use of such bonds as collateral for advances was omitted when the regulation was revised in 1955.

#### COMMODITY CREDIT CORPORATION CERTIFICATES OF INTEREST

By regulation in 1949, the Board permitted the use of one type of paper as collateral for section 13 advances even though it was not clearly eligible either for discount or for purchase by the Reserve Banks. As part of an effort to encourage banks to hold notes representing loans made to producers of agricultural products pursuant to commodity loan programs of the Commodity Credit Corporation (CCC), the Board amended its Regulation A, effective February 17, 1949, to except such producers' notes from the negotiability requirement of the regulation in order that they might be eligible for rediscount. Under some of the CCC programs, however, the producers'

notes were bought by CCC and held in "pools," and certificates of interest in such pools of notes were issued to banks. In 1917 the Board had ruled that a certificate of interest in a note was not eligible for discount.<sup>54</sup> Although this would suggest that certificates of interest in pools of CCC notes would not be eligible for discount, the Board amended Regulation A to provide "for the use of certificates of interest such as are issued by the Commodity Credit Corporation under its cotton loan program as security for advances made to member banks." <sup>55</sup>

In 1969 the reference to the use of CCC participation certificates as collateral for advances to member banks was omitted from Regulation A, but at the same time the Board added to its list of agency issues eligible as collateral for such advances "Commodity Credit Corporation certificates of interest in a price-support loan pool." 50

### MERCHANT MARINE BONDS

In 1960 the Board ruled that United States Government Insured Merchant Marine bonds were not eligible as collateral for Reserve Bank advances to member banks under section 13 of the Federal Reserve Act because, in the light of the legislative history, the reference in the eighth paragraph of that section to notes, drafts, bills of exchange, or bankers' acceptances contemplated only obligations arising out of commercial or agricultural transactions, and Merchant Marine bonds were not of that character.57 This interpretation was, of course, superseded by the 1968 amendment to the eighth paragraph of section 13 making eligible as collateral for Reserve Bank advances any obligations eligible for purchase under section 14(b). On the ground that the Merchant Marine bonds constituted obligations issued or guaranteed by a Government agency and that they were therefore eligible for purchase, the Board in 1968 expressly revoked its 1960 ruling holding such bonds to be ineligible for use as collateral.58

# FARMERS HOME ADMINISTRATION INSURED NOTES

In 1962 the Board considered the question whether notes evidencing loans to farmers by member banks that were insured by the Farmers Home Administration were eligible as collateral for advances under the eighth paragraph of section 13 of the Federal Reserve Act. The Board concluded that, while the term "insurance" rather than the term "guarantee" was used in connection with such loans, they were to be considered as fully guaranteed by the United States within the meaning of section 14(b) of the Federal Reserve Act and were therefore cligible for purchase by the Reserve Banks. In addition, the Board concluded that the insured notes involved in this case were to be distinguished from the insured Marine bonds, which had been considered by the Board in 1960. The latter bonds, although technically notes, were regarded as securities and not the kind of notes contemplated by the eighth paragraph of section 13, whereas the notes insured by the Farmers Home Administration were not in the category of securities. Accordingly, the Board held that such insured notes were eligible as security for Reserve Bank advances to member banks under section 13.59

# EXPORT-IMPORT BANK PARTICIPATION CERTIFICATES

The Export-Import Bank of Washington issued participation certificates representing interests in loans made by that Bank. Although the law did not give the Bank express authority to pledge the faith or credit of the United States to the redemption of such certificates, it did unconditionally guarantee the payment of principal and interest on such certificates. On the basis of an opinion of the Attorney General of the United States 60 to the effect that a guarantee by a Government agency is an obligation fully binding upon the United States despite the absence of statutory language expressly pledging its faith or credit to the redemption of the

guarantee, the Board in 1966 concluded that such participation certificates were "fully guaranteed by the United States as to principal and interest" within the meaning of section 14(b) of the Federal Reserve Act and were therefore eligible as collateral for advances to member banks under the eighth paragraph of section 13.61

#### NOTES GUARANTEED BY SMALL BUSINESS ADMINISTRATION

A few months later in 1966, the Board followed the principle stated in the Export-Import Bank case when it ruled that notes fully guaranteed by the Small Business Administration (SBA) under its Small Business Investment Company Program were eligible for purchase by the Reserve Banks under section 14(b) of the Federal Reserve Act and were, therefore, eligible as collateral for advances under the eighth paragraph of section 13.62 Again, although the Small Business Investment Act did not expressly pledge the faith or credit of the United States for the redemption of the notes guaranteed by the SBA, the Board relied upon the opinion of the Attorney General previously mentioned to the effect that a guarantee by a Government agency is an obligation fully binding on the United States despite the absence of statutory language expressly pledging the faith or credit of the Government for the redemption of the guarantee.

#### **AGENCY ISSUES**

In 1966, section 14(b) of the Federal Reserve Act was amended to authorize the Reserve Banks, under regulations of the Federal Open Market Committee, to buy and sell in the open market "any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States." <sup>63</sup> This authority was originally conferred for only 1 year, but in 1967 it was extended for another year and in 1968 it was made permanent. <sup>64</sup>

The effect of this amendment to section 14(b) was to make eligible for purchase by the Reserve Banks not only direct obligations of the United States and obligations fully guaranteed by the United States but also any obligation issued by any agency of the United States or fully guaranteed by any such agency, even though such obligation would not be fully guaranteed by the United States.

Although such agency issues were thus made eligible for purchase by the Reserve Banks, they were still not eligible, under Board rulings, as collateral for Reserve Bank advances under section 13 of the Act unless they could be regarded as notes arising out of commercial or agricultural transactions. The situation was changed by the 1968 amendment to the eighth paragraph of section 13 when any obligations eligible for purchase were made eligible as security for advances. Since 1968, any obligation issued or fully guaranteed by any Government agency has been eligible as collateral for section 13 advances to member banks.

Following the enactment of the 1968 legislation, the Board issued an interpretation listing the principal agency obligations that were eligible as collateral for Reserve Bank advances under section 13. The list of agency obligations was as follows: <sup>65</sup>

- Federal Intermediate Credit Bank debentures
- (2) Federal Home Loan Bank notes and bonds
- (3) Federal Land Bank bonds
- (4) Bank for Cooperative debentures
- (5) Federal National Mortgage Association notes, debentures, and guaranteed certificates of participation
- (6) Obligations of or fully guaranteed by the Government National Mortgage Association
- (7) Merchant Marine bonds
- (8) Export-Import Bank notes and guaranteed participation certificates
- (9) Farmers Home Administration insured notes
- (10) Notes fully guaranteed as to principal and interest by the Small Business Administration

- (11) Federal Housing Administration debentures
- (12) District of Columbia Armory Board bonds
- (13) Tennessee Valley Authority bonds and notes
- (14) Bonds and notes of local urban renewal or public housing agencies fully supported as to principal and interest by the full faith and credit of the United States pursuant to section 302 of the Housing Act of 1961 (42 U.S.C. 1421a (c), 1452(c))

This list was supplemented in 1969 by the addition of Commodity Credit Corporation certificates of interest in a price-support loan pool 66 and was further supplemented in 1971 by the addition of notes, debentures, and guaranteed certificates of participation of the Federal Home Loan Mortgage Corporation and obligations of the United States Postal Service.67 In 1972, on the basis of opinions of the Attorney General to the effect that they were obligations of the United States, the Board took the position that certain guaranty contracts entered into by the Department of Health, Education, and Welfare and certain participation certificates issued under a Purchase Contract Program of the General Services Administration should be treated as direct obligations of, or fully guaranteed as to principal and interest by, a U.S. agency and were eligible as security for advances to member banks.65

The Board's 1968 interpretation made it clear that nothing less than a full guarantee of principal and interest by a Federal agency would make an obligation eligible as collateral for an advance. For example, mortgage loans insured by the Federal Housing Administration are not eligible because an insurance contract is not equivalent to an unconditional guarantee and does not fully cover interest payable on the loan. Moreover, obligations of international institutions, such as the Inter-American Development Bank and the International Bank for Reconstruction and Development, are not eligible as such collateral because they are not agencies of the United States.

It is interesting to note that when the Penn-Central Transportation Company collapsed in 1971 and was placed under reorganization pursuant to Federal law, the certificates issued by the trustees of the company were fully guaranteed by the Secretary of Transportation. Consequently, such certificates technically became eligible as security for Reserve Bank advances to member banks under section 13 of the Federal Reserve Act.<sup>68</sup>

#### TAX WARRANTS

Section 14(b) of the Federal Reserve Act authorizes the Reserve Banks to buy and sell "bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipality in the continental United States, including irrigation, drainage, and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Board of Governors of the Federal

Reserve System." This language was part of the original Federal Reserve Act and has never been changed.

Following the enactment of the 1916 amendment to the law authorizing advances by the Reserve Banks to member banks on paper eligible for rediscount or purchase by the Reserve Banks, the Board held that county tax warrants, although eligible for purchase under the Federal Reserve Act, were not eligible as collateral for advances to member banks under the eighth paragraph of section 13 of the Act, to presumably because tax warrants were not

regarded as notes, drafts, or bills of exchange within the meaning of that paragraph.

That such obligations were not regarded as eligible security for section 13 advances was indicated during consideration of the Glass-Steagall Act of 1932, when statements were made by Governor Meyer of the Board and by various Congressmen to the effect that the latter act, by authorizing advances on any satisfactory security under the new section 10(b), would have the effect of permitting municipal bonds to be used as collateral for advances under that section.71 When the Board's Regulation A was revised in 1937, it provided that advances to member banks under section 13 must be secured by paper eligible for rediscount or for purchase by the Reserve Banks under the provisions of the Board's Regulation B. That regulation dealt only with the purchase of bills of exchange and bankers' acceptances, not with the purchase of tax obligations of municipalities. Although the 1955 revision of Regulation A changed this reference so that it referred to paper eligible for purchase under the Federal Reserve Act (as provided in the statute), apparently this change was not intended to reflect any change in the Board's previous position that tax-anticipation obligations of municipalities were not eligible as collateral for advances to member banks under section 13

The 1968 amendment to the eighth paragraph of section 13, which has frequently been mentioned in this chapter, had the effect of making tax warrants that were eligible for purchase under section 14(b) also eligible as collateral for Reserve Bank advances to member banks. That change in the law was recognized by the Board in an interpretation that noted specifically that the kinds of tax-anticipation bonds and warrants described in section 14(b) had become eligible as collateral for advances to member banks, but only to the extent that such obligations would be eligible for purchase

under the Board's Regulation E.<sup>72</sup> Regulation E, Purchase of Warrants, was adopted many years ago and is still in effect, even though it purports to regulate the purchase and sale of tax warrants in the open market, a subject now within the jurisdiction of the Federal Open Market Committee and no longer subject to regulation by the Board. That regulation prescribes detailed conditions that must be met in order for warrants to be eligible for purchase by the Reserve Banks.

In 1969 the Board amended its 1968 interpretation regarding the eligibility of tax warrants as security for Reserve Bank advances. It eliminated the earlier requirement that in order to be eligible as such security, warrants had to comply with the requirements of Regulation E. It provided, however, that in each case a Reserve Bank should satisfy itself that sufficient tax or other assured revenues earmarked for payment of such obligations would be available for that purpose at maturity, or within 6 months after the date of the advance if no maturity was stated.<sup>73</sup>

One final point with respect to the use of tax warrants as collateral for Reserve Bank advances should be mentioned. The language of section 14(b) literally limits the eligibility of such warrants for purchase by the Reserve Banks (and therefore as collateral for advances) to warrants issued by a State, county, district, political subdivision, or municipality in the continental United States. This would appear to exclude warrants issued by municipalities in the State of Hawaii. However, the fact is otherwise because, when Hawaii was admitted to statehood in 1959, the enabling legislation amended section 1 of the Federal Reserve Act to define the term "the continental United States" as the States of the United States and the District of Columbia.74 Thus, although it consists of islands in the middle of the Pacific. Hawaii is a part of the continental United States, at least for certain purposes.

#### THE GLASS-STEAGALL ACT: A BREAK WITH THE PAST

#### EMERGENCY BACKGROUND

A date of importance in the history of the lending functions of the Federal Reserve Banks was February 27, 1932—the date of enactment of the Glass-Steagall Act. 75 It was a brief statute of only three sections, but one that marked a definite change in the traditional concept of the nature of the lending functions of the Reserve Banks. Previously, emphasis had been placed on compliance with more or less formal and technical requirements regarding eligibility for discount, in particular compliance with an arbitrarily fixed, short maximum maturity and a requirement for self-liquidation out of actual commercial or agricultural transactions; thereafter, more and more emphasis was placed upon the soundness of the paper offered as a basis for credit.

The Glass-Steagall Act was essentially an emergency measure. Its purposes were to restore confidence in the banking system, to halt bank failures, to loosen credit, and to bring currency out of hoarding. As stated by the bill's co-author, Congressman Steagall, the banking and credit machinery of the country had "drifted into unhappy days." 76 An omnibus banking bill, the so-called Glass bill, was then pending in the Senate. Designed to correct abuses that had led to the unhappy days-use of bank funds for speculative purposes and participation by banks in the securities business -that bill was to be enacted more than a year later as the Banking Act of 1933. In the meantime, some immediate action was deemed necessary to dispel the prevailing atmosphere of uncertainty and apprehension.

The extreme urgency of the situation is indicated by the legislative progress of the Glass-Steagall bill. It was introduced in both Houses on February 11; it was reported and debated in the Senate on Friday, February 12; on the same day hearings were held by the House Banking and Currency Committee; on Monday,

the 15th, it was passed by the House; after further debate in the Senate on the 18th, it was passed by that body on the following day; and the bill was signed by the President on the 27th. Indeed, some members of Congress complained of the shortness of time allowed for consideration of the bill.<sup>77</sup>

#### PROVISIONS OF THE BILL

One of the three sections of the bill amended section 16 of the Federal Reserve Act to permit direct obligations of the United States to be used as collateral for the issuance of Federal Reserve notes until March 3, 1933. Previously, such notes could be issued only against gold, gold certificates, and eligible paper rediscounted by the Reserve Banks. Because of the shrinkage in the amount of commercial paper offered for discount, Federal Reserve notes then outstanding were backed to the extent of nearly 80 per cent by gold, although the Federal Reserve Act then required a gold reserve of only 40 per cent against outstanding Federal Reserve notes.75 There were those who felt that permission for the use of Government obligations as security for Federal Reserve notes would be inconsistent with the original concept of an elastic currency backed by commercial paper rather than by Government bonds. 79 The majority, however, were willing-at least as a temporary measure—to depart from the original concept because they believed that hoarding would be offset by an "emergency circulation of Federal reserve notes secured by Government bonds." 50 Moreover, it was felt that this amendment would have the effect of "turning loose" about \$800,000,000 of "free gold," 51 and would thereby "fortify the gold status of the Federal reserve banks in this period of extraordinary disturbance." 52

But it is with the other two sections of the Glass-Steagall Act that this history is more directly concerned. They permitted the Fed-

eral Reserve Banks for the first time, although only in emergency situations, to extend credit to member banks on the basis of any satisfactory assets, whether or not technically eligible for rediscount. These sections added sections 10(a) and 10(b) to the Federal Reserve Act. Section 10(a) authorized any Reserve Bank, with the consent of at least five members of the Federal Reserve Board, to make advances to groups of five or more member banks on their promissory notes under certain conditions, one of which was that the bank or banks in the group that received the proceeds had no adequate amounts of eligible paper. Section 10(b) provided authority, until March 3, 1933, under which a Reserve Bank in exceptional and exigent circumstances could make an advance to an individual member bank on its notes secured to the satisfaction of the Reserve Bank if the member bank had no further eligible paper, but only at a rate of interest at least I per cent higher than the regular Reserve Bank discount rate.

#### GENERAL PURPOSES

The principal objective of these provisions was to reassure banks by making it clear that in an emergency they could use long-term paper, such as mortgages, as a basis for borrowing from the Reserve Banks. Actually, there was no real shortage of eligible paper among the banks of the country as a whole. During the hearings on the bill before the House Banking and Currency Committee, Governor Meyer of the Board estimated that member banks held from \$8 billion to \$81/2 billion of eligible paper, including Government bonds.83 The difficulty, Governor Meyer said, was that the banks were "timid" about borrowing. In the prevailing state of confusion and fear, banks felt it necessary "to keep on hand enough liquid securities or eligible paper to respond to any contingency that might arise" in order to meet possible demands of their depositors. 51 Senator Glass described the situation as follows:85

\* \* \* There is plenty of eligible assets in the portfolios of the member banks of the Federal reserve system \* \* \*. The member banks of the system, the banking community of the United States, have ceased to function through abject fear and have communicated this fear to depositors.\* \*

In other words, the purpose of the Glass-Steagall Act was largely psychological. At another point during the debates, Senator Glass remarked: 80

\* \* The chief psychological advantage of this measure—and it is perhaps a valuable psychological advantage—is that it gives assurance to these frightened and timid bankers throughout the country that if they will only respond to the requirements of commerce, if they will only help in relieving themselves and the country from this depression and in doing so exhaust their eligible assets, then and only then may they make use of their ineligible assets.

Similarly, Senator Fletcher felt that the bill would place banks in a position where they could "take greater risks and make loans and accommodate their customers to a greater extent" than they had been doing.<sup>87</sup>

Some feared that by broadening the base for borrowing from the Reserve Banks, the bill would be inflationary. The Senate committee's report, however, stated that the bill was "not intended nor should it be used for undue inflation of the currency." Similarly, the House report expressed the belief that the bill, "without undue expansion," would result in easier credit, which would aid in ending bank failures and in improving business conditions generally. In other words, it was felt that if the bill did cause some inflation, it would not, in the circumstances, be an undue or improper inflation. One Congressman put it as follows: 11

If by easing credit we increase confidence and dispel fear, we shall observe a resulting flow into rediscount channels of hoarded rediscountable paper, with a resultant issuance of Federal reserve notes. \* \* \* There is nothing inflationary in such a program, because there is no undue or unwarrantable element in that which is normal.

There were some, indeed, who were afraid not that banks would borrow too much under the bill but that they would borrow too little.<sup>92</sup>

In any event, it was emphasized that the provisions of the act were to be utilized only in exceptional and emergency situations. A few, like Senator Vandenberg, suggested that commercial practices had changed over the years; that "Federal reserve definitions should progress with the times"; and that "sound" assets should be eligible as a basis for Federal Reserve credit even though they "fell outside the arbitrary limitations set up in the original Federal reserve act." 93 But Governor Meyer of the Board declared that the bill was intended to be used only in "exceptional cases," " and that it would provide facilities to be availed of "in an emergency." 95 The act itself stated in its title that it was to provide means for meeting the needs of member banks "in exceptional circumstances"; and the new section 10(b), authorizing advances on any satisfactory assets, was limited to "exceptional and exigent circumstances" and was enacted to remain in force only until March 3, 1933.

The general objectives of sections 10(a) and 10(b) were summarized by the Senate Banking and Currency Committee 2 months after their enactment when Congress was considering a more comprehensive banking bill. That committee's report on the Glass bill, which later became the Banking Act of 1933, contained the following statement: <sup>96</sup>

Within recent months there has been a very widespread demand for some means of furnishing emergency relief to banks that are in difficult straits. The Federal reserve system was intended to furnish a means of mutual aid and if properly administered was entirely adequate to the necessities of the case. However, with conditions as they stand it is likely that some plan whereby actual assist-

ance could be furnished to banks which are willing to stand sponsor for one another and thus enable them to clear up danger spots in their own several communities would be helpful. We therefore suggested such a plan as an additional means of strengthening and rendering useful the provisions of the Federal reserve system. The general plan so recommended was founded upon the idea of joint action by clearing houses or groups of banks in different localities designed for the purpose of getting accommodations on their joint unsecured notes at reserve banks up to such amount as might be held prudent; likewise, in exigent cases, relief was provided for individual banks. Such emergency credit should be retired as soon as possible, and therefore it seemed best to provide severe restrictions upon its use and duration.\* \* \*

Although regarded in those unhappy days of 1932 as a piece of emergency legislation, the Glass-Steagall Act marked a turning point; and, as it later developed, it proved to be more than a temporary measure. The authority for the use of Government bonds as security for Federal Reserve notes was extended from time to time and was finally made permanent. Section 10(a), authorizing advances to groups of member banks, is still on the statute books, although it is of little practical significance for reasons hereinafter indicated. Section 10(b), providing for advances on satisfactory assets, is now permanent legislation and is no longer restricted to emergency situations, although it still requires that a penalty rate of interest be charged on such advances.

It is in order at this point to consider in more detail the purposes, history, and application of these sections of the Federal Reserve Act that relate to advances to member banks.

#### ADVANCES TO GROUPS OF MEMBER BANKS

#### PURPOSE AND NATURE

Section 10(a) of the Federal Reserve Act,<sup>87</sup> as added by the Glass-Steagall Act of February 27, 1932, authorized any Federal Reserve Bank to make advances to groups of five or more member banks, subject to a number of rigid restrictions. Its purpose was to enable several member banks to join together in an organization like a clearing house and, as a group, borrow from a Federal Reserve Bank funds with which to assist a weak or failing bank within the group.<sup>88</sup>

The report of the Senate Banking and Currency Committee stated that this section was "intended to provide a permanent reserve for groups of banks in periods of great distress." 99 Similarly, the House Banking and Currency Committee described the section as affording "a means of relicf to banks that find themselves in urgent need of accommodations when willing to enter into joint liability." 100 During the House hearings, Governor Meyer of the Board declared that if the provision had existed in the previous year it might have been used in a number of cases, since he felt that it was certainly "to the interest of neighbors in the banking business to save one of their number if unliquidity is the main difficulty affecting the condition of an important banking member of the community." 101

In general, it was contemplated that the section would be utilized by banks in a large city in order to prevent the imminent failure of one of their number and thus protect themselves from the possibility of similar disaster. As to the objection that the stronger banks would not be willing in this manner to assist a weak bank, Senator Glass stated: 102

\* \* \* To think that as many as five banks in any considerable community may not be willing to organize themselves in a group to avert the failure and consequent disaster of one or more other banks in that community is to assume that the bankers of the country have not even an intelligent selfishness, because the failure of any one of the weaker banks in any given community has its reactionary effect upon the stronger banks and, it is readily conceivable, might bring disaster to them also. So we provide that there may be this species of group banking in the populous centers, where it may readily be employed and prove effective.

In effect, the section provided for Federal Reserve advances of funds to a weak bank on the security of the guarantee of the stronger banks in the community. Recognizing the general rule that national banks could not legally guarantee the debts of others, the bill at first specifically provided that national banks should be authorized to endorse or guarantee notes of other member banks evidencing loans under this section. As the bill was finally enacted, it covered this point in broader language applicable to all member banks; the bill authorized member banks "to obligate themselves in accordance with the provisions of this section." 104

In keeping with its basic purpose of providing aid to banks in dire, or nearly dire, circumstances, the section imposed no limit on the amount that might be advanced by a Reserve Bank 105 or on the maturity of any such advance. Nor was any time limit placed on the period during which section 10(a) should remain in effect, although the other provisions of the Glass-Steagall Act, relating to advances to individual member banks and the use of Government obligations as security for Federal Reserve notes, were limited to a period of 1 year.100 It seems clear, however, that the authority to make advances to groups of member banks was intended as an emergency measure to be utilized only in the exceptional case in which a member bank had exhausted its discountable eligible paper and other banks in the community were willing to come to its aid through the joint borrowing mechanism provided by this section.

#### LIMITATIONS

That loans authorized by section 10(a) of the Federal Reserve Act would be made only in truly emergency circumstances was insured by the limitations imposed by its provisions. In order for any advance to be made by a Federal Reserve Bank under this section, nine separate requirements were required to be met:

- 1. The advance had to be approved by at least five members of the Federal Reserve Board.<sup>107</sup>
- 2. The advance was required to be made to a group of not less than five member banks, except that it might be made to a lesser number if the aggregate amount of their deposit liabilities was at least 10 per cent of the total deposit liabilities of the member banks in the Federal Reserve district. Originally, said Senator Glass, the proposal had been for a minimum of 10 banks, but, "in a yielding mood," the number had been reduced to five. 108 There were some, on the other hand, who saw no reason to impose even a five-bank minimum, and the conference committee agreed to the exception stated above. 109
- 3. A majority of the banks in the group obtaining the advance were required to be independently owned and controlled. Originally, the bill required all of the banks to be independent banks. The purpose was to prevent holding companies from forming exclusive groups of their own members. 110 At Senator Glass's suggestion, an amendment was adopted to make the requirement applicable only to a majority of the borrowing banks.
- 4. The most important requirement was that the bank or banks receiving the proceeds of the advance must have no adequate amounts of eligible and acceptable assets available to enable such bank or banks to obtain sufficient credit accommodations from the Federal Reserve Bank through rediscounts or advances other than as provided in section 10(b). The bill at first provided that advances could be made to groups of banks only if such banks had exhausted their eligible assets. The language was changed by a Senate committee amend-

- ment to make it clear that the requirement applied only to the weak bank or banks that actually received and used the proceeds of the advance. If this requirement were met, the advance could be secured by any satisfactory assets, whether technically eligible for discount or not, with only one exception—foreign securities.
- 5. The liability of each bank in the borrowing group was limited to such proportion of the total amount of the advance as the amount of the deposit liabilities of that bank bore to the aggregate deposit liabilities of all the banks in the group. The lawmakers were not certain whether the banks in the group would be jointly and severally liable to the Federal Reserve Bank, 112 but Senator Robinson and Senator Glass felt that each bank would be so liable in proportion to its deposits. 113
- 6. The borrowing banks were authorized to distribute the proceeds of the advance to such of their number and in such amounts as they might agree upon, but the recipient banks were required to deposit with a suitable trustee their individual notes made in favor of the entire group and protected by such collateral as might be agreed upon.
- 7. The rate of interest charged on the advance was required to be not less than 1 per cent above the Reserve Bank's regular discount rate at the time of the advance.
- 8. Notes representing advances under this section were not to be used as collateral security for Federal Reserve notes issued under section 16 of the Federal Reserve Act. As previously noted, some Congressmen in 1932 were reluctant to permit even Government obligations to be used as security for Federal Reserve notes; Congress clearly was not prepared to allow notes given for emergency advances under section 10(a) to be used for this purpose.
- 9. Finally, foreign securities—obligations of foreign governments or of foreign persons or corporations—could not be offered as collateral security for advances under this section of the law. The implication clearly was that any and all other types of collateral security were permissible.

#### **EFFECT**

In view of the many limitations and requirements imposed with respect to group advances under section 10(a), it is not surprising that this authority proved to be of little significance. Moreover, any importance the section might otherwise have had was all but nullified by the provisions of section 10(b) enacted at the same time. When the conference report on the Glass-Steagall bill was being considered in the House, Chairman Steagall recognized that in practical effect there would be no use made of the authority available under section 10(a) by those banks that would be permitted to apply for loans under section 10(b).<sup>115</sup>

Shortly after the enactment of the Glass-Steagall Act, the Board announced that since

the advances authorized by section 10(a) were to be made only in unusual circumstances, it did not contemplate issuing any regulations on the subject but would consider each request for its consent to such an advance in the light of the facts of the particular case. 115 Actually, no regulations ever became necessary, nor were any rulings or interpretations issued under this section. In short, section 10(a) was never of any real practical significance. It would have been repealed by the proposed Financial Institutions Act, which passed the Senate in 1957 but was allowed to die in the House Banking and Currency Committee.116 Although still in effect today, section 10(a) is virtually a dead letter, overshadowed by its sister section-section 10(b).

#### ADVANCES ON SATISFACTORY ASSETS

#### ORIGINAL AUTHORIZATION

Section 10(b) of the Federal Reserve Act, as originally added by the Glass-Steagall Act of February 27, 1932, was intended, in the words of Senator Glass, to provide for the needs of the smaller country banks that were "so detached from commercial and financial centers as to make it exceedingly inconvenient, if not actually impossible, for them either to organize into a group or readily to join an existing group" 117 that might obtain an advance under section 10(a) of the Act.

Briefly, the original section 10(b) authorized any Federal Reserve Bank to make advances to a member bank on its notes secured to the satisfaction of the Reserve Bank, subject to certain limitations. As explained by Governor Meyer of the Board, the section was designed to permit the Reserve Banks to make advances on "adequate and safe security" in cases in which member banks, "because of unsatisfactory business conditions, or through unusual

withdrawal of deposits," had reached the point where their remaining paper, although good, was ineligible for rediscount.<sup>118</sup>

But, as in the case of section 10(a), the restrictions imposed by section 10(b) were somewhat severe. In the first place, authority to make advances under section 10(b) was limited to a period expiring March 3, 1933. Some felt that such a time limit was unnecessary, 119 and the Senate approved an amendment offered by Senator Thomas to extend the period until March 3, 1934. 120 However, the conference committee agreed to go back to the 1-year limitation. 121

Second, advances under the section were expressly limited to exceptional and exigent circumstances. This was a requirement that, although perhaps implicit in section 10(a), had not been specifically prescribed as a condition to advances to groups of banks under that section.

Third, in order to make it clear that advances under section 10(b) would be for the benefit of

small country banks,<sup>122</sup> it was provided that they could be made only to member banks having a capital of not exceeding \$5,000,000. Originally, the Senate bill had fixed this capital requirement at \$500,000; an amendment on the floor had increased it to \$2,000,000; <sup>123</sup> the House bill had prescribed no such capital limitation; and the conference committee, in view of the decision to limit the period of the authority to 1 year instead of 2, agreed to compromise by permitting advances to be made to banks with a capital of up to \$5,000,000.<sup>121</sup>

Fourth, each advance under the section was required to have the affirmative approval of not less than five members of the Federal Reserve Board. This corresponded to the similar requirement imposed upon group advances under section 10(a).

Fifth, the borrowing bank was required to have "no further eligible and acceptable assets available to enable it to obtain adequate credit accommodations through rediscounting at the Federal reserve bank or any other method provided by this Act other than that provided by section 10(a)." In other words, the member bank must have exhausted its eligible paper.

Three additional limitations were similar to those prescribed in connection with group advances under section 10(a): The interest rate was required to be not less than 1 per cent higher than the regular discount rate; notes representing advances under the section could not be used as collateral security for Federal Reserve notes; and foreign securities could not be accepted as collateral for such advances.

In addition to all of these limitations, the Federal Reserve Board was authorized by regulation to limit and define the classes of assets that might be accepted as security for advances to member banks under this emergency authority.

#### EXTENSIONS OF TIME LIMIT

Even while the Glass-Steagall bill was under consideration in 1932, it was recognized that if the banking emergency continued, the authority provided by section 10(b) might have to be extended. The emergency not only continued but became more acute.

On January 9, 1933, with banks failing at an alarming rate, Governor Meyer wrote to Chairman Steagall of the House Banking and Currency Committee: 126

- \* \* While demands upon the Federal reserve banks for accommodations under section 10(b) have not been large, the existence of the authority to extend such accommodations has been a helpful factor in the disturbed situation through which we have been passing and has enabled the Federal reserve banks to render service to individual member banks in a number of instances.
- \* ° \* The Federal Reserve Board feels that the Congress might well consider the enactment of these provisions in permanent form, with whatever safeguards may be deemed appropriate as to the exercise of the authority granted by them, but, in any event, it is the opinion of the Board that, in view of existing conditions, it would be highly desirable to extend such authority for at least one year beyond March 3, 1933.

One month before the section would have expired, Congress, by the Act of February 3, 1933, 127 extended the time limit to March 3, 1934.

The banking crisis reached its climax on March 4, 1933, when all banks were closed by order of President Roosevelt. On the day the banking holiday ended, March 9, 1933, Congress rushed to enactment an Emergency Banking Act 125 in order, as Senator Glass said, to deal with "an extraordinary and desperate situation." 120

Among other things, the Emergency Banking Act modified section 10(b) to eliminate some of its restrictions. The \$5,000,000 capital limitation was removed, thus making advances under this section available to any member bank regardless of its size. The requirement for approval of each advance by at least five members of the Board was also omitted; instead, it was provided that advances should be made under rules and regulations prescribed by the Board. The prohibitions on the use of notes representing such advances as collateral security for Federal Reserve notes and on the use of foreign securities as security for advances were repealed.

The liberalized section, however, continued to provide that advances should be made only in exceptional and exigent circumstances and only when the borrowing bank had no further assets eligible for rediscount. It continued also to require that the rate of interest on such advances should be at least 1 per cent higher than the regular discount rate.

The termination date of March 3, 1934, was retained, but it was qualified to permit extension for such additional period of not more than I year as the President might prescribe.

Senator Glass observed that the provisions of the Emergency Banking Act were "so broad and so liberal that no friend of the Federal Reserve System, in ordinary times, would tolerate them for a moment" and that under the bill member banks might bring their "cats and dogs" to the Federal Reserve Banks and have them discounted. In the House, Chairman Steagall stated, "We have provided a simpler and broader authority for loans by Federal reserve banks upon securities and collateral not eligible under the general authority of the Federal Reserve Act." Is

In his fireside chat of March 12, 1933, President Roosevelt said: 132

Remember that the essential accomplishment of the new legislation is that it makes it possible for banks more readily to convert their assets into cash than was the case before. More liberal provision has been made for banks to borrow on these assets at the reserve banks and more liberal provision has also been made for issuing currency on the security of these good assets. This currency is not fiat currency. It is issued only on adequate security—and every good bank has an abundance of such security.

Less than a year later, on February 16, 1934, acting under the authority conferred upon him by the statute, the President by proclamation extended the duration of section 10(b) for an additional year—until March 3, 1935. 123

#### PERMANENT AUTHORIZATION

From the time of the original enactment in 1932, there were those individuals who felt that the authority for advances on satisfactory

collateral under section 10(b) should not be merely a temporary measure but should be made a permanent part of the law. Their views finally prevailed after the section expired—according to its terms—in March 1935 and the authority was re-enacted in permanent and liberalized form by the Banking Act of 1935 on August 23, 1935.<sup>131</sup> It is of interest to note how this came about.

On February 5, 1935, an omnibus banking bill had been introduced in the House; and a similar bill was introduced in the Senate on the following day.135 Both bills contained a provision that would have added a new paragraph to section 13 of the Federal Reserve Act authorizing the Federal Reserve Banks, under regulations of the Board, to discount for their member banks any commercial, agricultural, or industrial paper, and to make advances to their member banks on their promissory notes secured by any sound assets and without charging a penalty rate of interest. The House adopted this provision. The Senate, however, was not willing to go so far. Instead, it approved a provision reenacting section 10(b) in the same form in which it had previously existed but as a permanent measure and with one important liberalizing change—the omission of the requirement that advances be made only in exceptional and exigent circumstances. The conference committee followed the Senate version, but with two additional liberalizing changes: The requirement that the borrowing bank must have exhausted its eligible paper was eliminated and the penalty rate of interest was reduced from 1 per cent to one-half of 1 per cent. At the same time, the conference committee added a new requirement that maturities should not exceed 4 months.

As finally enacted on August 23, 1935, and as still in force, the revised section 10(b) provides:

Any Federal Reserve bank, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, may make advances to any member bank on its time or demand notes having maturities of not more than four months and which are secured to the satisfaction of such Federal Reserve bank. Each such note shall bear

interest at a rate not less than one-half of 1 per centum per annum higher than the highest discount rate in effect at such Federal Reserve bank on the date of such note.

In this form the authority for advances under this section today is subject to four limitations: (1) Advances must be made in accordance with such rules and regulations as the Board may prescribe; (2) maturities may not exceed 4 months; (3) a member bank's note must be secured to the satisfaction of the Reserve Bank; and (4) the interest rate must be not less than one-half of 1 per cent higher than the currently effective discount rate. With regard to these limitations, the Board has prescribed no restrictive regulations; the collateral need be satisfactory only to the Reserve Bank; and the 4-month maturity limitation is more liberal than the 90-day maturity limitation on rediscounts. Hence, the only important restriction now imposed by the law on advances under section 10(b) is the requirement for a higher rate of interest.

#### EMERGENCY USE VEL NON

Despite the enactment of section 10(b) as permanent legislation and the omission of the provision limiting advances to exceptional and exigent circumstances, some statements were made in 1935 that suggested that the section was still intended to be used only in emergencies.

Thus, during the House committee hearings, Reserve Board Governor Eccles observed that banks should have the assurance that all sound assets could be liquified at the Federal Reserve Bank "in case of an emergency." <sup>136</sup> In the House debates, Mr. Hancock stated that the Federal Reserve Board should be in a position to "consider emergencies promptly." <sup>137</sup> Mr. Hollister referred to the use of "the emergency provisions." <sup>138</sup>

On the other hand, these and similar statements can reasonably be regarded as meaning that section 10(b) advances would be available in emergency situations, but not that such advances could be made only in such situations. Numerous statements were made during the

committee hearings and during the debates in Congress to the effect that this section would enable banks to meet the needs of their communities for long-term as well as short-term funds, placing emphasis on soundness rather than the technical form of the paper.<sup>139</sup>

After the 1935 re-enactment of section 10(b), the Board pointed out in a published statement that these provisions were a recognition of the fact that the scope of the operations of member banks had changed since 1913; that the amount of paper technically eligible for discount had become very small; and that a major factor had been the development of larger volumes of savings deposits, which permitted banks to put their funds into long-time investments.110 In its 1937 Annual Report, the Board stated that changes in the law made by the Banking Act of 1935 reflected a change in the intention of Congress with regard to the character of assets that might be used as a basis for Federal Reserve credit accommodations and that under the 1937 revision of Regulation A any sound assets could be used as a basis for advances by Federal Reserve Banks.111 These statements contained no suggestion that section 10(b) advances were limited to emergency situations; on the contrary, they clearly suggested that it was contemplated that such advances might be available at any time to member banks desiring to obtain credit on the security of long-term paper not eligible for discount, such as real estate mortgages.

Legally, then, the use of section 10(b) is not restricted to emergencies. As a practical matter, it would not normally be used except as a last resort, since member banks usually would not wish to pay the higher rate of interest provided by this section unless they had no paper eligible for rediscount or as security for advances under section 13 at the lower discount rate; and, generally speaking, member banks today have ample amounts of Government obligations that in times of need they may offer as collateral for section 13 advances. Nevertheless, the words "normally," "usually," and "gencrally" have been used here for good reason-There have been occasions, some in recent years, when member banks in trouble did not hold either eligible paper or Government securities in amounts sufficient for use as collateral for Reserve Bank advances at the regular discount rate, and they were compelled to borrow under section 10(b). In addition, there are times when large member banks requiring overnight adjustment credit are willing to pay the extra rate of interest under section 10(b) rather than go to the trouble and expense of sorting out the paper held by them that would meet the technical eligibility requirements prescribed by section 13.

#### THE "SOUND ASSETS" CONCEPT

Even at the time of the enactment of the original Federal Reserve Act there were some who felt that the Federal Reserve Banks should have authority, at least in emergencies, to make advances to member banks not only on eligible paper but on any good security.

In the Senate, both the Owen and Hitchcock bills would have authorized the Federal Reserve Banks, with the approval of the Board, to discount the direct obligations of member banks secured by the pledge and deposit of "satisfactory securities," subject to limitations as to amount. The Owen bill would have limited any such direct advance to three-fourths of the value of the securities pledged. The Hitchcock bill imposed the same limitation and in addition provided that the amount loaned should not exceed the amount of the member bank's capital

Senator Owen described this provision for direct advances on any satisfactory security as an emergency provision. He said: 112

rovides, that in case of an emergency the Federal reserve bank, with the approval of the Federal reserve board, may extend the accommodation to a bank against its assets of whatever character, provided they are a good security.

The provision was regarded as an answer to those who contended that the 90-day maturity limitation on discounts was too short to accommodate country banks in agricultural areas. Thus, Senator Pomerene noted that in order

that such banks might not be at a disadvantage, a provision had been added that would enable a member bank to discount its own notes secured by farmers' notes of longer maturity.<sup>143</sup>

The provision was in the bill as it passed the Senate, but it was eliminated in conference. Three years later, in 1916, the law was amended to authorize advances to member banks on their own notes secured by eligible paper or Government bonds. It was not until 1932, however, that Congress in section 10(b) of the Act finally provided for advances to member banks on any satisfactory collateral, and then only at a higher rate of interest.

As first enacted in temporary and emergency form by the Glass-Steagall Act in 1932, section 10(b) provided for advances to member banks on their notes "secured to the satisfaction" of the lending Reserve Bank; but the Board was authorized by regulation to "limit and define the classes of assets" that might be accepted as security. This was understood to mean that the character of assets acceptable as security would be left entirely to regulation by the Board 143 or, in other words, that the nature of such security would be "largely decided as an administrative matter." 145 Senator Glass stated that the security could be of "any type which the Federal reserve bank, with the approval of the Federal Reserve Board, may by regulation admit." 146

It was understood during consideration of the Glass-Steagall bill that section 10(b) would include authority for advances on tax warrants, 117 and on State, county, and city bonds. 148 It was also assumed that real estate mortgages would be eligible as collateral for such advances. 149 In fact, as stated by Governor Meyer, the collateral could include any "good security," with the exception of foreign securities that were specifically barred by the statute itself. 150

In the course of the debates on the Glass-Steagall bill, some Congressmen criticized the bill for not going far enough in the direction of permitting Federal Reserve advances on any sound assets. Mr. Williamson felt that the bill failed to recognize "a permanent change in the character of paper held by national and other member banks" resulting from the fact that

banks had found it difficult to make a profit without investing in long-term paper, municipal bonds, and other securities not technically eligible for discount.<sup>151</sup> Senator Vandenberg similarly referred to the fact that "commercial practices" had changed since the enactment of the Federal Reserve Act.<sup>152</sup>

The idea that a fundamental change had taken place in the character of paper held by commercial banks and that, consequently, the Reserve Banks should be authorized to lend on the basis of sound assets rather than on short-term, self-liquidating eligible paper gained even greater acceptance during consideration of the legislation that became the Banking Act of 1935.

During the House hearings on the 1935 act, Governor Eccles recommended an amendment to section 13 to authorize advances on any sound assets, subject to regulations of the Board. He asserted that this proposal would not open the door to all kinds of paper regardless of its soundness but that, on the contrary, it was proposed "to place emphasis on soundness rather than on the technical form of the paper that is presented." 153 He pointed out that. under the emergency provisions of section 10(b), the Board had exercised caution and that, although credit had been extended on ineligible assets to the extent of \$300,000,000, all but \$1,500,000 had been paid back. He also pointed out that the total volume of eligible paper held by member banks at that time was only about \$2 billion, or less than 8 per cent of the resources of the banks; that in periods of "timidity" banks tended to refrain from making loans except on paper eligible for discount; and that banks conducting business on this theory could not serve their communities adequately. "Such a bank," he said, "would confine its operations to the purchase of the most liquid open-market paper, with the consequence that it would neglect its local responsibilities and would nevertheless find it difficult to earn enough from the low returns on such paper to cover expenses and dividends."

With respect to the traditional idea that discounted paper should be liquid, Governor Eccles contended that many assets that were eligible for discount because they were considered liquid were actually less sound than many other assets held by banks that could not technically qualify for discount.<sup>154</sup> He pointed out that long-term credits had not been responsible for the depression and that short-term credit is not necessarily sounder than long-term credit.<sup>155</sup>

As to what specific types of assets would be permissible under his proposal, Governor Eccles stated that he would permit the Reserve Banks to lend "on any and all assets, real-estate mortgages, collateral loans, bonds, or other assets, which they considered sound, on such a basis as they considered sound." 126

The proposal made by Governor Eccles was not that section 10(b), which had expired by its terms in March 1935, should be revived, but that the existing limitations of section 13 on paper eligible for discount and as security for advances to member banks be completely discarded in favor of broad authority to extend credit on any sound assets, subject only to such regulations as the Board might prescribe. Some members of the House committee questioned whether, if this were the intent, the existing provisions of section 13 should not be repealed. The Board's General Counsel, Mr. Walter Wyatt, explained, however, that the proposed broad authority would be construed as repealing by implication the provisions of the old law.157

The House Banking and Currency Committee approved the proposal. In its report on the bill, it said: 125

The purpose of this provision is to relax or remove stringent technical limitations on the character of paper that can be used as a basis of borrowing from the Federal Reserve banks, and thus to give member banks the assurance they need so that it will be possible for them to meet the needs of their communities for both short-time and long-time funds. Since in practice existing restrictions must be relaxed whenever they become really restrictive, it is best not to have them in the law, but to place full regulatory responsibility on the Board, which is always in session and in a position to take prompt action when it is required.

Changes in the country's economic life, notably in the methods of financing business enterprise, have materially reduced the vol-

ume of short-term self-liquidating paper of the classes to which the discount privileges of the Reserve Banks are largely restricted by law. In times of stress, therefore, when the help of the Federal Reserve System has been most urgently needed, many banks, though holding sound assets in their portfolios, have been devoid of the particular kinds of paper available under the law for borrowing at the Reserve banks.

This amendment, by removing many of the technical restrictions of the present law, will enable the Federal Reserve banks to render better service to their member banks in times of need. This will not only make membership in the Federal Reserve System much more attractive but will encourage the member banks to invest their savings deposits, which are essentially capital funds, in longer-term loans, a course that would greatly facilitate business recovery.

Concluding its explanation, the committee's report made the following significant statement:

\* \* \* Soundness of assets (a term which is here for the first time introduced into the Federal Reserve Act) is a greater safeguard to the banks than short maturity of loans or the particular form of the underlying transaction.

The sound-assets principle approved by the House committee was reiterated in the House debates on the bill. Chairman Steagall asserted that the liberal provisions for discounts and advances would enable the Reserve Banks to be conducted upon "principles of solvency rather than technical requirements." 150 Mr. Hancock declared that "the old idea of commercial paper or such paper as can be liquidated almost overnight" had been "the greatest curse to business activity." 160

In the Senate, as has previously been noted, the Eccles proposal to replace the discount provisions of section 13 by a broad and simple authority to make discounts and advances on any sound assets did not prevail. During the Senate hearings, Winthrop Aldrich and Adolph Miller, a veteran member of the Board, opposed the proposal. Senator Glass resisted the use of the term "sound assets" because brokers had lestified that brokers' loans were the soundest

that could be made, and he feared that its use might lead to the employment of Federal Reserve credit for stock speculation. As a consequence, the Senate decided simply to restore the provisions of section 10(b)—which had expired several months before—but in permanent form and without the restriction that advances be made only in exceptional and exigent circumstances. However, the charging of interest at a rate higher than the rate on advances on eligible paper was still a requirement.

Nevertheless, the liberalized version of section 10(b) approved by the Senate was as much a departure from the orthodox theory of security for Federal Reserve Bank loans as was the provision of the House bill for advances on sound assets.164 In fact, although the conference committee adopted the Senate version, there were some who felt that the sound-asset principle had not been abandoned. When the conference report was considered in the House, Chairman Steagall referred to the liberalized provisions of section 10(b) as authorizing loans "upon any security regarded sound and satisfactory"; 165 and Mr. Hollister thought that the provisions would permit loans "on practically any reasonable assets." 166

The Board itself obviously regarded the new section 10(b) as representing congressional approval of the sound-assets concept. In its 1937 Annual Report to Congress, the Board stated that its recent revision of Regulation A, in conformity with the changes made by the Banking Act of 1935, established rules "which in effect permit any sound assets of member banks to be used as a basis for advances by Federal Reserve banks." By way of elaboration, the Board said: 167

Act the conception of the rediscount function of the reserve banks was limited to providing member banks with credit on short term paper arising out of specific commercial, industrial and agricultural transactions, particularly to meet seasonal requirements; whereas under the more recent amendments to the law it is provided that any assets of a member bank which are satisfactory to a reserve bank may be used as a basis for obtaining credit.

In formulating the revised regulation, the Board had in mind the fact recognized by Congress in the Banking Act of 1935 that under our banking system member banks carry time deposits as well as demand deposits, and, since these banks are custodians of the funds representing the savings or capital accumulation of the people, they properly invest a part of their funds in long-time paper, and consequently provision should be made for using them in case of need as a basis for advances from the Federal Reserve banks. Experience has demonstrated that the solvency of banks is better safeguarded by careful regard to the quality of the paper that they acquire than by strict observance of the form that this paper takes, and that greater emphasis on soundness and less emphasis on form is a sound banking principle.

## PARTICULAR TYPES OF SECURITY

As has been noted, when section 10(b) was first enacted in 1932 in its temporary form, it was contemplated that the authority granted by that section would permit advances to member banks on almost any type of satisfactory security, including municipal bonds, tax warrants, and long-term real estate mortgages.

As it was in force between 1932 and 1935, section 10(b) authorized the Board by regulation to limit and define the classes of assets accepted as security for advances; and, as re-enacted in permanent form by the Banking Act of 1935, the section authorized advances under rules and regulations prescribed by the Board. In published rulings after 1935, the Board made it clear that advances could be made under this section to member banks that had not exhausted their eligible paper and that any such assets eligible for discount could also be used as security for section 10(b) advances.168 In addition, the Board held that loans insured under the National Housing Act might be accepted as collateral for such advances.169 It was not until 1937, however, when Regulation A was revised to reflect changes in the law, that the Board undertook to prescribe any regulations on this subject.

The 1937 regulation provided that a Federal Reserve Bank might accept as security for a section 10(b) advance any of certain enumerated classes of assets.<sup>170</sup> These were:

- 1. Assets eligible as collateral for section 13 advances, that is, eligible paper and Government obligations;
- 2. Paper that would be technically eligible for discount except for the fact that its maturity was greater than that permitted for eligible paper;
- 3. Investment securities eligible for purchase by member banks under section 5136 of the Revised Statutes:
- Obligations representing loans on stocks in conformity with the Board's Regulation U;
- 5. Obligations insured under Titles I and II of the National Housing Act;
- 6. Obligations issued by Federal Home Loan Banks or under the Federal Farm Loan Act, regardless of maturity;
- 7. Revenue bonds and warrants representing general obligations of any State or political subdivision;
- 8. Obligations issued or drawn to finance, refinance, or carry real estate that complied with the standards for real estate loans set forth in an appendix to the regulation; and
- 9. Obligations issued or drawn to finance instalment sales that complied with the standards for instalment loans set forth in the appendix to the regulation.

These enumerated classes of assets were not intended to be exclusive. The regulation provided that, in addition, a Reserve Bank might make advances on any other types of satisfactory assets if in the judgment of the Reserve Bank the circumstances made it advisable to do so. However, the various types of assets enumerated in the regulation were clearly regarded as preferred kinds of security for section 10(b) advances. In its Annual Report to Congress the Board stated that the regulation listed "certain preferred classes of assets which cover the principal fields of financing" and indicated that the paper so described would have "first claim for advances." 171

In order to encourage member banks to have their real estate loans and instalment paper in a form that would make them acceptable as a basis for advances, 172 the Board set forth in an appendix to the 1937 revision of Regulation A certain recommended minimum standards for observance in making such loans, as a matter of sound banking practice. 173

When—18 years later—Regulation A was revised in 1955, the listing of specific types of security acceptable for section 10(b) advances and the minimum standards for real estate and instalment loans were both omitted, presumably because they were considered no longer necessary and possibly because, after the passage of time, they might be misleading and inadequate.

#### **MATURITY**

In its temporary and emergency form, section 10(b) had prescribed no requirement as to maturity. As revived and made permanent by the Banking Act of 1935, the section provided that notes representing advances should have maturities of not exceeding 4 months. In the form in which it had passed both the House and Senate, the 1935 bill had contained no such limitation. However, during the committee hearings Governor Eccles conceded that a 6-month limitation might be reasonable; 171 and the conference committee adopted the 4-month maturity restriction.

This was, of course, a somewhat more liberal limitation than the 90-day maturity requirement imposed by section 13 with respect to discounts and advances under that section. Moreover, it was recognized that advances might be subject to renewal, 113 although, as in the case of any other extensions of credit, a Reserve Bank could not make a prior commitment to renew such advances at maturity.

#### RATE OF INTEREST

One requirement prescribed by section 10(b) has effectively prevented advances under that section from taking the place of discounts of eligible paper and advances on the security of Government obligations and paper eligible for discount or purchase under the Federal Reserve Act. That is the requirement that any advance

made by a Federal Reserve Bank to a member bank on its note secured by satisfactory assets shall bear interest at a rate higher than the "highest discount rate in effect at the Federal Reserve bank on the date of such note."

As originally enacted in 1932, section 10(b) required the rate on advances under that section to be at least 1 per cent higher than the regular discount rate. As re-enacted in permanent form by the Banking Act of 1935, this penalty rate was reduced to one-half of 1 per cent.

When the section was first enacted in 1932 as an emergency measure, the only discount rates then in effect were those applicable to discounts of eligible paper for member banks under sections 13 and 13a and advances to member banks on the security of eligible paper and Government obligations under the eighth paragraph of section 13. Subsequently, in 1932, section 13 was amended to provide for discounts of eligible paper for individuals, partnerships, and corporations; in March 1933 it was further amended to authorize advances to individuals, partnerships, and corporations on direct obligations of the United States; and in 1934 Congress enacted section 13b providing for advances to industrial and commercial businesses. Under these various special authorizations designed to revive the economy during the depression years, the Board fixed rates that were higher than the regular rates on discounts for member banks under sections 13 and 13a. The Board took the position, however, that the required differential between the rate on advances under section 10(b) and the discount rate should be determined by reference to the regular discount rate on discounts and advances under sections 13 and 13a rather than the rates prescribed under the other special provisions mentioned above.176

In accordance with this position, the 1955 revision of Regulation A specifically provided that the rate on advances under section 10(b) should be not less than one-half of 1 per cent higher "than the highest rate applicable to discounts for member banks under the provisions of sections 13 and 13a of the Federal Reserve Act" in effect at the Reserve Bank making the advance.<sup>177</sup> As again revised in 1973, the regu-

lation meets the problem in a different manner: It provides that the rate on section 10(b) advances to member banks shall be at least one-half of 1 per cent higher than the rate on advances to member banks secured by obligations or other paper eligible for discount or purchase by Reserve Banks.

# PROPOSALS FOR LIBERALIZATION

The idea espoused by the Board in 1935 that Federal Reserve loans should be available to member banks on the security of any sound assets without a penalty interest rate is by no means dead.

In its replies to the questionnaire submitted by Senator Douglas in 1949 (Douglas Questionnaire) the Board made the following recommendation: 178

The provision of section 10/b) which requires an interest rate higher by at least one-half percent per annum than the highest discount rate of the Federal Reserve Bank for advances to member banks secured by any satisfactory collateral other than eligible paper should be eliminated.

Fourteen years later, in 1963, Chairman Martin, on behalf of the Board, again proposed that the Reserve Banks be authorized to make advances to member banks on any satisfactory security without charging a premium or penalty interest rate. In letters to the Banking and Currency Committees of both Houses of Congress, he argued that the real-bills doctrine had long been abandoned and that the test of paper eligible as security for Federal Reserve advances should be its soundness rather than compliance with outmoded technical requirements. In this connection, he said: 179

Despite changes in the character of paper held by commercial banks and the repeated and necessary departures from the original concept that discounts should be based only on short-term, self-liquidating paper, the law continues to impose unduly restrictive requirements as to the nature and maturity of the paper that may be discounted by the Reserve Banks or offered as security for advances by the Reserve Banks.

For many years, it has been generally recognized that the concept of an elastic currency based on short-term, self-liquidating paper is no longer in consonance with banking practice and the needs of the economy. It has long been apparent that the narrow requirements of the law regarding "cligible paper" serve no useful purpose and that it would be preferable to place emphasis on the soundness of the paper offered as security for advances and the appropriateness of the purposes for which member banks borrow. The one-year paper of many bank customers that is not now eligible for discount may be as satisfactory collateral as the 90-day notes of other customers. Moreover, the nature of the collateral provides no assurance that the borrowing bank will use the proceeds for an appropriate purpose.

As long as member banks hold a large enough volume of Government securities, they need not, of course, be particularly concerned as to the eligibility for discount with the Reserve Banks of customers' paper held by them. Since World War II, however, there has been a sharp net decline in the aggregate holdings of Government securities by member banks. If any substantial increase in economic activity should cause banks to reduce their holdings of Government securities in order to meet increased credit demands, many banks would be obliged to tender other kinds of collateral if they should seek to obtain Federal Reserve credit.

If such a situation should develop, the Reserve Banks could accept technically "ineligible" paper as collateral for advances to their member banks only under section 10(b) of the Federal Reserve Act at a rate of interest one-half of one per cent above the regular discount rate. However, the necessity for distinguishing between "eligible" and "ineligible" paper would give rise to cumbersome administrative procedures that are not warranted by the exigencies of current banking conditions. In order to avoid these problems, it would clearly be preferable to move in advance and to revise and up-date the law so as to eliminate the existing restrictions with respect to "eligible paper."

Bills to implement this proposal were introduced in Congress. 180 They would have repealed all of the provisions of the Federal Reserve Act regarding discounts and advances and would have replaced them with a new section 13A that would have authorized the Reserve Banks, under regulations of the Board, to make advances to member banks on any satisfactory security. Such bills were passed by the Senate in 1965 and 1967 but they never succeeded in obtaining the approval of the House Banking and Currency Committee.

In 1971 the Board changed its approach. Instead of recommending comprehensive legislation like that proposed by Chairman Martin, it suggested simply an amendment to section 10(b) of the Federal Reserve Act to eliminate the requirement that advances to member banks under that section should bear a rate of interest at least one-half of 1 per cent above the regular discount rate.<sup>14</sup> Tactically, this approach may

be preferable to the earlier proposal to eliminate the various provisions of the Act relating to discounts and advances by the Reserve Banks. Technically, it would have certain disadvantages. For example, unlike the earlier proposal, it would not give the System complete flexibility in fixing discount rates and it would not eliminate the necessity for applying the traditional technical eligibility rules with respect to emergency extensions of credit under the third paragraph of section 13 to individuals, partnerships, and corporations—a matter to be discussed in a subsequent chapter.

In any event, the fact remains that under present law the Reserve Banks may make advances to member banks at the regular discount rate only on the security of paper that either meets technical requirements for discount or is eligible for purchase by the Reserve Banks.

# **Credit for Nonmember Banks**

#### SUMMARY

As of December 31, 1972, there were 14,413 commercial banks and mutual savings banks in the United States. Of this number, 4,613 were national banks, 1,092 were State member banks, and 485 were mutual savings banks. Thus, there were 8,223 State banks that were not members of the Federal Reserve System.<sup>1</sup>

In general, but with significant exceptions, nonmember banks are the smaller banks of the country; their total deposits comprise only about 22 per cent of the total deposits of all commercial banks. Since they have not subscribed to Federal Reserve Bank stock—and thus have not subjected themselves to the various requirements, restrictions, and limitations imposed by the Federal Reserve Act—they do not directly enjoy the benefits of the System, including access to the credit facilities of the Federal Reserve Banks.

In a sense, however, all nonmember banks are in a position to obtain the advantages of the System indirectly. Thus, in their dealings

For NOTES AND REFERENCES, see pp. 260-61.

with correspondent member banks they benefit from the services afforded by the System to such member banks through the collection of checks and distribution of coin and currency. In an indirect way also, nonmember banks benefit from extensions of Federal Reserve credit to member banks. When the Glass-Steagall Act of 1932 authorized the Reserve Banks to make emergency advances to member banks on any satisfactory security, Mr. Steagall pointed out that while a nonmember bank could not obtain such advances directly, it could borrow from a national bank or a State member bank and thereby have "its paper indirectly fed into the Federal reserve bank and indirectly" get the benefit of that legislation.2

Since the time of its original enactment, the Federal Reserve Act itself has specifically provided for indirect extensions of credit to non-member banks through the medium of member banks if permitted by the Federal Reserve Board. For a brief period during 1933, the Reserve Banks were expressly authorized to make direct advances to nonmember banks on

satisfactory security. These two provisions, one permanent and one temporary, will be discussed in subsequent sections of this chapter.

Two other provisions of the law that authorize extensions of credit to individuals, partnerships, or corporations in limited circumstances also afford a basis for extension of Federal Reserve credit to nonmember banks, since such banks, of course, are corporations. These provisions will be considered generally in the following chapter; but insofar as they

affect nonmember banks they will be discussed in subsequent sections of the present chapter.

Finally, nonmember banks for many years had direct access to Federal Reserve credit to a limited extent by virtue of the provisions of section 13b (no longer in effect), which authorized the Reserve Banks to extend credit to financing institutions on the basis of paper of industrial or commercial businesses. That authority, however, will be dealt with in a separate chapter.

#### CREDIT THROUGH MEDIUM OF MEMBER BANKS

#### LEGISLATIVE HISTORY

Section 19 of the Federal Reserve Act, which otherwise relates to entirely different subjects, contains one sentence that affects the discounting functions of the Federal Reserve Banks and in particular extensions of credit to nonmember banks. That sentence was a part of the original Act and has never been amended. It reads:

\* \* \* No member bank shall act as the medium or agent of a nonmember bank in applying for or receiving discounts from a Federal reserve bank under the provisions of this Act except by permission of the Federal Reserve Board. [Emphasis supplied.]

Although stated in the form of a prohibition, this provision, by its exception, contemplates indirect extensions of credit to nonmember banks whenever permitted by the Board. The legislative history of the provision is of interest as indicating the belief on the part of the framers of the Act that the benefits of the Act should be limited to member banks, but that in some circumstances even nonmember banks should be afforded at least indirect access to the credit facilities of the System.

The provision was not in the Glass bill that passed the House in 1913 nor in the originally reported Owen bill in the Senate. It grew out

of a provision contained in Senator Owen's substitute bill that broadly prohibited any member bank from extending "directly or indirectly the benefits of this system to a nonmember bank, except upon written permission of the Federal reserve board, under penalty of suspension."

When the bill was under debate, Senator Owen himself pointed out that while the broad provisions in his substitute bill would prevent nonmember banks "from being the beneficiaries of a system supported by others," it might go too far, especially in the case of small banks that could not, under the terms of the bill, come into the System.3 He suggested that the provision might place a "stigma of exclusion" upon every bank that was not a member of the System and might, in addition, have the effect of barring such banks from all transactions with their correspondent member banks except by permission of the Board. He felt that this prohibition would tend to build up "a monopoly in banking instead of stabilizing the banking system" and would prevent thousands of banks "from continuing their business." In a like vein, Senator Weeks said that the provision had brought forth "a general protest" from all sections of the country, and Senator Root referred to the provision as amounting "almost to a nonintercourse provision as between the banks forming a part of the new system and the State banks in general." 2

Senator Owen asserted that no such effect was intended and that the provision would be redrafted.4 On December 18, 1913 (5 days before the bill was signed), he offered an amendment limiting the provision to discounts. As thus amended, the bill prohibited any member bank "from acting as the medium or agent of a nonmember bank in applying for or receiving discounts." 7 Senator Owen explained that this would mean that member banks would be "at liberty to have any transactions whatever with the nonmember banks, but that they must not act as a medium for nonmember banks to get loans out of Federal reserve banks." 8 In this amended form the provision passed the Senate.

The conference committee adopted the provision, but restored the exception permitting member banks to act as the medium for discounting paper of nonmember banks "with the permission of the Federal Reserve Board." Thus, while reflecting an intent to limit the discounting facilities of the Reserve Banks to members of the System, this provision in effect gave the Board authority to determine when and in what circumstances those facilities might be extended to nonmember banks indirectly through the medium of member banks.

# LIBERAL INTERPRETATION OF STATUTE

For some years the Board took no steps to exercise its authority to permit discounts of nonmember bank paper through the medium of member banks. It did, however, adopt a somewhat liberal interpretation of the prohibitory portion of the provision of the law in question. It held that if a member bank in good faith acquired notes from a nonmember bank that were eligible for discount and were held as part of the assets of the member bank, there was no objection to the discounting of such paper if the officers of the Reserve Bank were satisfied that it was a bona fide transaction and

that the member bank was not extending accommodations to the nonmember bank.9

During World War I, in order to facilitate the sale of Liberty bonds, the Board expressly authorized the Reserve Banks to discount for nonmember banks, with the endorsement of a member bank, notes secured by Government obligations if the proceeds were to be used for carrying Treasury certificates or U. S. Government bonds. Subsequently, the Board ruled that the Reserve Banks could discount for member banks any notes of nonmember banks secured by Government bonds.

In 1918, still following a liberal construction of the statutory prohibition, the Board held that the law did not preclude the discounting for member banks of paper bearing the signature or endorsement of a nonmember bank 12 or of notes endorsed without recourse by a nonmember bank.13

#### **BLANKET AUTHORITY**

It was not until 1921, however, that the Board, in a period of economic stress, gave general authority to the Reserve Banks to discount for member banks any eligible paper acquired from nonmember banks.<sup>14</sup>

Two years later, in 1923, that general permission was withdrawn on the ground that the temporary emergency that had made it necessary had passed. At the same time, the Board specifically rescinded the liberal rulings previously mentioned that had permitted the discounting of paper signed or endorsed by nonmember banks. Also at the same time, the Board undertook to set forth some general rules on this subject:

- 1. No paper acquired from, or bearing the signature or endorsement of, a nonmember bank was to be discounted for any member banks except with the Board's permission, unless such paper had been bought by the offering member bank in good faith on the open market from some party other than the nonmember bank.
- Applications for the Board's permission were required to state the facts fully and the

reason why the member bank felt justified in seeking such permission.

- 3. As a general rule, the Board would not give its permission in the case of any non-member bank that was eligible for membership in the System; the Board felt that eligible non-member banks should join the Federal Reserve System if they desired to participate in its benefits.
- 4. However, the Board would make exceptions, for limited periods, to assist nonmember banks in emergencies, but only until the nonmember banks could qualify for membership.

Following this action in 1923, the Board in some specific cases granted temporary permission for the discounting of paper of nonmember banks. In 1926 it expressly gave general permission for the discounting of paper signed or endorsed by a Federal intermediate credit bank on the ground that, since such banks were not eligible for membership in the System, such permission was consistent with the policy announced in the Board's 1923 ruling.<sup>19</sup>

During the banking crisis of March 1933, the Board for the second time gave blanket permission for the discounting of paper acquired from nonmember banks. This permission continued in effect until the revision of Regulation A in 1937, when it was allowed to terminate.

In the summer of 1966, there was what became known as a credit crunch-a situation in which not only nonmember commercial banks but savings and loan associations and mutual savings banks were subjected to unusual deposit drains that made it difficult for them to meet the loan demands of their customers. To ameliorate this situation, the Board on July 1, 1966, advised the Reserve Banks that, as a matter of general policy, they should be prepared to provide emergency credit facilities to such institutions in accordance with certain guiding principles. To implement this policy, the Board, among other things, gave blanket permission, pursuant to section 19(e) of the Federal Reserve Act, for the use of assets acquired from nonmember banks as security for Federal Reserve advances to member banks, whether under section 13 or section 10(b).17 This permission was limited to a period ending on September 1, 1966.

During a similar crunch in 1969, the Board, for the fourth time, gave general permission for the use of assets acquired from nonmember banks as security for advances to member banks. As of December 24, 1969, that permission was made effective for a period ending April 1, 1970. After additional extensions, the permission expired on August 1, 1971.

In 1972 the Board again gave blanket permission for Reserve Bank loans to member banks for the benefit of nonmember banks but for entirely different reasons. The Board had amended its Regulation J, relating to the collection of checks by the Reserve Banks, to require every bank to which checks are sent for payment by the Reserve Banks to make payment on the day of receipt in immediately available funds. Previously, drawee banks had the option of making payment for a cash letter received from its Reserve Bank by means of drafts that would not be collected by the Reserve Bank until 1 or 2 days following the receipt of the cash letter by the drawee bank; consequently, the drawee bank enjoyed the use of the funds represented by the cash letter for a short period after its receipt, thus giving rise to what was known as Federal Reserve float. This amendment to Regulation J, which, after some delay resulting from litigation, became effective November 9, 1972, in effect deprived drawee banks of such float with a resulting loss that varied from bank to bank. The adverse effect was mitigated in the case of drawee member banks by a simultaneous amendment to the Board's Regulation D that substantially lowered reserve requirements for most member banks; but, since nonmember banks are not subject to reserve requirements under the Federal Reserve Act, they could not be given the same offsetting advantage.

Shortly before the change in Regulation J was originally scheduled to have gone into effect, the Board sought to ameliorate its impact upon nonmember drawee banks by providing for extensions of Federal Reserve credit to such banks either directly or through correspondent member banks. To facilitate indirect extensions of credit to nonmembers, the Board granted blanket permission to the Reserve Banks under section 19(e) of the Federal Reserve Act to

make advances to member banks for the benefit of nonmember banks in order that Federal Reserve credit could be made available to any nonmember bank if the change in Regulation J would "result in a significant impairment of liquidity or impair the bank's ability to serve its community." 19

#### REGULATORY PROVISIONS

Not until 1928 did Regulation A include any specific provisions regarding loans to member banks for the benefit of nonmember banks.20 In its general revision of the regulation at that time, the Board required that a member bank's application for discount be accompanied by a certificate to the effect either that the paper offered for discount had not been acquired from a nonmember bank or that, if so acquired, the Board's permission had been obtained. In a new separate section, the revised regulation provided that, except with the Board's permission, no Federal Reserve Bank should discount paper acquired by a member bank from a nonmember bank or bearing the signature or endorsement of a nonmember bank, unless the paper had been bought by the offering bank "in good faith on the open market from some party other than the nonmember bank." Applications for the Board's permission were required to state the facts and the reasons for requesting it. Express

permission was granted for the discounting of paper signed or endorsed by Federal intermediate credit banks. In effect, these provisions of the regulation merely incorporated the substance of the 1923 and 1926 rulings of the Board that have previously been mentioned.

As revised in 1937 21 and again in 1955,22 Regulation A continued to include the provisions first incorporated in the regulation in 1928: prohibition of discounting of nonmember bank paper without the Board's permission, and specific permission to discount only paper acquired from Federal intermediate credit banks. One change in language, however, was made by the 1937 revision. Whereas the regulation had previously excepted paper purchased in good faith in the open market from a party other than the nonmember bank, the 1937 amendment provided more broadly that the prohibition should not apply to paper purchased in the open market or "otherwise acquired in good faith and not for the purpose of obtaining credit for a nonmember bank." The revision of Regulation A adopted in 1973 condensed these provisions, without intending any change of substance. They now provide simply that, except with the Board's permission, no member bank shall act as the medium or agent of a nonmember bank-other than a Federal intermediate credit bank-in receiving credit from a Reserve Bank.23

### EMERGENCY DISCOUNTS OF ELIGIBLE PAPER

Pursuant to the statutory and regulatory provisions just discussed, nonmember banks have been enabled, since the enactment of the Federal Reserve Act, to obtain Federal Reserve credit indirectly through the medium of member banks, subject to permission granted by the Board. It was not until 1932, however, that there was any statutory authority under which direct credit could be extended to nonmember banks by the Federal Reserve Banks—except the special authority granted in 1924 to any

banks to discount notes of veterans of World War I, as discussed in Chapter 7.

The Emergency Relief and Construction Act of July 21, 1932,<sup>21</sup> added to section 13 of the Federal Reserve Act a new paragraph, now the third paragraph of that section, that made it possible for the Reserve Banks, in unusual and exigent circumstances and with the affirmative authority of the Federal Reserve Board, to discount eligible paper for any individual, partnership, or corporation unable to secure ade-

quate credit accommodations from other banking institutions. This authority will be discussed generally in the following chapter. At this point it is sufficient merely to note that since a non-member bank is a corporation, the authority is broad enough to encompass discounts of eligible paper for nonmember banks.<sup>25</sup>

Nevertheless, when the Board on July 26, 1932—5 days after the enactment of the provision—granted permission for discounts under this authority and prescribed certain rules to be followed, it was specifically stated that for this purpose the term "corporations" should not be considered as including banks.<sup>26</sup> Thus, nonmember banks were excluded from the benefits of this authority.

As has been noted, during the credit crunches of 1966 and 1969 the Board for temporary periods expressly permitted advances to member banks for the benefit of nonmember banks. At the same time, the Board also activated the authority under the third paragraph of section 13 for extensions of Federal Reserve credit on the basis of paper eligible for discount to nonmember deposit-type financial institutions, principally mutual savings banks and savings and loan associations, and also to nonmember commercial banks. This authorization was never actually utilized by any nonmember bank, and since August 1, 1971, the authority for loans under the third paragraph of section 13 to nonmember institutions has not been in effect.

#### ADVANCES ON GOVERNMENT OBLIGATIONS

By the Emergency Banking Act of March 9, 1933,27 Congress added still another paragraph to section 13 of the Federal Reserve Act under which the Reserve Banks could extend credit to nonmember banks. This paragraph, the thirteenth and last in section 13, as amended in 1968, authorizes advances to any individual, partnership, or corporation for periods of not more than 90 days on notes secured by direct obligations of the United States or by obligations issued or fully guaranteed by U.S. agencies.28 Again, a discussion of this paragraph belongs properly within the scope of the following chapter, but it needs to be mentioned here because the term "corporation" includes a nonmember bank and nonmember banks have used this paragraph as the basis for obtaining direct access to the credit facilities of the Reserve Banks in emergency circumstances.

When the Emergency Banking Act of 1933 was under consideration in Congress, it was clearly contemplated that the new thirteenth paragraph of section 13 of the Federal Reserve Act would permit nonmember banks to obtain credit from the Federal Reserve Banks. Thus,

Senator Glass, with some reservations as to the wisdom of the measure, stated: 29

\* \* It broadens—in a degree that is almost shocking to me—the currency and credit facilities of the Federal Reserve Banking System, and largely extends these facilities to State banks which are not members of the Federal Reserve Banking System, that have never endured one penny of the expense of the establishment of the system or its maintenance, and do not do so today.

Similarly, when the bill was being debated in the House, Chairman Steagall of the House Banking and Currency Committee declared that any State bank could obtain an advance from a Reserve Bank to the amount of the face value of U.S. Government bonds offered as security. "That," he said, "is where we have gone in liberalizing credit and expansion." 30

When, in 1937, Regulation A was revised to reflect changes in the law made since 1930, no provision in the text of the regulation covered advances to individuals, partnerships, and corporations; but in a footnote attention was called to the fact that, under the last paragraph of

section 13 of the Federal Reserve Act, the Reserve Banks could make advances to individuals, partnerships, or corporations "(including banks)" on the security of direct obligations of the United States. In 1942 an amendment to the regulation changed this footnote to state explicitly that the term "corporation" included an incorporated bank; 31 and in the same year the Board published a ruling that made it clear that, under the last paragraph of section 13, advances could be made to nonmember banks on the security of direct obligations of the United States.32 Thus, although the Board had not interpreted the reference to corporations in the third paragraph of section 13 as applying to nonmember banks, a similar reference in the last paragraph of the section was explicitly applied to cover loans to such banks.

Except in special circumstances or during certain limited periods, advances to nonmember banks under the last paragraph of section 13 have not been encouraged. In a footnote in the 1955 revision of Regulation A, it was stated that while a Reserve Bank has authority under that paragraph to make advances on Government obligations to individuals, partnerships, and corporations, including nonmember banks, it was "not the practice to make advances to others than member banks except in unusual or exigent circumstances." 33 In 1968 even this reference to the legal authority for advances to nonmember banks was eliminated from the regulation,31 so that the regulation thereafter contained no reference whatsoever to extension of Federal Reserve credit to nonmember banks. The revision of the regulation adopted in 1973, however, contains a section expressly referring to advances under the last paragraph of section 13 to individuals, partnerships, and corporations on the security of direct obligations of the United States or obligations issued or fully guaranteed by any agency of the United States, but the wording makes it clear that any such extensions of credit are limited to emergency circumstances.<sup>35</sup>

Discouragement of advances to nonmember banks under the last paragraph of section 13 has been evidenced not only by provisions of the Board's regulation but also by the fact that, in general, the rate charged on such advances has been higher than the regular or basic discount rate for advances to member banks. From September 1939 until April 1946just before, during, and after World War II -advances to nonmember banks were authorized to be made at the same rate as that fixed for loans to member banks on eligible paper at the regular discount rate. Since 1946 the rate on advances to nonmember banks has been substantially higher than the regular discount rate. As previously discussed, the Board in 1972 acted to provide credit through the discount window to nonmember banks adversely affected by changes in Regulation J. At that time a special rate of 41/2 per cent was established by six Reserve Banks-but only for a temporary period of time-for advances to nonmember banks under the last paragraph of section 13 for cases in which nonmember banks were seriously affected by the changes in Regulation J. This special rate was the same as the regular rate at that time for advances to member banks-2 per cent less than the rate for advances in general under the last paragraph of section 13.

In actual practice, Federal Reserve loans to nonmember banks under the last paragraph of section 13 have been few and far between.

# TEMPORARY AUTHORITY FOR ADVANCES ON SOUND ASSETS

In only one instance has Congress authorized direct extensions of Federal Reserve credit to nonmember banks as such, as distinguished from advances to such banks as corporations or as financing institutions, and that authority was in force only for an emergency period of one year ending March 24, 1934.

As noted in the previous chapter, the Glass-Steagall Act of 1932 authorized the Federal Reserve Banks, by the addition of section 10(b) of the Federal Reserve Act, to make direct advances to member banks on any satisfactory security, though only on an emergency basis and subject to certain restrictions. That authority was somewhat liberalized by the Emergency Banking Act of March 9, 1933. About 2 weeks later, on March 24, 1933,36 Congress amended the Emergency Banking Act by adding a new section 404 under which the Reserve Banks were authorized to make advances to nonmember banks on the same terms as advances could be made to member banks under section 10(b) of the Federal Reserve

This new authority, however, was severely limited. In the first place, its effectiveness was restricted to "the existing emergency in banking" or until the authority might be terminated by proclamation of the President, but in no event beyond 1 year from the date of enactment. A Reserve Bank could make an advance to a nonmember bank only after inspection and approval of the collateral and a "thorough examination of the applying bank or trust company." 37 Each application was required to be accompanied by the written approval of the appropriate State banking authority and by a statement of that authority that in its judgment the bank was in a sound condition. As long as it was indebted to the Reserve Bank, the borrowing bank was required to comply in all respects with the provisions of the Federal Reserve Act and regulations of the Board applicable to member State banks, except that instead of subscribing to Federal Reserve Bank stock, the bank was required to maintain during the period of such indebtedness the reserve balance required for member banks under section 19 of the Act.

Although this authority for advances to nonmember banks was a limited one of short duration, its legislative history is of interest because it reflects both an intent to ease the banking crisis by affording credit to nonmember banks and, at the same time, an intent to adhere to the concept that Federal Reserve credit facilities should be limited to member banks except in emergencies.

The disposition of Congress to permit more liberal extensions of credit to nonmember banks was obviously influenced by the fact that the bars had already been lowered by the Acts of July 21, 1932, and March 9, 1933.34 In the light of the conditions that still prevailed, it was felt that the bars should be lowered even further to allow nonmember banks the same access to Federal Reserve credit that member banks enjoyed under the provisions of section 10(b) of the recently enacted Emergency Banking Act. Mr. Steagall believed that there was no reason to discriminate against nonmember banks during the emergency.39 He described the bill as permitting State nonmember banks: 10

\* \* to borrow temporarily of Federal Reserve banks and to use as collateral, the same as was provided in the legislation of last week for member banks of the Federal Reserve System, any security whether eligible or not under the general provisions of the Federal Reserve Act that may be found to be satisfactory to Federal Reserve officials \* \* \*.

Similarly, Senator Robinson stated: 41

or opportunities to State banks and trust companies to obtain direct loans from the Federal Reserve banks on their time and demand notes, secured to the satisfaction of

the Federal Reserve banks. \* \* ° It is believed that the change now proposed will tend to place the State banks nearer on a parity with member banks.

At the same time, it was recognized that the privilege thus afforded to nonmember banks was exceptional and that it should be strictly limited. When Senator Barkley suggested that the requirement for approval by the State banking commissioner might be too restrictive, Senator Robinson replied that such approval was necessary because the bill would extend "a rather extraordinary privilege to an outside bank—that is, a bank that is not a member of the Federal Reserve System" and that it had been "thought wise" to make this requirement.<sup>12</sup>

An interesting sidelight on the legislative history of the Act of March 24, 1933, is the fact that in attempting to provide the same accommodations to nonmember banks as those provided to member banks by section 10(b) of the Federal Reserve Act, the bill at first referred to advances on eligible or ineligible paper. Mr. Beedy felt that the term "eligible or ineligible paper" was subject to varying interpretations. Mr. Steagall explained that it was intended to permit a nonmember bank to "tender its eligible or noneligible paper, and that gets all the paper it has, just as it does with a member bank." 43 He pointed out that originally section 10(b) had been limited to advances in cases in which member banks had no further eligible paper available and that, if advances to nonmember banks were permitted only on the same terms as those prescribed by section 10(b), such banks would be enabled to borrow only on noneligible paper. Eventually, to make the point clear, the provision in question was omitted and, instead, there was included a proviso stating that loans might be made to any applying nonmember State bank or trust company upon eligible security.

The limited and temporary authority for advances to nonmember banks on any satisfactory security expired on March 24, 1934, and has never been revived. It may be noted that the so-called eligible paper bill recommended by the Board in 1963 not only would have permitted Reserve Bank advances to member banks on any satisfactory security but also would have authorized advances to any individual, partnership, or corporation secured to the satisfaction of the lending Reserve Bank in exigent circumstances. This authority is not contained in the current Board proposal 45 for legislation that would simply remove the penalty rate requirement from section 10(b) of the Federal Reserve Act authorizing advances to member banks on any satisfactory security. If that proposal should be enacted, nonmember banks, as at present, would have direct access to Federal Reserve credit only under the last paragraph of section 13 of the Federal Reserve Act on the security of Government obligations or obligations issued or fully guaranteed by agencies of the United States, or under the third paragraph of section 13 on the security of paper eligible for discount if that paragraph is activated by the Board in unusual and exigent circumstances.

# Loans to Individuals, Partnerships, and Corporations

# LOANS ON ELIGIBLE PAPER IN EMERGENCY CIRCUMSTANCES

#### REJECTION IN ORIGINAL ACT

When the original Federal Reserve Act was being considered in 1913, some members of Congress argued that the Reserve Banks should be permitted to discount paper for individuals as well as for member banks, on the theory that the System's control over discount rates would be made that much more effective and also that Federal Reserve credit would thereby be made more widely available in emergencies.1 The great majority in Congress, however, felt that the Federal Reserve Banks should be strictly bankers' banks, dealing only with commercial banks and not with the general public. By the same token, it was generally agreed that the Reserve Banks should not compete with commercial banks by making loans to individuals.2

This concept was maintained intact until the early 1930's when the depression created a situation that resulted in a fundamental change in the role of the Federal Government with respect to loans to nonbanking institutions and

individuals, and the Federal Reserve System felt the effects of this change. As noted in the previous chapter, the original Federal Reserve Act provided a means for at least limited and indirect extensions of credit to nonmember commercial banks. Some years later, authority was added to permit access to Federal Reserve credit by the Federal intermediate credit banks. It was not until 1932, however, that the Reserve Banks were first given authority to provide credit assistance to individuals, and that authority was very limited and was given with reservations on the part of some members of Congress, including Carter Glass.

#### 1932 AMENDMENT

On July 11, 1932, President Hoover vetoed a bill to relieve unemployment through highway construction projects because it also contained provisions for loans to individuals by the Reconstruction Finance Corporation. The President felt that these provisions "would place the Government in private business in such fashion as to violate the very principle of public rela-

For NOTES AND REFERENCES, see pp. 261-62.

tions upon which we have builded our Nation, and render insecure its very foundations." Such action, he believed, "would make the Reconstruction Finance Corporation the greatest banking and money-lending institution in all history." <sup>3</sup>

A new bill was introduced on the day of the President's veto, and Senator Glass promptly offered an amendment to authorize the Federal Reserve Banks, in unusual and exigent circumstances, to discount eligible paper for individuals and corporations. A similar provision was included in another bill introduced by Senator Wagner as a substitute for the highway construction bill vetoed by the President. The provision was retained in that bill when it passed the Senate on July 12, although the duration of the authority for such discounts would have been limited to a period of 2 years. The conference committee made three changes, all of a liberalizing nature: The 2-year limitation was omitted, thus making the authority permanent legislation; the authority was expanded to cover discounts for partnerships as well as corporations and individuals; and a prohibition against the use of paper discounted under the provision as collateral security for Federal Reserve notes was omitted.

The bill became law on July 21, 1932.4 Thus, tucked away in a road construction measure, authority for extension of Federal Reserve credit to individuals, partnerships, and corporations was incorporated in the Federal Reserve Act. That authority—with one small change to be mentioned later—is contained in the third paragraph of section 13 of the Act. That paragraph which is the same as originally enacted, reads as follows: 5

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange of the kinds and maturities made eligible for discount for member banks under

other provisions of this Act when such notes. drafts, and bills of exchange are indorsed and otherwise secured to the satisfaction of the Federal Reserve bank: Provided, That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.

#### LIMITATIONS

As will be observed, this authority for loans to individuals, partnerships, and corporations is strictly limited.

First, loans may not be made by the Reserve Banks under this authority unless the Board of Governors, in unusual and exigent circumstances, authorizes them to do so. It should be noted that it is activation of the authority by the Board that is dependent upon unusual and exigent circumstances and not the making of individual loans once the authority is activated.

Second, activation of the authority by the Board must have the affirmative vote of at least five members of the Board. This is one of the few instances in which the law requires that action taken by the Board must be approved by a greater majority than a quorum.

Third, if the authority is activated by the Board, its duration may be limited to such periods as the Board may determine.

Fourth, loans under this authority may be made only through the discounting of paper of the kinds and maturities made eligible for discount for member banks under other provisions of the Federal Reserve Act. This is an important limitation. While advances may be made to member banks under the eighth paragraph of section 13 on the security of any paper eligible for discount or purchase by the Reserve Banks or, at a higher rate of interest, on any satisfactory security under section 10(b) of the Act, the only paper made eligible for discount for member banks is paper arising out of actual

commercial transactions with a maturity of not more than 90 days (under the second paragraph of section 13) or agricultural paper with a maturity of not more than 9 months (under section 13a).

Nonbank financial institutions, such as savings and loan associations, ordinarily do not hold customers' paper of the kind that would be eligible for discount, and it is even less likely that business enterprises would hold any substantial amounts of such paper. There are, however, certain possibilities. For one thing, the note discounted for an individual, partnership, or corporation need not be one of its customer's notes but may be its own note. Under Regulation A, a note the proceeds of which are to be used for current operating expenses of a business enterprise is eligible for discount by a member bank. Consequently, a business concern's own note would be eligible for discount under the third paragraph of section 13 if the proceeds were to be used by it for current operating expenses. Again, if the proceeds of a note executed by a financial institution such as a finance company or a savings and loan association were to be used for making loans to others for eligible purposes, that note, under rulings of the Board heretofore mentioned, would be eligible for discount in the hands of a member bank and hence would be eligible as a basis for direct credit under the third paragraph of section 13.6 In any such case, however, the note of a business enterprise or of a financial institution must have a maturity of not more than 90 days in order to be cligible for discount under that paragraph.

Fifth, whereas a member bank may discount eligible paper with its Reserve Bank without offering any additional security, a borrower under the third paragraph of section 13 not only must present a note—its own or its customer's—that is eligible for discount but also must provide security or obtain an endorsement that is satisfactory to the lending Reserve Bank. As originally enacted, the paragraph required that the paper offered for discount should be "indorsed and otherwise secured" to the satisfaction of the Reserve Bank. In 1935, on the Board's recommendation, the word "and" was changed to "or" so that either an endorsement

or additional security could be accepted by the Reserve Bank. In any case, it seems clear that it was the intent of Congress that loans should be made only to creditworthy borrowers; in other words, the Reserve Bank should be satisfied that a loan under this authority would be repaid in due course, either by the borrower or by resort to security or the endorsement of a third party.

Sixth, the lending Reserve Bank must obtain evidence that an applicant for credit under this paragraph is unable to secure adequate credit accommodations from other banking institutions. This is a significant limitation—one designed to assure that loans will be made only in truly unusual and exigent circumstances.

Finally, all loans under this authority are subject to such limitations, restrictions, and regulations as the Board may prescribe and to rates established in accordance with section 14(d) of the Act.

# BOARD ACTIVATION OF AUTHORITY

Notwithstanding the restricted nature of the authority, it was apparently felt in 1932 that, in the economic circumstances of the time, such authority would be used to provide needed credit to business concerns and individuals. The Board lost no time in implementing the statute. Five days after its enactment, on July 26, 1932, the Board issued a circular granting permission to the Reserve Banks to make discounts under the new authority for a period of 6 months beginning August 1, 1932.8 The circular stated that since such discounts would be made only in unusual and exigent circumstances, the Board did not propose to prescribe any formal regulations. However, the requirements of the law and the procedure to be followed were outlined in the circular.

Among other things, the circular required that an applicant for any discount under the new authority must submit a statement as to the circumstances and the purpose for which the proceeds would be used, describe the efforts made by him to obtain credit from other banking institutions, list each bank with which the applicant had had banking relations during the

previous year, provide complete credit data, and agree to furnish additional credit information when requested.

Upon the Federal Reserve Banks the circular imposed a duty in each case to determine that the applicant's financial condition and credit standing justified the discount; that the paper offered for discount was acceptable from a credit standpoint and eligible from a legal standpoint; that the security was adequate; that there was a reasonable need; and that the applicant was unable to obtain adequate credit accommodations from other banking institutions. The Reserve Banks were prohibited from making any commitments to renew credits granted by them, and, except with the Board's permission, no Reserve Bank could discount for any one individual or corporation paper aggregating more than 1 per cent of the Reserve Bank's own capital stock and surplus.

The circular included one important restriction not prescribed by the law. Although the statute authorized discounts for corporations, a term broad enough to include banks, the Board's circular specifically provided that the term should not include banks. Because of this, nonmember banks that otherwise might have availed themselves of this avenue of access to Federal Reserve credit were precluded from doing so.

The 6-month permission for discounts for individuals, partnerships, and corporations granted by the Board on August 1, 1932, was extended for successive periods of 6 months until July 31, 1936, when the permission was allowed to terminate. In large part, it was rendered unnecessary by the enactment in 1934 of section 13b of the Federal Reserve Act under which the Reserve Banks were authorized to make loans to business enterprises for working capital purposes. That authority will be discussed in the next chapter.

Although the third paragraph of section 13

has not been reactivated by the Board since 1932 as a means of providing Federal Reserve credit to businesses, it was activated in 1966 and again in 1969 for the purpose of meeting possible credit needs of savings and loan associations, mutual savings banks, and nonmember commercial banks.<sup>10</sup>

#### USE OF AUTHORITY

The authority for discounts in exigent circumstances for individuals, partnerships, and corporations was an emergency authority—one of several measures undertaken in the early 1930's to meet the need for credit during the depression. It was used only for a short while and only to a limited extent. Pursuant to the activation of the authority in 1932, the Reserve Banks, over a period of 4 years, made loans to only 123 business enterprises aggregating only about \$1.5 million. The largest single loan was for \$300,000.

One of the reasons for the limited use of this authority has already been noted-the enactment in 1934 of legislation authorizing working capital loans to business enterprises. Another was the enactment in March 1933 of legislation authorizing advances by Reserve Banks to individuals, partnerships, and corporations on the security of U. S. obligations, an authority to be discussed in the following section. Moreover, the rate established for discounts under the 1932 authority was considerably higher than the regular discount rate; " and, though later reduced, the rate on emergency discounts for individuals, partnerships, and corporations, when such discounts have been authorized, has always been substantially higher than the regular discount rate and higher also than the rate on direct advances to individuals, partnerships, and corporations on the security of Government obligations under the thirteenth paragraph of section 13 of the Act.

#### ADVANCES ON GOVERNMENT OBLIGATIONS

The Emergency Banking Act of March 9, 1933,12 signed by President Roosevelt at the height of the most critical banking situation in the country's history, was, as stated in its enacting clause, designed to remedy a "serious emergency." It gave legal confirmation to the drastic action taken by the President a few days earlier in closing all banks; it provided for their reopening under licenses from the Secretary of the Treasury; it authorized the Secretary to call in all privately held gold and gold coin; and, along with these and other equally drastic steps, it briefly but explicitly authorized the Federal Reserve Banks to make advances to individuals, partnerships, and corporations on their promissory notes secured by direct obligations of the United States. This authority was set forth in a new paragraph—the thirteenth—added at the end of section 13 of the Federal Reserve Act.

Unlike the authority granted in 1932 for the discounting of paper of individuals, partnerships, and corporations, this authority contained relatively few restrictions and limitations. It provided only that such advances should be made for periods not exceeding 90 days; that they should bear interest at rates fixed by the Reserve Banks subject to review and determination of the Board; and that they should be subject to such limitations, restrictions, and regulations as the Board might prescribe.

Again, like the 1932 authorization for discounts for individuals, partnerships, and corporations, the provision for direct advances on Government obligations represented a definite departure from the traditional concept that the Reserve Banks should act only as bankers' banks. Senator Glass observed that, under these two provisions, individuals were: 13

\* \* \* permitted to do business with the Federal Reserve banks, something that has never been done before since they were organized, individuals who have eligible paper in their possession, and who can not get accommoda-

tion at the member bank, permitted to take it directly to the Federal Reserve banks and be accommodated.

Chairman Steagall of the House Banking and Currency Committee, after stating that under the new authority an individual could obtain Federal Reserve credit to the amount of the face value of Government bonds offered as security, remarked: "That is where we have gone in liberalizing credit expansion." 14

While the Board was authorized to prescribe restrictions and limitations, it did not do so. In contrast to its action after the enactment of the 1932 authority to discount paper for individuals, partnerships, and corporations, the Board did not exercise its regulatory authority to exclude banks from the scope of the term "corporations." On the contrary, as noted in the preceding chapter, it became clear that incorporated banks, both member and nonmember, could avail themselves of the new provision authorizing advances to corporations. Indeed, the thirteenth paragraph of section 13 made it possible for advances to be made to member banks on U.S. Government obligations for periods of up to 90 days, in contrast to the 15-day maturity limitation on such advances under the eighth paragraph of that section. Since 1968, when the eighth paragraph was amended to authorize 90-day advances to member banks on the security of any obligations eligible for purchase by the Reserve Banks under section 14(b) of the Act, including obligations of the United States, it has been unnecessary to resort to the thirteenth paragraph of section 13 as a basis for advances to member banks on Government obligations for periods in excess of 15 days.

In 1968, when the temporary authority of the Reserve Banks to purchase obligations issued or guaranteed by agencies of the United States was made permanent, the thirteenth paragraph of section 13 was broadened to authorize advances to individuals, partnerships, and corpo-

rations not only on the security of direct obligations of the United States but also on the security of such agency issues.<sup>15</sup>

It should be observed that, although conferred by an emergency statute, the authority contained in the last paragraph of section 13 of the Federal Reserve Act was not limited to emergency circumstances. Perhaps the authors of the Emergency Banking Act contemplated that the authority would be used only under extraordinary circumstances such as those prevailing at that time; but they did not place any such limitation in the law. Legally, the provision makes it possible for the Reserve Banks to make advances under this provision in ordinary times as well as in times of economic stress. Actually, the authority provided by the thirteenth paragraph of section 13 has always been regarded as being limited to unusual or exceptional circumstances. The revision of Regulation A adopted in 1973 expressly provides for use of the authority only in emergency circumstances, and the general principles contained in the revision contemplate advances to individuals, partnerships, and corporations only when, in the judgment of a Reserve Bank, credit "is not practically available from other sources and failure to obtain such credit would adversely affect the economy." 18

One factor that tends to preclude any extensive use of the last paragraph of section 13 is that business enterprises—and even nonmember banks—may not hold Government securi-

ties in sufficient amounts to be used as security for advances under that paragraph. Another important factor that militates against use of the paragraph is that the rate fixed for advances under the paragraph has usually been substantially higher than the regular discount rate. For instance, in early April 1973, the rate for such advances was 71/2 per cent, whereas the regular rate for advances to member banks was 51/2 per cent. As noted in the previous chapter, the rate for advances to nonmember banks on Government securities was the same as that for similar advances to member banks from 1939 to 1946. and in 1972 a like concession was accorded (by six of the Reserve Banks) to nonmember banks adversely affected by changes in the Board's rules regarding payment of checks collected through the Reserve Banks. No such rate concession has ever been given to nonbank borrowers under the last paragraph of section 13.

Because of these deterrents—limitation to use in emergency circumstances, the acceptance of only Government securities as collateral for advances, and a penalty rate of interest—very few loans have been made to business enterprises under this authority. Nevertheless, it continues to be the only authority, except for the even more limited authority provided by the third paragraph of section 13, under which the Reserve Banks, as lenders of last resort, may provide credit directly to business enterprises or to nonmember financial institutions.

# Working Capital Loans to Business

#### ORIGIN AND PURPOSE

# A DEPARTURE FROM TRADITION

This chapter deals with a form of Federal Reserve credit that is no longer authorized by the law. Nevertheless, it should not be passed over quickly, for it represented a significant development in the history of the lending functions of the Federal Reserve Banks.

For more than 20 years after the enactment of the Federal Reserve Act, the concept that Reserve Bank loans should have relatively short maturities was firmly entrenched. So also was the concept that security for Reserve Bank loans should be limited to certain types of paper; the only exception was for advances under section 10(b) in 1932 and, as has been noted, such advances were authorized only at a penalty rate of interest.

These concepts were drastically modified in 1934 when Congress added to the Federal Reserve Act a new section 13b authorizing the Reserve Banks to extend credit, either directly

or through commitments to financing institutions, to established business enterprises for working capital purposes with permissible maturities of up to 5 years and without any limitations as to the type of security.<sup>1</sup>

This departure from tradition did not take place without protest. During the debates on the bill, Mr. Beedy deplored the fact that, in an effort to stimulate business recovery, it had been necessary "to bring the Federal Reserve banks into this picture." He said: <sup>2</sup>

\* \* \* The Federal Reserve banks, 12 in number, which were never designed to do business with any individual or any person, but were banks of issue or rediscount to deal with other banks, ought never, in my opinion, to be put into the lending business. It is a perversion of the original purpose for which those banks were established \* \* \*.

Somewhat later, when the bill had been agreed to by the conference committee and 3 days before it was signed by the President, Mr. Beedy again, as he put it himself, raised his "feeble voice \* \* \* in this hour of the Nation's crisis" and accused the House conferees of having

For NOTES AND REFERENCES, see pp. 262-63.

taken "a decided step toward destroying the character of the Reserve banks." "

But the overriding mood of the day was to make credit more freely available to business through Government channels. In that atmosphere, Congress sought to provide such business credits not only through the Reserve Banks but also through the Reconstruction Finance Corporation (RFC), as will be noted later.

#### NEED FOR THE AUTHORITY

The statute grew out of evidence that business enterprises, particularly small businesses, were unable to obtain necessary working capital loans from the usual sources of credit. Commercial banks, with painful memories of the 1933 banking crisis and subject to more vigilant surveillance by bank examiners, were not, so it was alleged, meeting the needs of small business. Although the RFC had been empowered in 1932 to make loans to banks and insurance companies with the expectation that the money would filter down to industry and the small borrower, there was a feeling that this expectation had not been fulfilled because the banks and other lending institutions had not done their part to bring the country out of the depression.4 It was said that banks were frequently unable or unwilling to extend industrial loans, due in large part to the fact that bank examiners had required them to maintain a degree of liquidity.5

On March 19, 1934, President Roosevelt wrote to the chairmen of the Banking and Currency Committees of both Houses of Congress: "I have been deeply concerned with the situation in our small industries. In numberless cases their working capital has been lost or seriously depleted."

The fact that not only commercial banks but also Federal Reserve Banks were limited to short-term loans and could not, therefore, adequately meet the credit needs of business was emphasized by the Federal Reserve Board in a letter to the Senate Banking and Currency Committee dated April 13, 1934:

In the judgment of the Board, there exists an undoubted need for credit facilities for industry and commerce beyond those that are now being supplied through the commercial banks or that can be supplied through the ordinary operations of the Federal Reserve System acting within the limitations of the Federal Reserve Act. In brief, the need is for loans to provide working capital for commerce and industry, and such loans necessarily must have a longer maturity than those rediscountable by Federal reserve banks.

Throughout the debates in Congress, it was indicated repeatedly that the primary purpose of the legislation was to assist, not just business, but *small* business. Thus, Mr. Kopplemann declaimed: "The main purpose of this bill is the rehabilitation of small businesses and small industries. The small industries are the backbone of America." <sup>6</sup>

As will be noted later, the purpose of aiding small business was emphasized by provisions in the bills under consideration that would have limited the amount of any loan to \$100,000. Although this limitation was omitted in the statute as finally adopted, it is clear that small enterprises were expected to be its chief beneficiaries.

#### LEGISLATIVE HISTORY

At the outset, two principal plans for providing credit to business enterprises had competed for consideration by Congress. One was to expand the existing lending powers of the RFC to include power to make loans to business enterprises, and various bills for this purpose were introduced in Congress.7 The other was a plan for the establishment of regional credit banks for industry under the supervision of either the RFC or the Federal Reserve Board.\* Bills to authorize the establishment by the Federal Reserve Board of 12 credit banks for this purpose were actually prepared in the offices of the Federal Reserve Board and represented, at least at that time, the mature conclusions of the Board.º

Eventually, however, a third method of providing business credits was incorporated in a committee print of the Senate Banking and Currency Committee. This proposal would have stricken provisions of the bill then under consideration to establish regional credit banks and, instead, would have amended section 13 of

the Federal Reserve Act to authorize the Reserve Banks to make working capital loans to business. On April 28, 1934, Senator Glass incorporated this committee print in a new bill (S. 3487) but in the form of an addition of a new section-13b-to the Federal Reserve Act instead of an amendment to section 13. A few days later, Senator Fletcher introduced another bill authorizing the RFC to make business loans and, subsequently, the substance of that bill was combined with the new Glass bill. The result was a bill authorizing business loans by both the Reserve Banks and the RFC. On May 12, 1934, the Senate adopted a proposal to add to the Glass bill authorizing business loans by the Reserve Banks a separate provision for RFC loans to business.10 As thus amended, that bill was approved by the Senate on May 14. On May 23, a new RFC bill that included also authority for business loans by the Reserve Banks was passed by the House.

Insofar as the business loan authority of the Reserve Banks was concerned, the bills passed by the Senate and House differed in only one major respect. The Senate bill authorized and directed the Secretary of the Treasury to pay to the Reserve Banks the sum of \$139,299,557 to aid in the making of business loans, with provision for repayment at a rate of at least 1 per cent per annum. The House bill contained no such provision for payments by the Treasury. The conference committee adopted the Senate provision, but modified it so as to permit, but not direct, the Treasury to make payments to the Reserve Banks and to provide for repayments at a rate of not less than 2 per cent per annum.

The conference report was approved in both Houses on June 16, and the bill was signed into law by the President on June 19.11

In the course of the legislative process, the original idea of establishing 12 credit banks for industry had been abandoned because, as Senator Glass said, "it was totally unnecessary to set up another banking system of 12 banks to do what might be done more readily and with greater facility by the Federal Reserve banks themselves." <sup>12</sup> At the same time, the question whether business loans should be made by the Federal Reserve Banks or by the RFC was

resolved by giving both agencies somewhat similar, but not identical, authority in this field.

### RESERVE BANKS VERSUS RFC

The fact that both the Federal Reserve Banks and the RFC were given authority to make business loans was not regarded as involving any inconsistency. It was expected that such loans would be made primarily by the Reserve Banks and that the RFC would make them only if they could not be obtained from a Reserve Bank. Moreover, it was contemplated that the Federal Reserve authority would be permanent, whereas that of the RFC would be only temporary. (Members of Congress in 1934 could not know that the RFC, an emergency agency, would continue to function for another 23 years.)

In accordance with the idea that the RFC's authority should be supplemental to that of the Federal Reserve Banks, the bill that passed the Senate and was reported by the House committee expressly provided that business loans were to be made by the RFC "when credit at prevailing bank rates for the character of loans applied for is not otherwise available at banks or at the Federal Reserve bank of the district in which the applicant is located." However, on May 23, the day that the bill was passed by the House, a floor amendment was introduced by Mr. Beedy (who had not wanted the Reserve Banks in the picture in the first place) to strike out the words "or the Federal Reserve bank of the district in which the applicant is located." Mr. Beedy expressed the fear that "many of these loans will never get as far as the Reconstruction Finance Corporation if they are turned down by the Federal Reserve bank in the first instance." His amendment was adopted.13 So it was that, as finally enacted, the statute authorized business loans by the RFC when credit was not otherwise available at banks, thereby indicating that, despite all that had been said carlier, the RFC's authority was not to be merely supplemental to that of the Reserve Banks.

Nevertheless, Chairman Steagall apparently agreed to the Beedy amendment only because he felt that it would not change the substance of the previous provision, presumably on the ground that the Federal Reserve Banks would still be embraced by the word "banks." He stated that he had no objection to the amendment because it was one "which really perfects the language of the section." <sup>14</sup> Chairman Steagall's feeling that nothing had been changed and that the RFC would make business loans only if they were not obtainable from the Reserve Banks was more explicitly stated when, during the House debate on the conference report on June 16, he answered a question as to the procedure to be followed by a business in seeking credit. He replied: <sup>15</sup>

It would apply through regular channels, and if it did not obtain the money it would apply to the Federal Reserve Banks, and if the Federal Reserve Bank did not make the loan, the application would then go to the Reconstruction Finance Corporation, which in this case would be in the nature of an appellate court for loans, where applications might be reviewed and reconsidered.

Whatever may have been the intent of Congress as to the respective roles of the Federal Reserve Banks and the RFC, the fact is that the 1934 statute gave both agencies coordinate authority to make loans to commercial and industrial businesses, but with certain important differences in respect to limitations on their authority:

- 1. The authority of the Reserve Banks was permanent; that of the RFC was limited in duration and, by the terms of the 1934 act, was scheduled to expire on January 31, 1935.
- 2. The RFC could make loans only to businesses established before January 1, 1934; the Reserve Banks could make loans to established

businesses, presumably including any established after January 1, 1934.

- 3. The aggregate amount of loans made by the RFC to any one borrower could not exceed \$500,000; no such limitation was placed on loans made by the Reserve Banks.
- 4. The Reserve Banks could make direct loans only in exceptional circumstances; the RFC was not similarly restricted.
- 5. The RFC was authorized in general to make loans in cooperation with banks or other lending institutions, including authority to purchase participations; the Reserve Banks were permitted to participate with lending institutions only if the latter assumed at least 20 per cent of the risk.
- 6. RFC loans were required to be adequately secured and could be made only if the directors were of the opinion that the borrower was solvent; Reserve Bank loans were required to be made on a reasonable and sound basis.

On the basis of this comparison, and especially in view of the temporary nature of the RFC's authority, it might be supposed that Mr. Steagall's expectation that the Reserve Banks would be the primary source of business loans would be fulfilled. Actually, time proved otherwise. Not only was the authority of the RFC extended for many years, but the limitations on its authority were gradually relaxed by subsequent amendments, while the limitations on the authority of the Reserve Banks remained unchanged. As a result, the RFC came to be the principal Federal agency for the making of business loans, while the volume of such loans made by the Federal Reserve Banks-at first considerable—eventually declined to an amount that was almost negligible.

### LIMITATIONS

#### GENERAL LIMITATIONS

The authority granted to the Reserve Banks by the 1934 legislation was of two different

kinds: (1) authority to make direct loans to businesses; and (2) authority to extend credit to business enterprises indirectly by means of discounts for financing institutions of obliga-

tions of business enterprises, loans to financing institutions on the security of such obligations, and commitments with respect to such discounts or loans. For convenience only, the first of these two alternate types of authority is here referred to as authority for direct loans and the second as authority to make commitments.

On both types of authority the law placed certain significant restrictions. Some were common to both direct loans and commitments; others were in the nature of special limitations, some applicable only to direct loans and some applicable only to commitments. Such special limitations will be discussed in subsequent sections.

In the first place, it was clearly the purpose of Congress in 1934 to provide, through both the Reserve Banks and the RFC, credit assistance that would enable existing businesses to get back on their feet, not to encourage the establishment of new businesses. In the House debates on the bill, Congressman Martin stated that the legislation would "not provide for loans to a new industry," but that its purpose was "to keep old industries functioning." 16

In furtherance of this purpose, the RFC, as noted, was authorized to make loans only to businesses in existence before January 1, 1934. Although the Reserve Banks were not so strictly limited, their loans were restricted to established industrial or commercial businesses. Perhaps, in the light of Mr. Martin's remark, this was meant to confine Federal Reserve loans to businesses in existence on the date of the act; but it seems more reasonable to interpret the limitation as meaning that a Reserve Bank could make a loan only to a business established before the loan was made. Also, it seems fairly clear that the word "established" was not used in the sense of meaning a long-established, successful enterprise but simply in the sense of being already in existence.17

To be eligible for aid under section 13b of the Federal Reserve Act, a business had to be not only an established business but also an industrial or commercial business. There is little in the legislative history of the legislation that throws any light on the intended scope of these words. No published rulings of the Board sought to define industrial or commercial businesses. However, in announcing the issuance of Regulation S under the new law, the Board indicated that it did not propose to place any restrictions not required by the statute upon the making of business loans by the Federal Reserve Banks and that consequently the terms used in the law would be liberally interpreted. The Board stated: 18

\* \* Any attempt to prescribe technical definitions of such terms as "working capital", "established commercial or industrial business", and "financing institutions" has been avoided, lest it have the effect of restricting and hampering the operations of the Federal Reserve banks under this statute.

A major limitation placed upon the lending authority of the Reserve Banks was that loans should be made only to provide businesses with "working capital." During the Senate debates on the bill, Senator Bone proposed an amendment to strike out the reference to working capital and instead to authorize loans "for working capital, for reducing and refinancing outstanding indebtedness if such refinancing is concurrent with a substantial write-down of such outstanding indebtedness, for rehabilitating and making improvements to plants, for reopening plants not in operation on the date this section takes effect, and for new buildings and new machinery." 19 This effort to broaden the purposes for which business loans might be made was unsuccessful. The House was more liberally inclined. It would have authorized loans for the purpose of providing a business with capital, a term broad enough to include almost any type of loan. The conference committee, however, resolved the difference on this point in favor of the Senate bill, limiting both the Federal Reserve Banks and the RFC to the making of business loans to provide working capital. While the Board never undertook to define the term "working capital," it is clear from its legislative history that section 13b was not intended to authorize the Reserve Banks to make loans to enable businesses to refinance outstanding indebtedness or to build, improve, or replace plant and machinery.

Another limitation imposed by the law both upon direct loans to businesses by the Reserve

Banks and upon commitments with respect to business loans made by private financing institutions was that no such loans should have maturities in excess of 5 years. This, however, was a liberal limitation. Never before had the Reserve Banks been authorized to extend credit for such a long period. Prior to 1934, the maximum maturity permitted had been the 9-month maturity authorized with respect to discounts of agricultural paper for member banks.

# LIMITATIONS ON DIRECT LOANS

Subsection (a) of section 13b, relating to direct loans by the Reserve Banks, imposed the four limitations discussed in the preceding section: They could be made only to established businesses, only to industrial and commercial businesses, only for working capital purposes, and only with maturities of not more than 5 years. Such loans were also made subject to four additional limitations.

- 1. They could be made only in exceptional circumstances when it appeared to the satisfaction of a Federal Reserve Bank that a business was unable to obtain requisite financial assistance on a reasonable basis from the usual sources. Obviously, this limitation was designed to make it clear that the Reserve Banks should not compete with commercial banks and other private lending institutions. The Board so construed the law when, in issuing its Regulation S, it declared: "It is expected \* \* \* that the Federal Reserve banks will not compete with local banks, but rather will assist and cooperate with them in meeting local requirements for working capital." <sup>20</sup>
- 2. They should be made only pursuant to authority granted by the Federal Reserve Board. It may have been contemplated that such authority would be granted by the Board in individual cases. However, in its Regulation S, issued shortly after enactment of the new law, the Board expressly authorized "every Federal Reserve Bank, in exceptional circumstances, until such time as the Federal Reserve Board may revoke or modify such authority" to make direct loans to businesses in accordance with the provisions of the statute.<sup>21</sup> This authority

was never revoked or modified. In explanation, the Board stated: 22

- \* \* in order to avoid the necessity of having applications for such accommodations passed on in Washington, the Board has granted blanket authority to all Federal Reserve banks to grant such accommodations directly on their own responsibility without reference to Washington.
- 3. By the terms of the statute, a Reserve Bank could make a direct loan only to a business located in its district. This requirement was interpreted broadly by the Board as covering any business having an office or place of business in the district of the lending Reserve Bank.<sup>23</sup>
- 4. Although the law contained no requirement as to the security upon which loans might be made to business enterprises, it did provide that direct loans should be made on a reasonable and sound basis. In this connection, it may be noted that, as in the case of their other lending operations, the Reserve Banks were not obliged to make a business loan even though it might meet all the requirements of the statute; a Reserve Bank was free to turn down any application if it felt, for example, that it would not be a sound loan from a credit viewpoint. An effort in Congress to make such loans mandatory rather than permissive was voted down.<sup>24</sup>

# LIMITATIONS ON COMMITMENTS

Like direct loans, all indirect extensions of credit to businesses through financing institutions were made subject to the general requirement that the underlying loan be one made to an established industrial or commercial business for working capital purposes with a maturity of not more than 5 years. The special limitations placed on direct loans that were discussed in the preceding section—that the loan be one made in exceptional circumstances, that it be authorized by the Board, that it be to a business located in the Federal Reserve district of the Reserve Bank involved, and that it be made on a reasonable and sound basis—were not made applicable to commitments with respect to busi-

ness loans made by private financing institutions. However, discounts for and purchases from financing institutions and loans made in participation with such institutions were made subject to certain other special limitations.

1. The law authorized the Reserve Banks to extend indirect financing assistance to business enterprises only through a bank, trust company, mortgage company, credit corporation for industry, or other financing institution. In order to facilitate the participation of national banks in the making of business loans under the new law, the Comptroller of the Currency ruled that limitations on national banks with respect to loans to a single customer and with respect to real estate loans did not apply to the extent that a loan to a business enterprise was covered by a commitment by the RFC or a Federal Reserve Bank pursuant to the new law.25 The Comptroller's ruling with respect to limitations on real estate loans was later incorporated in the law by the Banking Act of 1935, and was made still more liberal. That act added to section 24 of the Federal Reserve Act a new paragraph exempting from the limitations of that section loans made by national banks to established industrial or commercial businesses that were in whole or in part discounted or purchased or loaned against as security by a Federal Reserve Bank under section 13b, or for any part of which a commitment was made by a Reserve Bank, or in which a Reserve Bank participated. Thus, not only that part of the loan subject to a commitment by a Reserve Bank but the entire loan was exempted from limitations on real estate loans by national banks.

There was no question that national banks and other commercial banks qualified as financing institutions under section 13b. In addition, the Board ruled that an investment banking firm might be considered a financing institution if a substantial part of its business represented provision of funds for business enterprises through the underwriting, sale, and distribution of securities.<sup>26</sup>

2. The law provided that a Reserve Bank could make discounts or purchases, loans, participations, or commitments only with respect to a financing institution operating in its district.

Following the policy of liberal construction announced when Regulation S was issued, the Board held that a Reserve Bank could discount for a financing institution operating within its district the obligation of an industrial or commercial business located in another Federal Reserve district.27 Thus, while a direct loan could be made by a Reserve Bank only to a business located within its district, indirect extensions of credit could be made to businesses located in other districts, provided the financing institution through which the credit was extended could be regarded as operating within the Reserve Bank's district. This ruling was incorporated in Regulation S when the regulation was revised in 1942.28

3. The final special limitation placed upon participations by the Reserve Banks with private financing institutions in extensions of credit to business was that in all cases the financing institution should bear at least 20 per cent of any loss. If the obligation of a business was acquired by a Reserve Bank from a financing institution, the latter was required to "obligate itself to the satisfaction of the Federal Reserve bank for at least 20 per centum of any loss." In lieu of such an obligation, however, the financing institution could itself advance 20 per cent of the amount of the credit, the Reserve Bank advancing the other 80 per cent; in that event, these separate advances were to be considered as one advance, with repayment to be made pro rata under regulations prescribed by the Board. When a Federal Reserve Bank acquired from a lending institution the obligation of a business enterprise, the law provided that the existence and amount of any loss should be determined in accordance with regulations of the Board. Pursuant to this provision, Regulation S provided that a Reserve Bank should be deemed to have sustained a loss on such an obligation whenever its directors, after investigation, determined that the obligation or any part of it was a loss and the Reserve Bank charged that amount off its books. The amount of the loss would be the amount so charged off, plus unpaid interest. The financing institution would then be required to reimburse the Reserve Bank for the portion of the loss for which it had obligated itself. If there was any subsequent recovery, the financing institution and the Reserve Bank would share pro rata in the amount recovered.<sup>29</sup>

### AMOUNT LIMITATIONS

Subsection (c) of section 13b provided that the aggregate amount of loans, advances, discounts, purchases, and commitments made under the section by all of the Reserve Banks and outstanding at any one time should not exceed the combined surplus of all the Reserve Banks as of July 1, 1934, plus all amounts paid to the Reserve Banks by the Secretary of the Treasury under authority of the section. The combined surplus of the 12 Federal Reserve Banks on July 1, 1934, was \$138,383,000. Under subsection (e), the Secretary of the Treasury was authorized to pay to the Reserve Banks up to a total of \$139,299,557. Conscquently, the aggregate amount of direct loans, advances in participation with private financing institutions, discounts for and purchases from such institutions, and commitments with respect thereto that could be outstanding as of any particular time, could theoretically be as much \$277,682,557. Actually, the aggregate amount of credit permitted under the new law proved more than adequate. The greatest amount outstanding at any one time was around \$60,000,000 late in 1935, when the volume of operations under section 13b was at its peak.

It is to be noted that the statute itself placed

only an aggregate limit on the amount of credit extended by all of the Federal Reserve Banks, without specifically limiting the amount that could be extended and outstanding by a particular Reserve Bank. By regulation, however, the Board limited the aggregate amount of loans, advances, discounts, purchases, and commitments that could be made by any Reserve Bank (and outstanding at any one time) to the surplus of that Reserve Bank as of July 1, 1934, plus amounts paid to it by the Secretary of the Treasury under subsection (e) of section 13b, unless permission to exceed that limit was given by the Board.30 Thus, each Reserve Bank was in general limited to its proportionate part of the over-all limit; but, if the need for business loans was found to be greater in some districts than in others, it was possible under the regulation for the Reserve Banks of those districts, with the Board's permission, to make loans in an amount far greater than their pro rata share of the aggregate amount allowed by the statute for all of the Reserve Banks.

No limitation was prescribed, either by statute or regulation, on the amount that a Federal Reserve Bank could lend to any one business enterprise, either directly or through private financing institutions. This is somewhat surprising in view of the fact that the RFC's business loan authority was made subject not only to an aggregate limitation of \$300 million but also to a limitation of \$500,000 to any one borrower.

## INDUSTRIAL ADVISORY COMMITTEES

Apparently there was some concern in Congress in 1934 that the Reserve Banks would not be especially inclined to make loans to business. Carter Glass observed that the President himself thought that "perhaps the Federal Reserve bank boards were too bank-minded to be as liberal as he could wish they would be in treating matters of this sort." Accordingly, said Senator Glass, the President had suggested the

insertion of a provision for the appointment of an "advisory committee in each Federal Reserve district, to be composed exclusively of active industrialists, to advise upon such loans." <sup>31</sup>

Such a provision was included in subsection (d) of section 13b. It provided for the establishment in each Federal Reserve district of an advisory committee, to be appointed by the

Reserve Bank subject to the approval and regulations of the Federal Reserve Board, and to consist of not less than three nor more than five members as determined by the Board. Each member was required to be actively engaged in some industrial pursuit within the Federal Reserve district. Every application under section 13b was to be submitted to this committee, which, after examination of the business involved, would transmit the application to the Reserve Bank with the committee's recommendation.

Implementing this provision of the statute, the Board's Regulation S provided that each committee should consist of five members familiar with the problems and needs of industry and commerce in the particular district; that before February 15 of each year the board of directors of each Reserve Bank should submit to the Board the names of members selected for the ensuing year; that, if approved by the Board, such members should serve for 1 year commencing March 1; and that the committee, after examining each application and considering the necessity and advisability of granting the application and such other factors as it deemed appropriate, should transmit the application to the Reserve Bank with the committee's recommendation,<sup>32</sup>

The regulation was adopted on June 26, 1934. Promptly thereafter, the names of the first members of the industrial advisory committee in each Federal Reserve district were announced by the Board.<sup>33</sup>

#### SOURCE OF FUNDS

Though not expressly stated, the law clearly contemplated that the Federal Reserve Banks would use their own funds in extending credit pursuant to section 13b. However, subsection (e) provided that, in order to enable the Reserve Banks to extend such credit, the Secretary of the Treasury should have authority to pay to each Federal Reserve Bank an amount not to exceed such portion of the sum of \$139,299,557 as might be represented by the amount paid by such Reserve Bank for stock of the Federal Deposit Insurance Corporation (FDIC). In a sense, this provision made possible the return to the Reserve Banks by the Treasury of funds that had once belonged to the Banks.

At the time the FDIC was established by the Banking Act of 1933, the Federal Reserve Banks were required to subscribe to stock of the Corporation in an amount equal to one-half of their respective surpluses as of January 1, 1933. The total amount that they were thus required to turn over to the FDIC was \$139, 299,557. By the 1934 enactment of section 13b, that amount was made available again to the Reserve Banks; however, all funds returned

were to be used only for business loans, and the portions to be returned to the individual Reserve Banks were to be decided by the Secretary of the Treasury.<sup>34</sup>

But the authority for such payments to the Reserve Banks by the Treasury was subject to certain conditions. Payment could be made to a Federal Reserve Bank only if it executed an agreement to hold its FDIC stock unencumbered and to pay to the United States all dividends, payments on liquidation, and other proceeds of such stock; and if the stock itself were pledged to the United States as security for this agreement. In addition, the Reserve Bank was required to agree that if such dividends, payments, and other proceeds from the FDIC stock in any year should not be as much as 2 per cent of the payments made to the Bank by the Treasury, the Reserve Bank would pay to the United States such further amount, out of its earnings derived from the payment received from the Treasury, as would make up the balance of the specified 2 per cent, and would continue to make such payments until the final liquidation of the FDIC stock.

Operations under section 13b never made necessary the payment by the Treasury to the Reserve Banks of the full amounts authorized by the law. An agreement was entered into by the Treasury and the Reserve Banks under which the Treasury agreed to make payments equal to approximately one-half of the credits extended by the Reserve Banks through loans and commitments under section 13b. The amounts actually advanced by the Treasury under this agreement aggregated about \$27,546,000. No such advances were made by the Treasury after 1937.

Pursuant to an Act of Congress approved August 5, 1947,35 the stock of the FDIC that had been subscribed by the Federal Reserve Banks in 1933 was cancelled on October 7, 1947, and the amount that had been paid for such stock (\$139,299,557) was turned over to the Treasury instead of being repaid to the Federal Reserve Banks. Since the 2 per cent annual payments by the Reserve Banks to the Treasury—previously mentioned—were related to ownership of the FDIC stock, those payments were discontinued after October 7, 1947. Nevertheless, there was no requirement in the law for repayment of the amounts advanced by the Treasury; consequently, the aggregate amounts paid by the Treasury to the Reserve Banks under section 13b (\$27,546,000) continued to be carried on the books of the Reserve Banks as "section 13b surplus" until 1958 when section 13b was repealed.

Finally, a word should be said concerning the source of the \$139,299,557 that the Secretary of the Treasury was authorized to pay to the Federal Reserve Banks under section 13b. The law provided that all amounts that might be required to be expended by the Secretary under this authority should come out of miscellaneous receipts of the Treasury created by the increment resulting from the reduction of the weight of the gold dollar under the President's proclamation of January 31, 1934, and that such sum as should be required for this expenditure should be appropriated out of such miscellaneous receipts. Under the Gold Reserve Act of January 30, 1934, the Reserve Banks had been required to transfer title to all gold coin and bullion held by them to the United States in return for equivalent amounts in dollars. On the next day, the President's proclamation pursuant to the Act of May 12, 1933, reduced the weight of the gold dollar; as a consequence, the dollar credits received by the Reserve Banks for their gold resulted in a substantial net profit to the U.S. Treasury. That profit was the increment from which payments by the Treasury to the Reserve Banks were authorized by section 13b.

### REGULATION S

On June 26, 1934—7 days after the enactment of section 13b of the Federal Reserve Act—the Board promulgated its Regulation S under the new law. In doing so, the Board stated: 36

In accordance with the policy of Congress and in order to facilitate as much as possible the performance of the new functions thus granted to the Federal Reserve banks, the Federal Reserve Board's regulation leaves the broad powers granted by Congress to the Federal Reserve banks wholly unimpaired and prescribes no restrictions beyond those

prescribed in the law itself. \* \* \* The regulations \* \* \* contain practically nothing except an analysis of the law and an outline of the necessary procedure.

That statement represented a fair indication of the contents of Regulation S, which did little more than paraphrase the requirements of the statute and outline the procedure to be followed by financing institutions and businesses in making applications to the Reserve Banks.

The regulation provided that each application by a financing institution or business should be

filed with the Reserve Bank of the district in which the principal place of business of the applicant was located, and that the application should then be submitted by the Reserve Bank to the industrial advisory committee of the district. In determining whether to approve any such application, the Reserve Bank was required to satisfy itself not only that all legal requirements were met but also that the financial condition and credit standing of the obligor and endorsers and the value of the security offered, if any, justified the granting of the accommodation.

As to transactions with financing institutions, the regulation contained a special provision regarding the manner of determining the existence and amount of any losses. With respect to direct loans, the regulation granted blanket authority to the Reserve Banks to make such loans without referring them to the Board for individual authorization. An industrial advisory committee of five members was required to be established in each Federal Reserve district. The aggregate amount of loans and commitments made by each Federal Reserve Bank was limited to the Reserve Bank's proportionate part of the over-all maximum amount fixed by the statute, except where permission to exceed the Reserve Bank's individual limit might be granted by the Board.

With respect to a matter not dealt with by the statute, the regulation provided that all rates of interest and discount established by the Reserve Banks on section 13b loans, advances, discounts, and purchases should be subject to the approval of the Board. Although a discussion of rates charged on section 13b loans and commitments is not within the scope of this study, it may be noted that such rates, unlike discount rates under sections 13 and 13a of the Act, were not usually fixed at stated percentages but were generally set in terms of a

maximum and a minimum. In addition, there was greater variation among the different Federal Reserve Banks.<sup>27</sup>

Only once was Regulation S amended or revised. In the spring of 1942, in connection with the inauguration of the so-called V-loan program for guaranteeing war production loans (discussed in the following chapter), the regulation was reissued with certain changes designed to facilitate participation by the Reserve Banks in that program.38 As stated in a foreword to the revised regulation, the changes were largely of a clarifying or technical character. They were intended to make operations more flexible. For example, whereas the original regulation had required an application by a financing institution to be filed with the Reserve Bank of the district in which the applicant was located, the revised regulation permitted the application to be filed with the Reserve Bank of any district in which the financing institution was operating; it was made clear that the business being financed by the applicant could be located in some other district. Similarly, an application by a business for a direct loan was permitted to be filed with any Reserve Bank in which the business had an office or place of business instead of only in the district in which its principal place of business was located. Also, the previous requirement that a Federal Reserve Bank must satisfy itself that the financial condition and credit standing of the obligor and endorsers and the value of the security offered justified the granting of the accommodation was omitted from the revised regulation. Finally, the revised regulation required that rates of interest and discount should be subject to review and determination of the Board rather than to approval by the Board-a change apparently made to conform to the general practice with respect to discount rates under other provisions of the Federal Reserve Act.

#### TERMINATION OF AUTHORITY

For a period of about 18 months after the enactment of section 13b, loans and commitments by the Federal Reserve Banks were made in considerable volume. By the end of 1935, 1,993 applications totaling about \$124.5 million had been approved. In 1936, however, activity tapered off. Only 287 applications were approved in that year and only 126 in 1937. This decline in activity after such a favorable beginning is easily explained. The authority granted the RFC in 1934 to make business loans had been somewhat broader than that given the Federal Reserve Banks, even though the RFC was looked upon as a temporary agency. Not only was the existence of the RFC continued, but in 1935 its business loan authority was liberalized.30 It was again liberalized in 1938 when maturity restrictions on RFC loans were eliminated.40 It followed that, with less restricted authority, the RFC made more business loans, and by the same token the Federal Reserve Banks made less. In 1938, the Board of Governors sought to obtain some relaxation of the limitations imposed by section 13b, but without success.41 This was the beginning of a long and fruitless effort to liberalize the authority of the Reserve Banks to make loans to business enterprises.

Early in 1941, when U.S. participation in World War II seemed imminent, bills to liberalize the authority of the Federal Reserve System to make business loans were revived as measures to finance defense production,12 but no action was taken by Congress for that purpose. After Pearl Harbor, the urgency was too great and the time too short to wait for legislative action; as will be seen in the following chapter, steps were taken promptly to provide financial assistance to business enterprises engaged in war production. Implementation of such assistance was not by statute but by an Executive order of the President authorizing a program of Government guarantees of loans to war contractors. Nevertheless, because of the experience of the Federal Reserve Banks in making business loans under section 13b, they were brought actively into the new guaranteed loan program as agents for the war procurement agencies of the Government. In addition, urgent demands for the financing of war production contracts stimulated activity under section 13b, and during 1942 the Reserve Banks approved applications under that section aggregating over \$128 million, the peak volume for any year in the history of their industrial loan operations.

Near the end of the war, efforts to liberalize section 13b were renewed. In May 1944, Senator Wagner introduced a bill 13 that would have authorized the Reserve Banks to guarantee, or make commitments to purchase, loans made by financing institutions to any business enterprise, subject only to regulations of the Board and with no statutory restrictions. Similar bills were considered in 1945, although with some limitations." In 1947 a new bill was introduced that would have repealed section 13b and would have added to section 13 of the Federal Reserve Act a provision broadly authorizing the Reserve Banks to guarantee, up to 90 per cent, loans made by financing institutions to business enterprises, provided that such loans had maturities of not more than 10 years, that the aggregate amount at any one time did not exceed the combined surplus of the Federal Reserve Banks, and that the aggregate amount of guaranteed loans in excess of \$100,000 did not exceed half of the combined surplus of the Reserve Banks.45 The Board supported this proposal. " Again, however, this effort to liberalize the business loan authority of the Reserve Banks was to no avail.

A sharp decline in business activity in late 1949 and early 1950 gave rise to new proposals for financing business enterprises, but it was still contemplated that the Federal Reserve Banks would be utilized for this purpose, though somewhat more indirectly. Active consideration was given to various bills to provide for Government insurance of business loans and for the establishment of national investment

companies to make long-term loans to cligible small business enterprises and to invest in stock of such enterprises. These bills would have repealed section 13b of the Federal Reserve Act and provided for investment by the Reserve Banks in the capital of the proposed investment companies and for regulation and supervision of such companies by the Board. In 1951, Senator Robertson introduced a bill very similar to the 1947 bills to liberalize the authority of the Reserve Banks under section 13b. This time, however, instead of endorsing the proposal, the Board felt that, because of thencurrent inflationary tendencies, the proposal should be deferred,

A complete shift in the Board's attitude toward participation of the Federal Reserve System in the financing of small business became evident in 1955. In May of that year the Board endorsed the objective of a bill 19 to establish national investment companies to make long-term loans to business, but it questioned the wisdom of Federal Reserve participation and recommended repeal of section 13b of the Federal Reserve Act. A similar attitude was expressed in February 1957, when the Board supported in principle a bill to set up national investment companies to make long-term loans to business, but flatly stated that the responsibility for supervision and regulation of such companies should not be vested in the Federal Reserve System. Again, in June 1957, Chairman Martin told the Small Business Subcommittee of the Senate Banking and Currency Committee that the primary duty of the Federal Reserve System was to guide monetary and credit policy and that, in the Board's opinion, it would be "undesirable for the Federal Reserve to provide the capital and participate in management functions" in the proposed small business investment companies. At the same

time, Chairman Martin suggested a "fresh study of the small business financing problem."

In the meantime, a bill to recodify and streamline all Federal banking laws, known as the Financial Institutions Act, which passed the Senate on March 21, 1957, would have had the effect of repealing section 13b of the Federal Reserve Act.<sup>50</sup> However, because of opposition to certain other provisions, the bill was allowed to die in the House Banking and Currency Committee.

In the spring of 1958, a general economic recession gave new impetus to legislative proposals to provide financial assistance to business enterprises. All such proposals contemplated the repeal of section 13b of the Federal Reserve Act. Finally, on August 21, 1958, the Small Business Investment Company Act of 1958 was enacted into law.51 It provided for the establishment of small business investment companies subject to regulation by the Small Business Administration. Section 601 of the act repealed section 13b of the Federal Reserve Act effective one year after the date of the new act, and section 602 required the Federal Reserve Banks, within 60 days, to pay to the United States the aggregate amount theretofore paid to the Reserve Banks by the Secretary of the Treasury under section 13b of the Federal Reserve Act.52

So it was that the departure from tradition in 1934, which for a time put the Federal Reserve Banks actively into the field of business loans, was followed by a long period of unsuccessful legislative efforts to liberalize the authority of the Reserve Banks in that field, then by a complete reversal of policy aimed at separation of the Federal Reserve from all participation in business financing, and finally by repeal of the business loan authority of the Federal Reserve Banks.



## V Loans

### ORIGIN AND NATURE

### WARTIME BACKGROUND

Strictly speaking, this chapter may not belong in a history of the lending functions of the Federal Reserve Banks, since it relates to loans made primarily by commercial banks and only minimally by Reserve Banks themselves. In a broad sense, however, such a history would be incomplete without a general discussion of the active and important part that the Federal Reserve System has played in the program of financing commonly known as the V-loan program.

Briefly, the V-loan program is a program under which Government procurement agencies guarantee loans made by banks and other financial institutions to business concerns engaged in producing goods or furnishing services necessary to the national defense both in wartime and in peacetime. Practically all of such guarantees have been made through the Federal Reserve Banks as fiscal agents of the Government.

For NOTES AND REFERENCES, see p. 263.

The program was partly an outgrowth of the efforts to liberalize the business loan authority of the Reserve Banks, which were discussed in the preceding chapter. As indicated, all bills in Congress for that purpose failed of enactment, including those introduced early in 1941 as a means of aiding in the financing of contractors engaged in defense production. However, the attack on Pearl Harbor and the entry of the United States into the war in December 1941 made the immediate financing of war contractors an essential part of the war effort. Numerous small subcontractors, because of their size and financial condition, were unable to obtain from commercial banks the credit that was necessary to carry out the large volume of Government contracts awarded to them.

Time did not permit the delay involved in the enactment of new legislation. On March 26, 1942, the President by Executive order authorized the War and Navy Departments and the U. S. Maritime Commission to make or guarantee loans to war production contractors through the agency of the Federal Reserve Banks. In issuing the order, the President emphasized that

its purpose was "to put working capital financing on a war basis" and that loans and guarantees would "not be made under peacetime credit rules." <sup>2</sup>

The Executive order made the operations of the Reserve Banks as fiscal agents subject to supervision and regulation by the Board of Governors. Under this authority, the Board on April 6, 1942, promulgated its Regulation V.<sup>3</sup> The use of the letter "V" to designate the regulation—a letter made popular by Winston Churchill as a symbol of victory—was purely fortuitous. It just so happened that among the letters of the alphabet, which the Board has customarily used in designating its regulations, "V" was the next unused letter. From this derived the short name given to the whole program of guaranteeing loans to defense and war contractors.

#### PHASES OF THE PROGRAM

Although it originated as a wartime measure, the V-loan program is still in effect at this writing. Actually, it has consisted of two distinct though similar programs, one a war program that began in 1942 and the other a peacetime defense program that began in 1950.

The wartime part of the program went through three different phases marked by certain differences in purpose: (1) the emergency phase from March 1942 until the fall of 1943, during which the prime objective was to finance war production; (2) the so-called VT period from the fall of 1943 until the fall of 1944, when guarantees were made not only to finance war production contracts but also to enable contractors to unfreeze their working capital pending settlement of their termination claims against the Government; and (3) the T-loan phase from September 1944 until about the middle of 1946, during which the chief purpose was to finance contractors in converting to peacetime operations while awaiting settlement of their claims in connection with termination of their war contracts.

More than 5 years after the end of the war the V-loan program was revived by the Defense Production Act of 1950 as a means of financing contractors engaged in defense production. This was the beginning of the peacetime part of the program.

Both in war and in peace, however, and despite shifts in emphasis, guaranteed loans have been made in essentially the same manner, that is, through the Federal Reserve Banks as fiscal agents of the Government and pursuant to general procedures outlined in the Board's Regulation V.

The wartime period was, of course, the most active part of the program. From the inception of the program in March 1942 until the end of September 1946, the Reserve Banks processed 8.771 guarantees aggregating nearly \$101/2 billion. Losses were relatively small and substantially less than the guarantee fees collected. As a matter of fact, the wartime program resulted in a net profit to the Government of about \$23 million. The gratifying success of the program was attested by a letter addressed to Chairman Eccles of the Board by Secretary of War Kenneth Royall on March 26, 1947, on the fifth anniversary of the program. Commenting on the part played by the Federal Reserve Banks, Mr. Royall's letter stated: 4

The underlying philosophy of the Executive order was, as you know, that in assisting war production contractors through guaranteed loans the War Department should use not only the funds already in the commercial banks of the country, but should utilize the existing credit machinery as well. It was to that end that the Federal Reserve banks were appointed the fiscal agents of the War Department.

The universal acceptance of the principle of regulation V-loans by both the contractors and the banks is due in no small part to the good judgment, the skill, and the expedition with which they have been handled by the Federal Reserve banks. Especially appreciated were the helpful suggestions of the Reserve banks during the liquidation phase of the V and T programs which, in many respects, called for an even greater degree of financial management than that required in the initial extension of credit.

You and the members of the Federal Reserve System who participated in this program should feel a deep satisfaction in your contribution to this important part of the war effort.

While not so active or exciting as the wartime program, the peacetime V-loan program under the Defense Production Act of 1950 has operated smoothly and successfully. Under this part of the program, the guaranteeing agencies had approved 1,647 applications totaling over \$3.6 billion as of June 30, 1972.

A complete account of all aspects of the Vloan program would require more space than is practicable in this study of the lending functions of the Federal Reserve Banks. A full description of the wartime period of the program may be found in the March 1946 issue of the Federal Reserve Bulletin, beginning at page 240. For present purposes, it will suffice to discuss briefly those aspects of the program that might be regarded as involving legal considerations: the legal basis for the program; the role of the Federal Reserve System in the program; the form of the guarantee agreement; interest rates and guarantee fees; and certain legal problems that arose in connection with the program.

#### LEGAL BASIS

#### **EXECUTIVE ORDER 9112**

Legal authority for the V-loan program was originally based upon provisions of the First War Powers Act of December 18, 1941.<sup>5</sup> Title II of that act gave the President power to authorize any department of the Government exercising functions in connection with the conduct of the war to enter into contracts without regard to other provisions of law, whenever the President deemed that such action would facilitate the prosecution of the war.

Pursuant to this broad authority, the President on March 26, 1942, issued Executive Order 9112. authorizing the War and Navy Departments and the Maritime Commission to enter into contracts guaranteeing any Federal Reserve Bank, the RFC, or any other financing institution against loss on loans made by them for the purpose of financing any contractor, subcontractor, or others engaged in any business or operation that was "deemed by the War Department, Navy Department or Maritime Commission to be necessary, appropriate or convenient for the prosecution of the war." The order also authorized direct loans for the same

purposes. The Reserve Banks were authorized to act as agents of the designated agencies in carrying out the order, and the Secretary of the Treasury was directed to designate each Federal Reserve Bank as fiscal agent for this purpose pursuant to provisions of section 15 of the Federal Reserve Act.

The Executive order had been approved by the Attorney General before it was issued.7 Its validity was impliedly recognized by Congress in the Supplemental National Defense Appropriations Act of April 28, 1942,8 and the Independent Offices Appropriation Act of June 27, 1942,9 which made funds available to the War and Navy Departments and the Maritime Commission for the purpose of carrying out the provisions of the Executive order. Any doubt as to the legality of the order was set at rest by the Act of June 11, 1942,10 which created the Smaller War Plants Corporation. Section 7 of that act specifically authorized the War and Navy Departments and the Maritime Commission "to make or participate in loans, guaranties, and commitments in accordance with Executive Order Numbered 9112 of March 26, 1942."

### VT GUARANTEES

In the summer of 1943, when the prospect of ultimate military victory began to appear likely, war contractors remembered that after the end of World War I final settlement of claims under cancelled war contracts had been delayed in some instances for more than 20 years. Fearing that a successful conclusion of the current war might bring wholesale contract cancellations and similar delays in the settlement of contract claims, some contractors raised the question whether they could continue to draw down funds under a V loan after termination of their war contracts. Literally, it appeared that Executive Order 9112 authorized guarantees only to finance war production and not to finance contractors pending settlement of their cancelled contracts.

In January 1944, the Attorney General held that if commitments and guarantees were made prior to the termination of all of a borrower's war production contracts, the Executive order was broad enough to permit funds to be advanced under such commitments and guarantees even after termination of the borrower's contracts. However, the problem had reached a critical point before the Attorney General's opinion was rendered; on September 1, 1943, the Board and the guaranteeing agencies had approved a modified form of guarantce agreement that, in order to avoid the legal question of authority, had provided that funds should be available under a guarantee for termination purposes if they were also technically available for current war production purposes.

#### CONTRACT SETTLEMENT ACT

Meanwhile, concern as to possible delays in the settlement of contract claims upon termination of the war led to the introduction in Congress of various bills on this subject. Out of these bills came the Contract Settlement Act of July 1, 1944, which became effective on July 21, 1944. The act set up procedures designed to provide for the prompt payment of claims against the Government that grew out of the cancellation of war contracts. Section 10 of the act declared it to be the policy of the Govern-

ment to provide adequate financing to all war contractors having termination claims "within 30 days after proper application therefor." To this end, the act provided for two methods of financing: (1) advance or partial payments and (2) Government loans or guarantees.

As to loans and guarantees, the act specifically authorized any Government contracting agency to guarantee any Federal Reserve Bank or other public or private financing institution against loss on loans made to a war contractor "who is or has been engaged in performing any operation deemed by such contracting agency to be connected with or related to war production, for the purpose of financing such war contractor or other person in connection with or in contemplation of the termination of one or more such war contracts or operations." Direct loans for such purposes were also authorized. The Federal Reserve Banks were expressly authorized, subject to regulations prescribed by the Board of Governors with the approval of the Director of Contract Settlement, to act on behalf of the contracting agencies as fiscal agents of the United States in carrying out the purposes of the act.

On August 18, 1944, the Director of Contract Settlement prescribed procedures and policies to be followed in the guaranteeing of termination loans under the act and approved standard forms of guarantee agreement and loan agreement to be used for that purpose. <sup>12</sup> On September 11, 1944, the Board revised its Regulation V to cover guarantees under the new program. <sup>13</sup> In connection with the inauguration of the new T loans, the Board issued a press statement that indicated the difference between the legal basis for such loans and the legal basis for the earlier VT loans:

The T loan program is a logical extension of the V and VT loan programs under Executive Order 9112, which provide war contractors with financing necessary for production. VT loans, in use since September 1, 1943, provide both production and termination financing, but have not been available after cancellation has taken place. T loans, which are authorized under the Contract Settlement Act, may be guaranteed after the borrower's war production contracts have been termi-

nated. However, commitments for such loans may be guaranteed in advance of cancellation. Thus the program affords war production contractors a means of insurance against the freezing of their working capital which might result from sudden termination of their war contracts.

#### **DEFENSE PRODUCTION ACT**

By 1950 the great majority of claims under war production contracts had been settled, and the authority for guarantees of termination loans under the Contract Settlement Act had, for all intents and purposes, become academic. However, the V-loan program was revived in that year as one of the measures provided by the Defense Production Act of September 8, 1950, to stimulate production for national defense purposes.<sup>14</sup>

Unlike Executive Order 9112 and the Contract Settlement Act, the authority contained in the Defense Production Act was spelled out in some detail. Section 301 of the latter act expressly gave the President power to authorize the Departments of the Army, Navy, Air Force, Commerce, and such other procurement agencies of the Government as he might designate, to guarantee any public or private financing institution (including any Federal Reserve Bank) against loss on any loan made to finance any contractor, subcontractor, or other person "in connection with the performance, or in connection with or in contemplation of the termination, of any contract or other operation deemed by the guaranteeing agency to be necessary to expedite production and deliveries or service under Government contracts for the procurement of materials or the performance of services for the national defense."

As under Executive Order 9112 and the Contract Settlement Act, the Federal Reserve Banks were expressly authorized to act as fiscal agents of the United States on behalf of the guaranteeing agencies. For the first time, however, it was specifically provided in the law that the funds necessary to carry out guarantees should be supplied by the guaranteeing agencies; that the Reserve Banks as fiscal agents should have no responsibility or accountability except as such

agents; and that the fiscal agents should be reimbursed by the guaranteeing agencies for all expenses and losses, including attorneys' fees and expenses of litigation. It was further provided that all operations of the Reserve Banks as fiscal agents should be subject to the supervision of the President and to such regulations as he might prescribe; that the President should be authorized to prescribe rates of interest. guarantee and commitment fees, and regulations governing the forms and procedures to be followed in connection with guarantees; and that each guaranteeing agency should be authorized to use, for the purposes of such guarantees, any funds theretofore or thereafter appropriated or allocated to it, or becoming available to it, for such purposes or for the purpose of meeting "the necessities of the national defense."

The act did not mention the Board of Governors of the Federal Reserve System. However, on the day after approval of the act, September 9, 1950, the President by Executive Order No. 10161 15 delegated to the Board his authority to prescribe regulations, interest rates and guarantee fees, and forms and procedures, subject to a requirement that the Board should first consult with the guaranteeing agencies. At the same time, the President expressly designated the Federal Reserve Banks as fiscal agents of the United States in carrying out under the act guarantees of loans made by private financing institutions. Finally, the Executive order designated as guaranteeing agencies not only the Army, Navy, Air Force, and Commerce Departments but also the Departments of the Interior and Agriculture and the General Services Administration.

The Defense Production Act was enacted as a temporary statute. Title III, containing the V-loan authority, was originally intended to expire on June 30, 1951. This authority, however, was further extended by successive amendments; at this writing it is scheduled to terminate on June 30, 1974.<sup>16</sup>

The provisions of section 301 of the act regarding guaranteed loans were amended by the Act of June 30, 1953.<sup>17</sup> The amendment was designed to clarify the availability of V loans to finance contractors pending settlement of their

defense contracts. The language of the law was changed to provide specifically that such guarantees might be made "for the purpose of financing any contractor, subcontractor, or other person in connection with or in contemplation of the termination, in the interest of the United States, of any contract made for the national defense." At the same time, a provision was added to make it clear that no small business concern, as defined in the act, should be ineligible for a guaranteed loan by reason of alternative sources of supply.

At the time of the financial collapse of the Penn Central Transportation Company in 1970. some consideration was given to the possibility of governmental assistance to the company by means of a V loan. The idea was dropped, however, and, on the contrary, Congress specifically amended section 301 of the Defense Production Act for the purpose of guarding against the use of V loans as a means of preventing financial insolvency or bankruptcy unless such an occurrence would have an adverse effect upon defense production. A new subsection was added to section 301 that limited the maximum obligation of any guaranteeing agency to \$20 million except with the approval of Congress,

and that prohibited the use of the V-loan authority for the purpose of preventing the financial insolvency or bankruptcy of any person unless the President certified that the insolvency or bankruptcy would have a direct and substantially adverse effect upon production. A copy of such certification, with a detailed justification, must be transmitted to Congress at least 10 days before any such use of the authority.<sup>15</sup>

Executive Order 10161 was subsequently affeeted, amended, and superseded by other Executive orders,19 but no essential change was made in the authority delegated by the President to the Board or in the scope of the authority given to the Federal Reserve Banks to act as fiscal agents. It should be noted, however, that, as of the present writing, the designated guaranteeing agencies are the Army. Navy, and Air Force Departments and the Defense Supply Agency of the Defense Department; the Departments of Commerce. Interior, and Agriculture; the General Services Administration; the Atomic Energy Commission; and the National Aeronautics and Space Administration.

# ROLE OF THE FEDERAL RESERVE BANKS

## AS FISCAL AGENTS

It must always be borne in mind that the part played by the Federal Reserve System in the operation of the V-loan program was primarily that of agent and coordinator. The principals in the program were the procurement agencies of the Government, chiefly the military departments and—during the later defense phase of the program—the General Services Administration and the Atomic Energy Commission. It was these agencies that guaranteed V loans. The Reserve Banks acted only as intermediary agents, investigating and making recommendations as to the credit aspects of applications, and guarantees, processing such applications, and

servicing the loans after they were made and guaranteed.

At the outset of World War II, Executive Order 9112 had directed the Secretary of the Treasury to designate the Federal Reserve Banks as fiscal agents of the United States under provisions of section 15 of the Federal Reserve Act. On March 31, 1942—5 days after the Executive order was issued—the Secretary formally designated each Federal Reserve Bank as fiscal agent for the purpose of carrying out the order. The Contract Settlement Act of 1944 made action by the Secretary of the Treasury unnecessary, since that act expressly authorized the Reserve Banks to act as fiscal agents of the United States in carrying out the provisions of

the act authorizing guarantees of termination loans. Similarly, the Defense Production Act of 1950 expressly authorized the Reserve Banks to act as fiscal agents of the United States on behalf of any guaranteeing agency "when designated by the President"; such designation was made by the President in section 302(b) of Executive Order 10161. It was made plain throughout the program that no Federal Reserve Bank should have any responsibility or accountability except as agent for the guaranteeing agencies and that the operations of the Reserve Banks should be subject to supervision and regulation by the Board of Governors.

Reimbursement of the Reserve Banks for their expenses and losses in acting as fiscal agents was provided by the original Executive Order 9112, and it was specifically stated that such expenses should include attorneys' fees , and expenses of litigation. Despite this specific provision, a question arose in the course of the wartime V-loan program whether a guaranteeing agency could lawfully reimburse a Reserve Bank for attorneys' fees paid out in connection with a guaranteed loan after the loan had been purchased by the guaranteeing agency. The War Department doubted its authority to do so because section 314 of Title 5 of the U.S. Code prohibited any Government agency other than the Department of Justice from incurring legal expenses in protecting the interests of the United States. This question was eventually settled by the Defense Production Act, which expressly authorized reimbursement of the Reserve Banks for attorneys' fees and expenses of litigation "notwithstanding any other provision of law."

The procedures followed by the Reserve Banks in executing guarantees and servicing guaranteed loans were prescribed in considerable detail by the guaranteeing agencies and, from the outset of the wartime V-loan program, they were generally uniform. The Defense Production Act expressly recognized the desirability of procedural uniformity. It provided that the President should prescribe regulations "governing the forms and procedures (which shall be uniform to the extent practicable) to be utilized in connection with such guarantees." As pre-

viously indicated, that authority was delegated to the Board, to be exercised after consultation with the heads of the guaranteeing agencies.

In accordance with this statutory injunction, Regulation V, as revised effective September 27, 1950,<sup>20</sup> for the first time undertook to outline the procedures to be followed in guaranteeing loans. Essentially, the prescribed procedures were as follows:

- 1. A financing institution desiring a guarantee of a loan to an eligible borrower would submit its application to the Reserve Bank of its district.
- 2. It would then be necessary to determine whether the contract or other operation of the prospective borrower to be financed by the loan was necessary to expedite defense production or services. This determination would be made by a duly authorized certifying officer of the appropriate guaranteeing agency.
- 3. The application would then be subject to approval either by the appropriate guaranteeing agency in Washington or, to the extent that authority was delegated to it, by the Federal Reserve Bank acting on behalf of the guaranteeing agency.
- 4. If approval from Washington were necessary and if the application were approved by an authorized contracting officer of the guaranteeing agency, that officer would authorize the Reserve Bank to execute and deliver the guarantee. If the application were one that could be approved by the Reserve Bank under delegated authority, the Reserve Bank would approve and execute the guarantee without reference to the guaranteeing agency in Washington.

Early in the wartime program, the War Department stationed liaison officers at each of the 12 Federal Reserve Banks and also at the Detroit Branch of the Chicago Reserve Bank and the Los Angeles Branch of the San Francisco Reserve Bank, with authority to certify the eligibility of the prospective borrower for a guaranteed loan. Field representatives of the Maritime Commission similarly furnished statements of necessity in connection with loans to be guaranteed by the Commission. The Navy Department, on the other hand, centralized its V-loan operations in Washington and had no

such field representatives. The peacetime phase of the program under the Defense Production Act did not involve the volume of applications or the element of urgency that characterized the wartime program, and since 1950 the operations of all guaranteeing agencies have been centralized in Washington, with no liaison officers or representatives at the Reserve Banks.

During the wartime phase of the program, the War Department and the Maritime Commission delegated to the Reserve Banks authority to approve guarantees up to certain prescribed amounts without reference to Washington. No such delegations were made by the Navy Department. Under the Defense Production Act none of the guaranteeing agencies has delegated such authority to the Reserve Banks; all applications are required to be submitted to Washington for approval.

Although the Reserve Banks have been utilized by the guaranteeing agencies as field agents for the purpose of expediting the consideration and execution of guarantees, it should be emphasized again that a primary role of the Reserve Banks has been the investigation of the creditworthiness of prospective guaranteed loans. The guaranteeing agencies have relied heavily upon the credit experience of the Reserve Banks and upon their recommendations as to whether particular applications warranted approval from a credit standpoint.

#### AS FINANCING INSTITUTIONS

In addition to acting as fiscal agents of the United States in guaranteeing V loans made by private financing institutions, the Federal Reserve Banks themselves acted to some extent as lending institutions under the V-loan program.

Executive Order 9112 had authorized guarantces of loans made not only by private financing institutions but also by the Federal Reserve Banks and the RFC. It was contemplated that the Reserve Banks might, under section 13b of the Federal Reserve Act, make loans to war contractors that would be eligible for guarantees. As noted in the preceding chapter, the Board revised its Regulation S to facilitate participation by the Reserve Banks in the V-loan program. Actually, however, the changes made in that regulation were largely technical and clarifying in nature. The restrictions prescribed by section 13b continued, as before the war, to limit the extent to which the Reserve Banks could extend credit to business concerns. Consequently, relatively few V loans were made to war contractors by the Federal Reserve Banks, and the role of the Reserve Banks as financing institutions under the V-loan program was not one of any considerable significance. It has become nonexistent since the repeal of section 13b of the Federal Reserve Act effective August 21. 1959.

# ROLE OF THE BOARD OF GOVERNORS

The role of the Board of Governors in the V-loan program is fourfold in nature: (1) It prescribes regulations governing the operations of the Federal Reserve Banks; (2) it prescribes guarantee fees and interest rates with respect to guaranteed loans; (3) it prescribes the forms and procedures to be followed; and, finally, quite apart from any statutory authority, (4) it acts as an over-all coordinator in the determination of general policies.

Throughout the program, the Board's Regulation V has been couched in the broadest terms. As first issued in April 1942,<sup>21</sup> the regulation contained general statements to the effect that the objective of the Federal Reserve System would be to facilitate and expedite war production by arranging for the financing of war contractors and that the Board and the Federal Reserve Banks would cooperate in every way possible in carrying out the provisions of Ex-

ecutive Order 9112. In addition, the regulation included brief sections relating to rates of interest and fees on guaranteed loans, maturities, and reports by the Reserve Banks. That was all.

As revised effective September 11, 1944,"22 Regulation V was, if anything, even more general in its language. Provisions as to maturities of guaranteed loans were omitted as unnecessary (there were never any limitations placed upon maturity, either by statute or Executive order); references to the Contract Settlement Act were included; and, in accordance with that act, a new section with regard to the responsibility of the Reserve Banks and reimbursement for expenses was added.

In the third and final revision of Regulation V, effective September 27, 1950, 23 references to the Defense Production Act replaced previous references to the Contract Settlement Act, and, as noted in the preceding section of this chapter, the regulation prescribed briefly the procedures to be followed in guaranteeing loans. Otherwise the regulation remained substantially the same.

The Board's role in prescribing uniform procedures has already been discussed. Its functions in fixing fees and interest rates and in prescribing forms used in connection with guaranteed loans will be considered later.

None of the applicable statutes or Executive orders contained any reference to the Board as a coordinating agency. Yet it was in that role that the Board probably played its most useful part in the program. All applications, approvals. and other communications between the guaranteeing agencies and the Reserve Banks were channeled through the Board. A separate Office of War Loans-later called the Office of Defense Loans-was set up within the Board's organization to handle V-loan matters, and that office was continued until 1959. It was thus possible for the Board to assist in the formulation of substantially uniform procedures and forms. In addition, during the wartime phase, all important questions of policy were considered and resolved at frequent meetings in the Board's offices by a joint policy committee composed of representatives of the guaranteeing agencies and the Board; and, when circumstances required, representatives of the Federal Reserve Banks attended such meetings. To a considerable degree, the success of the V-loan program was attributable to the uniformity of policies that resulted from these meetings.21

#### THE GUARANTEE AGREEMENT

As a legal matter, the most important aspect of the V-loan program was the form of guarantee agreement that constituted the contract between the guaranteeing agencies and the lending financing institutions.

On April 10, 1942, just 4 days after the Board promulgated Regulation V, the War Department approved a standard form of guarantee agreement. About a month later, on May 14, 1942, this form was superseded by a form designed for uniform use by the Navy Department and Maritime Commission as well as the War Department. During the summer of 1942, negotiations for a guaranteed revolving credit to General Motors Corporation in the amount of

\$1 billion, with more than 200 large banks participating, gave rise to numerous questions as to the effect of the guarantee agreement; the result was the adoption in October 1942 of certain special conditions, some mandatory and some optional. On April 6, 1943, the standard form was completely revised, incorporating some but not all of the special conditions. When the VT program was inaugurated in September 1943, a special section was added to the agreement. In June 1944, another standard amendment was adopted. After enactment of the Contract Settlement Act, a new form was approved in September 1944 for use in connection with guarantees of war production loans

and a separate T-loan form was adopted for guarantees of termination loans. When the program was reactivated by the Defense Production Act of 1950, a somewhat simplified form of guarantee agreement was put into effect, and that form has since been amended in only two minor respects.<sup>26</sup> Despite these many revisions and amendments, the guarantee agreement has remained essentially the same throughout the program.

The basic feature of the guarantee agreement is a commitment by the guaranteeing agency to purchase a specified percentage of the guaranteed loan. Such a purchase will be made, within 10 days after demand by the financing institution, at any time prior to the date of settlement between the guarantor and the financing institution. In the early forms, the guarantor reserved the right at its option to purchase the entire amount of the guaranteed loan, but this right of voluntary purchase by the guarantor later was limited to the guaranteed portion of the loan.

The earliest standard forms provided that losses on the guaranteed loan and expenses in connection therewith would be shared ratably by the guarantor and the financing institution in accordance with their respective interests in the loan. Since the guarantor obtained no interest in the loan unless it purchased a part of the loan, the agreement to share losses meant nothing unless there was a purchase. In October 1942, however, the agreement was amended to provide that regardless of whether there had been any purchase by the guarantor, losses and expenses would be shared by the guarantor and the financing institution according to the guaranteed and the unguaranteed percentages of the loan, respectively.

A large part of the guarantee agreement relates to details involved in the administration of the guaranteed loan. In general, the agreement makes the financing institution responsible for administering the loan, even after a purchase by the guarantor. However, in the event of a purchase, the guarantor, through the Federal Reserve Bank, may take over possession of the obligation and become the holder of the obligation. The holder of the obligation, whether the financing institution or the guarantor, is required to transmit to the other party its pro rata share of all payments on the loan in accordance with that party's interest in the loan at the time.

The agreement includes detailed and complex provisions regarding the application of the proceeds of collateral and other assets of the borrower to payment of the guaranteed loan. Such provisions, including "spreader" clauses, were the subject of much discussion in connection with revisions of the guarantee agreement; but the technicalities of such discussions would extend far beyond the scope of this history.

Of major importance during the war were those provisions of the guarantee agreement that were designed to protect both the financing institution and the borrower against the adverse effects of cancellation of the borrower's war production contracts. In a legal sense, these provisions became notorious for their complexity.

To protect the financing institution, the agreement provided for an automatic increase in the stated guaranteed percentage by the ratio that the dollar volume of cancelled contracts of the borrower bore to his total war production contracts. The dollar volume of contracts cancelled after the execution of the agreement was designated as "(a)." The dollar volume of all war contracts held by the borrower on the date of the agreement plus those entered into by him after that date, less payments received on all such contracts, was designated as "(b)." The ratio of (a) to (b) was then added to the originally specified guaranteed percentage to obtain the adjusted guaranteed percentage. Thus, if the original percentage was 90 per cent and half of the borrower's contracts were cancelled, the guaranteed percentage would be increased by 50 per cent of the unguaranteed percentage and the adjusted guaranteed percentage would be 95 per cent.

The protection afforded the borrower by another section of the agreement was based upon the same ratio of cancelled contracts to total contracts, but it took a different form. The borrower was entitled, upon request, to a suspension of maturity and waiver of interest as to that portion of the unpaid amount of the guaranteed loan that bore the same ratio to the total amount of the loan as the ratio of (a) to (b). At the same time, the financing institution

was protected by a provision relieving it of its obligation to pay any guarantee fee to the guarantor for any portion of the loan on which maturity was suspended and interest was waived. In addition, the guarantor was required to pay the financing institution interest on the suspended portion of the loan.

When the T-loan and the 1944 V-loan forms were adopted after passage of the Contract

Settlement Act, all provisions regarding adjustment of the guaranteed percentage and suspension of maturity and waiver of interest upon cancellation of the borrower's contracts were omitted, and, as a result, the form of guarantee agreement was substantially simplified. No such provisions were included in the form adopted for use under the Defense Production Act of 1950.

#### FEES AND RATES

Neither the President's Executive Order 9112 of March 26, 1942, nor the Contract Settlement Act of 1944 contained any provisions with regard to the rates of interest on guaranteed loans or the guarantee fees to be paid by financing institutions. However, the Board's Regulation V, as first issued in April 1942, specifically provided that rates of interest, fees, and other charges on guaranteed loans would be prescribed by the Board of Governors "either specifically or by maximum limits or otherwise \* \* \* after consultation with the War Department, Navy Department or Maritime Commission, and with the Federal Reserve Banks." Basically, this became the manner in which all rates and fees were fixed throughout the V-loan program, although under the Contract Settlement Act they were prescribed by the Board with the concurrence of the Director of Contract Settlement instead of after consultation with the guaranteeing agencies. The Defense Production Act of 1950 conferred upon the President authority to prescribe V-loan rates and fees "either specifically or by maximum limits or otherwise"; and this authority was delegated by the President to the Board, to be exercised after consultation with the heads of the guaranteeing agencies.

The first schedule of rates and fees was prescribed by the Board on April 9, 1942. It limited the interest rate on guaranteed loans to a maximum of 5 per cent and provided for payment of a guarantee fee by the financing institution on a graduated scale depending upon the

percentage of guarantee. If the guaranteed percentage was between 91 and 100 per cent, the financing institution paid a fee equal to 30 to 40 per cent of the loan rate; if the guaranteed percentage was between 75 and 90 per cent, the fee was 20 to 25 per cent of the loan rate; and if the guaranteed percentage was less than 75 per cent, the fee ranged from 10 to 20 per cent of the loan rate.

The flexibility of the original schedule of guarantee fees led to some bargaining and tended to tempt financing institutions to ask for the highest percentage of guarantee with the lowest applicable fee. As a consequence, the schedule was revised in December 1942 <sup>27</sup> to provide fixed guarantee fees in all cases, depending upon the guaranteed percentage, except that flexibility was retained for cases in which the guaranteed percentage was 90 per cent or more.

In May 1943 the Board set a maximum of one-fourth of 1 per cent for any commitment fee that might be charged a borrower by a financing institution. When the VT phase of the program was inaugurated in September 1943, the maximum commitment fee was increased to one-half of 1 per cent; but it was provided that any such fee should be shared with the guarantor on the same basis as interest was required to be shared under the schedule of guarantee fees.

After enactment of the Contract Settlement Act, the Board on September 11, 1944, reduced the maximum interest rate to 4½ per cent and

prescribed a simpler schedule of guarantee fees.<sup>28</sup> At the same time, the maximum commitment fee was fixed at one-fourth of 1 per cent, or a flat fee of not more than \$50, but without any requirement for sharing of the fee with the guarantor.

When the V-loan program was revived by the Defense Production Act, the Board prescribed a 5 per cent maximum interest rate, a one-half of 1 per cent maximum commitment fee (to be shared with the guarantor), and a revised schedule of guarantee fees.<sup>29</sup> This schedule of rates and fees remained unchanged until May 15, 1957, when the Board increased the maximum interest rate to 6 per cent.

Effective September 27, 1966, the Board increased the maximum interest rate to 71/2

per cent, without making any changes in the schedule of guarantee fees or in the commitment fee. It was provided, however, that in any case in which the rate of interest on the loan would be in excess of 6 per cent, the guarantee fee should be computed as though the interest rate were 6 per cent.30 In 1970, although the maximum interest rate of 71/2 per cent was not changed, the Board provided that a higher rate might be charged on a particular guaranteed loan if the guaranteeing agency should determine the loan to be necessary for the purpose of financing a person in connection with the performance of contracts deemed by the agency to be necessary to expedite production and deliveries or services for the procurement of materials or the performance of services for the national defense.31

### RELATED LEGAL PROBLEMS

# ELIGIBILITY OF V-LOAN PAPER FOR DISCOUNT

The V-loan program gave rise to legal questions involving an interpretation of the discount provisions of the Federal Reserve Act. Notes given by borrowers under V loans, particularly under revolving credit arrangements, ordinarily were not negotiable; however, the Board's Regulation A required that all paper discounted by the Reserve Banks be negotiable. This problem was met by an amendment to Regulation A effective September 21, 1942, that made the negotiability requirement inapplicable to notes subject to a guarantee by the War or Navy Departments or the Maritime Commission pursuant to Executive Order 9112.32 This exception was later extended to cover paper guaranteed under T-loan guarantees pursuant to the Contract Settlement Act.33 After the end of the war, the exception for V-loan paper was eliminated from Regulation A; 31 but it was restored on March 21, 1951, to remove any doubt as to the eligibility for discount of paper acquired by member banks in connection with V loans under the Defense Production Act.<sup>35</sup> In April 1970 this exception was removed from the regulation as being unnecessary when the Board eliminated the regulatory requirement concerning negotiability of paper offered for discount or as collateral for advances.

A further question arose from the fact that a V-loan note usually incorporated by reference the provisions of the guarantee agreement relating to suspension of maturity in the event of cancellation of one-fourth or more of the borrower's war contracts. Did this fact make the note ineligible for discount on the grounds that it had a maturity of more than 90 days? The Board ruled that it did not, since the note remained payable at its stated maturity unless one-fourth of the borrower's contracts were cancelled, a contingency that might never occur. However, any notes offered for discount after the happening of that contingency were held to be ineligible for discount.<sup>36</sup>

Under a revolving credit arrangement, the financing institution could be required, upon the maturity of a 90-day note, to lend the same amount for another 90 days, and the proceeds

of the second note could be used to pay off the first. Again, question was raised whether a revolving credit arrangement under which loans could be made up to a specified maximum amount over a period of months or years would violate the 90-day maturity requirement of section 13 of the Federal Reserve Act. The Board ruled that since the Reserve Bank was under no commitment to renew such notes at maturity, notes issued under a revolving credit were not rendered incligible for discount.<sup>27</sup>

# LENDING LIMITS OF NATIONAL BANKS

Early in the V-loan program, question arose as to the extent to which national banks could legally participate in the making of V loans because of statutory limitations on the amount that such a bank could lend to any one borrower. Because of the great volume of war production contracts that a war contractor usually held, it was necessary in many cases for him to seek credit in equally large amounts; and, under section 5200 of the Revised Statutes, the most a national bank could lend him was an amount equal to 10 per cent of the bank's capital and surplus. Sometimes this proved to be an obstacle to the necessary financing.

On April 9, 1942, the Comptroller of the Currency ruled that if the portion of a V loan in excess of 10 per cent of a national bank's capital and surplus was subject to a commitment to purchase within 10 days after demand by the War or Navy Department or the Maritime Commission, the loan would not violate section 5200.<sup>35</sup> It was made clear, however, that any part of the loan not subject to such a commitment must be within the statutory limitation.

By the Act of June 11, 1942, 39 a new paragraph (10) was added to section 5200. It provided that the amount limitations should not apply to the extent that loans were secured or covered "by guaranties, commitments or agreements to take over or purchase, made by any Federal Reserve bank or by the United States or any department, bureau, board, commission, or establishment of the United States." This exception, however, was subject to one condition: The guaranties, agreements, or commit-

ments were required to be unconditional and to be performed by payment of cash or its equivalent within 60 days after demand.

The Comptroller of the Currency was authorized to define the terms used in the statute. On June 18, 1942, the Comptroller issued a definition of the term "unconditional," 40 In effect, the definition stated that in order to meet this requirement, the protection afforded to a bank by a guarantee must not be substantially less than it would be in the absence of any provisions that might be regarded as conditions. This made it necessary to determine, with respect to every revision or amendment of the standard form of guarantee agreement, whether it complied with exception (10) to section 5200 and the Comptroller's definition of unconditional. Thus, on successive occasions, favorable rulings as to unconditionality were obtained from the Comptroller with respect to the standard form of May 14, 1942,41 the special conditions added to the guarantee agreement in October 1942, the revised standard form of April 6, 1943,42 the so-called VT amendments of September 1943, and the 1944 V-loan and T-loan forms of agreement adopted in September 1944.13 Similarly, the revised standard form of September 27, 1950, adopted for use under the Defense Production Act, was held by the Comptroller to comply with exception (10) to section 5200, Revised Statutes,44 as were also certain minor amendments later made to that form.

# ASSIGNMENT OF CLAIMS UNDER GOVERNMENT CONTRACTS

In general, the principal security taken by financing institutions as security for V loans was an assignment of the borrower's claims under his war or defense production contracts with the Government. This circumstance gave rise to important and sometimes serious legal problems. Thus, questions arose concerning the priority of the claims of an assignee bank as against those of a trustee in bankruptcy in the case of an insolvent borrower and as against those of a surety company on a contractor's performance bond in the event of default by the contractor; these questions were the subject of various court decisions that caused consider-

able concern to banks participating in the V-loan program. However, it was the status of an assignee bank's claims against the borrower as opposed to those of the Government itself that gave rise to the greatest difficulty. This was a problem that did not develop until after the reactivation of the V-loan program under the Defense Production Act; and, since the Board of Governors played some part in its final resolution, a brief discussion of that problem seems justified here.

For many years before 1940, an old statute (Rev. Stat., sec. 3477) had prohibited the assignment of any claims against the Government. As early as 1938, the Federal Advisory Council had recommended that the Board seek an amendment to this statute to permit the assignment of claims where legitimate credit has been extended, and the Council renewed this recommendation in the spring of 1940. In June of that year, Chairman Eccles of the Board urged Congress to liberalize the statute as a means of facilitating the Government's defense program.45 Meanwhile, the National Defense Advisory Council (with offices in the Board's building) was endeavoring to promote the financing of emergency plant facilities contracts with the Government by making such contracts "bankable." Working in cooperation, the Defense Council and the Board drafted an amendment to the law that was enacted on October 9. 1940, and designated as the Assignment of Claims Act of 1940.46 In brief, this act expressly permitted the assignment to a bank or other financing institution of moneys due or to become due from the United States under contracts providing for payments aggregating \$1,000 or more.

This act was a fortunate, ready-made aid in the private financing of Government contractors when the outbreak of war in 1941 converted the defense program to a war production program. It was because of this act that, during the wartime period of the V-loan program, banks were able to accept assignments of contract claims as security for V loans.

After the war, however, certain opinions rendered by the Comptroller General raised

questions as to the protection afforded lending banks by the Assignment of Claims Act. The statute provided that contracts entered into by the War and Navy Departments might include "no set-off" provisions under which payments to an assignce would not be subject to reduction or set-off for any indebtedness of the assignor (the borrower-contractor) to the United States "arising independently of such contract." In 1949, the Comptroller General held that when a contract contained a price-revision clause, any amounts in excess of the revised contract price could be withheld from payments to an assignce or, even more alarming, could be recovered directly from the assignee if already paid.17 Again, in 1950, the Comptroller General ruled that claims by the Government against a contractor for unpaid social security contributions and withheld income taxes were claims that did not arise independently of the assigned contracts and were therefore not subject to the no-set-off clause.48

These and similar rulings operated to deter banks from making loans to defense contractors on the security of assignments of contract claims, and the revived V-loan program was seriously retarded as a result. In an effort to meet this problem, the form of guarantee agreement was amended in 1950 to define the term "loss on the loan" to include any amounts received by a financing institution and applied to the loan that might later be recovered from the financing institution by the United States. 49 However, this amendment did little to allay those fears of financing institutions that had been engendered by the rulings of the Comptroller General.

On February 13, 1951, the Board recommended to the Senate Banking and Currency Committee an amendment to the Assignment of Claims Act that was designed to remove this impediment to the V-loan program. This amendment, with some modifications, was enacted on May 15, 1951. In brief, its principal effect was to make it clear that when the noset-off clause was included in a Government contract, an assignee financing institution was protected against set-off of any claims by the

Government against the assignor on account of renegotiation, fines, penalties, or taxes or social security contributions, whether or not such claims arose from, or independently of, the assigned contract. In addition, authority for inclusion of the no-set-off clause, previously limited to the War and Navy Departments, was extended to the Department of Defense, the General Services Administration, the Atomic Energy Commission, and such other departments or agencies as the President might designate.

## **Interdistrict Rediscounts**

#### LEGISLATIVE PURPOSE

So far in this study consideration has been given to extensions of credit by the Federal Reserve Banks to their own member banks, to Federal intermediate credit banks, to nonmember banks, to individuals and corporations, to business enterprises, and, as agents for the Government, to defense production contractors. There remains to be considered a final recipient of Federal Reserve credit—the Federal Reserve Banks themselves.

Section 11(b) of the original Federal Reserve Act authorized and empowered the Federal Reserve Board:

To permit, or, on the affirmative vote of at least five members of the Reserve Board to require Federal reserve banks to rediscount the discounted paper of other Federal reserve banks at rates to be fixed by the Federal Reserve Board.

This provision has never been amended; it is in the law today, although its presence is all but forgotten.

The most noteworthy feature of the provision is that it contemplates compulsory rediscounts

For NOTES AND REFERENCES, see p. 264.

between Federal Reserve Banks if ordered by the Board, a feature completely at variance with the otherwise discretionary character of the discounting authority of the Reserve Banks. This element of compulsion was the cause of considerable controversy during the debates on the original Federal Reserve Act.

As included in the Glass bill, the provision was phrased so as to be operative only in time of emergency. The House Banking and Currency Committee felt that the authority of the Board to compel rediscounts between Reserve Banks should be subject to such restrictions as would "unquestionably make its use sporadic and exceptional"; and Chairman Glass suggested that the power would "rarely, if ever" be exercised by the Board.<sup>1</sup>

The House committee compared this authority to compel interdistrict rediscounts to that by which the head office of a central bank with branches is enabled to "employ the resources of one portion of the country for the advantage of other portions or for the purpose of safeguarding them at critical times if its managers deem such actions to be wisest." <sup>2</sup>

In further explanation of the provision's purpose, Mr. Phelan stated: 3

\* \* Herein is provided a means whereby funds in one part of the country for which there is no demand may be applied to that part of our country which is in need. A Federal reserve bank in the Southwest, for example, has a demand for the rediscounting of paper beyond its power to supply. At the same time a reserve bank in the East may have funds for which there is no immediate demand. Under such conditions the Federal reserve bank in the East may rediscount paper for the reserve bank in the Southwest.\* \* \*

The compulsory feature of the provision met with some opposition in the House.<sup>4</sup> It was in the Senate, however, that this feature was most strongly opposed.

Senator Owen's bill contained no limitations on discounts by one Federal Reserve Bank for another. It provided only that rates on such interdistrict rediscounts should be fixed each week by the Board. Senator Hitchcock's version of the bill, however, limited the use of the authority to times of emergency; required unanimity of action by the Board; and provided for a special rediscount rate of not more than 3 per cent above the discount rate of the accommodated Federal Reserve Bank.

Senator Burton, the chief antagonist of the compulsory rediscount provision, regarded it as "a frank admission of the fatal defects of the regional system" and believed that it would "accentuate the rivalry between sections for the accumulation of reserves" and cause "unlimited irritation and friction." 5 Worst of all, he argued that under this provision no Federal Reserve Bank "could make calculations for the care of its customers or the utilization of its resources, because any day it might be called upon to transfer its funds elsewhere." In addition, he contended that the provision might seriously handicap the bank that would have to "take care of foreign exchanges" if a time should come when gold exports might make it necessary for that bank to buy foreign bills in order to check the outflow of gold. Finally, he visualized the adverse psychological effect if it should become known that one Federal Reserve Bank had been compelled to borrow from another Reserve Bank under this "obnoxious provision." 6

Near the close of the debates in the Senate, Senator Newlands offered an amendment that would have added to the provision in question, as modified in the Owen substitute bill, another provision authorizing the Board to require from the Federal Reserve Banks up to one-third of their member banks' reserves for the purpose of enabling the Board to make advances to any Federal Reserve Bank. The argument was made that in an emergency the Board should not be called upon to exercise the indirect method of requiring one Reserve Bank to rediscount paper for another, but should "have the power itself to put these funds directly into the reserve bank which requires aid."

Senator Burton's objections were overruled and Senator Newlands' amendment was defeated. As finally adopted, the Board's authority to permit or require rediscounts between Federal Reserve Banks was made subject to no limitations or qualifications, except that compulsory rediscounts were authorized only on the affirmative vote of at least five members of the Board and except that the rates of interest were required to be fixed by the Board.

#### USE OF THE AUTHORITY

Senator Burton's fears proved to be without foundation. In practice such rediscounts as were made between the Reserve Banks were accomplished almost entirely on a voluntary basis. Actually, the published record indicates that, except for one occasion in 1933, interdistrict rediscounts were confined to the period between December 1917 and late 1921.

In 1915, when it appeared that the marketing of the cotton crop might present problems of financing and that the southern Reserve Banks might need to seek accommodations from the other Reserve Banks, the Board contemplated that interdistrict rediscounting might become necessary. In its *Annual Report* for that year, the Board said: <sup>8</sup>

The Board \* \* \* in the exercise of the powers conferred upon it by the Federal Reserve Act, was fully prepared to set in operation, if it should become necessary, at rates to be fixed by it, the machinery of interbank rediscounting, in order to make available for Federal Reserve Banks requiring larger re-

sources the available funds of other reserve banks, the collective strength of the reserve system as a whole being far in excess of any demands that might reasonably be expected to be brought to bear upon it at that time.

In preparation for this eventuality, the Board on March 10, 1915, fixed rates to be charged for interbank rediscounts, setting them somewhat lower than the regular discount rates then prevailing.

Nevertheless, the first interbank rediscounting did not occur until December 1917. In 1918 rediscount transactions between the Reserve Banks, including voluntary purchases of bankers' acceptances, aggregated over \$660 million. All such transactions were negotiated through the medium of the Federal Reserve Board, but without resort to compulsion by the Board.<sup>10</sup>

In 1919 interbank rediscounts and purchases totaled \$2,658 million, again on a voluntary basis. In its *Annual Report* for that year, the Board stated: 11

There has \* \* \* been such a spontaneous spirit of cooperation between the Federal Reserve Banks that all transactions suggested by the Federal Reserve Board have been made voluntarily, and in no case has the Board found it necessary to exercise its statutory authority to require such operations.

On such a basis of spontaneous cooperation, interdistrict rediscounts were made in considerable volume throughout 1920 and 1921, tapering off toward the end of 1921. At one time or another all of the Federal Reserve Banks were both borrowers and lenders, depending upon the credit needs of member banks in different districts and the resulting reserve ratios of the Reserve Banks. The relationship between interdistrict rediscounts and reserve ratios was described in the Board's 1921 Annual Report to Congress (page 42):

Reserve ratios of Federal Reserve Banks, considered separately, are closely related to the rediscount transactions between Federal Reserve Banks. A Federal Reserve Bank will seek rediscount accommodations from other reserve banks at times when its own reserve is insufficient, without declining to a point below the legal minimum, to supply the credit

demands of its member banks. Reserve ratios on the basis of reserves actually owned by a bank are known as "actual" reserve ratios, while reserve ratios on the basis of reserves before interbank borrowing or lending are referred to as "adjusted" ratios. It is the adjusted ratio, therefore, that is an index of the reserve position of a Federal Reserve Bank from the standpoint of its ability to make rediscounts for other reserve banks or its need to apply for accommodation to other reserve banks.

Fluctuations in the reserve positions of the various Reserve Banks, leading to interdistrict borrowings, resulted from special causes. Thus, during 1920 and 1921, the Richmond, Atlanta, St. Louis, and Dallas Districts felt the effect of a decline in the price of cotton; the Chicago, Minneapolis, and Kansas City Districts experienced a decline in the price of grains, wool, and other agricultural products. Consequently, it was the Federal Reserve Banks of these districts, under the pressure of the credit needs of their member banks, that were the principal borrowers from other Reserve Banks. Conversely, the New York Reserve Bank's reserve ratio increased during the latter part of 1921 as a result of a large inflow of gold from abroad and a marked liquidation of advances to its own member banks, and thus that Reserve Bank became a lending rather than a borrowing bank.12 At other times, as during 1918, a constant flow of Government funds from New York to the interior of the country made it necessary for member banks in the New York District to borrow from the Reserve Bank in order to replenish their reserves, and the New York Reserve Bank had to borrow from other Federal Reserve Banks.

Since 1921, there have been no interdistrict rediscounts, with the exception of a single instance in March 1933. At that time the banking crisis caused an unusual flow of bank reserves away from New York and the reserve position of the Federal Reserve Bank of New York sank so low as to necessitate borrowing from other Reserve Banks in the amount of \$210 million.<sup>13</sup> This was the last occasion when section 11(b) of the Federal Reserve Act had any actual significance. Through allocations of securities in the System Open Market Account,

it has been possible to maintain a constant equalization of the reserve ratios of all Federal Reserve Banks so that resort to interdistrict rediscounting has been unnecessary.

As a strictly legal matter, it would no longer be necessary for any Federal Reserve Bank to borrow from another Reserve Bank in order to maintain its reserve ratio. In 1965 provisions of section 16 of the Federal Reserve Act requiring Reserve Banks to maintain reserves against deposits were repealed, and in 1968 reserve requirements for Federal Reserve notes as prescribed in that section were also repealed. It is still conceivable, however, that occasions may arise when, for one reason or another, an interdistrict rediscount under section 11(b) of the Act might be considered appropriate or desirable.

# **Discount Rates**

## STATUTORY PROVISIONS

In preceding chapters references have been made to the discount or interest rate charged on various types of Federal Reserve credit—a "discount" rate when the credit takes the form of a discount of paper representing loans made by a member bank, or an "interest" rate when the loan is in the form of a direct advance to a member bank on its own note. The present chapter deals with the legal history of such discount and interest rates, generally referred to without distinction as discount rates. Since its authority to fix Federal Reserve discount rates has always been regarded as one of the System's major instruments of credit policy, it is particularly necessary to emphasize again that this history is concerned principally with the legal aspects of the subject rather than its economic aspects.

The basic provision of the law with respect to discount rates is to be found in section 14 of the Federal Reserve Act. That section purports to set forth specific powers of the Federal Reserve Banks, although the section is entitled

For NOTES AND REFERENCES, see pp. 264-65.

"Open-Market Operations." Among other things, the section presently provides that: 1

Every Federal reserve bank shall have power:

(d) To establish from time to time, subject to review and determination of the Board of Governors of the Federal Reserve System, rates of discount to be charged by the Federal reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business; but each such bank shall establish such rates every fourteen days, or oftener if deemed necessary by the Board;

Except for the last clause, this provision is identical with the provision as it appeared in the original Federal Reserve Act. The provision was amended in 1920 to authorize progressive discount rates, but that authority was repealed in 1923.

As discussed in the preceding chapter, section 11(b) of the original Act authorized the Federal Reserve Board to permit or require the Reserve Banks to rediscount the discounted

paper of other Reserve Banks. Under this provision, which has never been changed, the rate of interest on such rediscounts is required to be fixed by the Board.

Since 1913, various amendments to the Act authorizing advances to or discounts for member banks and others have included provisions relating to the fixing of rates.

When section 13 of the Act was amended in 1916 to authorize the Federal Reserve Banks to make advances to member banks on their collateraled notes (as distinguished from discounts of eligible paper), it was provided that such advances should be made "at rates to be established by such Federal reserve banks, subject to the review and determination of the Federal Reserve Board"; and this provision has not been substantially changed.<sup>2</sup>

In 1932 when sections 10(a) and 10(b)—authorizing emergency advances to groups of member banks and to individual member banks—were added to the law, it was provided that the rates on such advances should be not less than 1 per cent above the discount rate of the Reserve Bank at the time of any such advance. Since that time, section 10(b) has been changed to lower the premium rate to one-half of 1 per cent for advances under that section.<sup>3</sup>

When the Reserve Banks were authorized in 1932 to discount paper for individuals, partnerships, and corporations in unusual and exigent circumstances, it was required that such discounts be made at rates established in accordance with the provisions of section 14(d) of the Federal Reserve Act, the basic discount rate provision quoted on page 167.

In 1933, when Congress added at the end of section 13 of the Act a paragraph authorizing advances to individuals, partnerships, and cor-

porations on the security of direct obligations of the United States, such advances were required to bear interest "at rates fixed from time to time by the Federal reserve bank, subject to review and determination by the Board of Governors of the Federal Reserve System"; this language paralleled that of section 14(d).

The authority granted by section 13b of the Act in 1934 for working capital loans to business enterprises contained no provision with respect to interest rates; but, as will be noted, various rates were established by the Reserve Banks while that authority was in effect.

For the sake of completeness, two provisions of law relating to discount rates should be mentioned here although they are no longer in effect. Section 11(c) of the original Federal Reserve Act required the Board to fix a graduated "tax" to be paid by the Reserve Banks on deficiencies in gold reserves required to be held by them against outstanding Federal Reserve notes and provided further that any Reserve Bank having any such deficiency should "add an amount equal to said tax to the rates of interest and discount fixed by the Federal Reserve Board." In 1933 Congress authorized the Reserve Banks in certain circumstances to purchase obligations of the United States and provided that operations under that authority should not require the imposition of the graduated tax on reserve deficiencies or the automatic increase in discount rates otherwise specified in section 11(c) of the Federal Reserve Act.6 In 1968 the provisions of section 16 of the Act requiring the maintenance of reserves against Federal Reserve notes were repealed and, as conforming amendments, the provisions of section 11(c) and of the 1933 legislation just mentioned were also repealed.7

# OBJECTIVES OF DISCOUNT RATES

### UNIFORMITY OF RATES

It is a cardinal principle of private business, established by centuries of custom, that one

who lends money is entitled to receive interest as compensation for the borrower's use of the lender's funds. Interest on loans is one of the major sources of income of commercial banks. The Federal Reserve Banks, however, as explained in the first chapter of this study, are operated for public purposes and not for profit. While the law makes provision for the payment of interest on loans made by the Reserve Banks, its primary purpose is not to enable them to realize a profit from their lending activities. Although it was not so clearly defined at the outset as it was in later years, the philosophy of the original Federal Reserve Act was that Federal Reserve discount rates would serve as a means of stabilizing commercial interest rates and as a safeguard against inflation.

In 1913 uniformity in discount rates throughout the country was regarded as eminently desirable. The National Monetary Commission had looked forward to "absolute uniformity" of discount rates.8 The House Banking and Currency Committee regarded the "establishment of a more nearly uniform rate of discount throughout the United States" as one of the "essential features of reform." 9 The Senate committee's report declared that the fixing of rates of discount "would have a steadying effect upon the interest rate throughout the United States, and will enable the banks of the country to extend accommodation at a comparatively stable rate of interest upon a lower basis than heretofore, because the element of hazard of panic and of financial stringency will be removed by the proposed system." 10

In its first Annual Report to Congress after the enactment of the statute, the Federal Reserve Board declared that "the adoption of a fairly uniform and consistent policy to be pursued by all the [Federal Reserve] banks would go far to insure the smooth working of the system." <sup>11</sup> Initial discount rates were fairly uniform. Thus, the rate on 60- to 90-day paper was 6 per cent at seven Reserve Banks and 6½ per cent at five Reserve Banks. <sup>12</sup>

In its Annual Report for 1915, the Board observed: 13

\* \* Beginning at the opening of the system with a comparatively high rate for ordinary commercial paper and with more or less variation between the different districts, the reserve banks have during the year steadily reduced the general level of discount rates and have worked rapidly and effectively toward uniformity for the entire country. It may not be practicable to maintain uniform rates throughout the twelve districts, but they should unquestionably bear a consistent relation one to another, while a very much greater adherence to uniformity than before the enactment of the Federal Reserve Act will undoubtedly be secured.

Uniformity in rates was generally maintained in the early years of the System, and at the end of 1923 the rate at all Reserve Banks on all classes of paper was 4½ per cent. Although variations in rates developed in subsequent years, in recent times uniformity has again become the rule as the result of acceptance of the fact that discount rates reflect not so much regional credit conditions as national credit policy.

# ACCOMMODATION OF COMMERCE AND BUSINESS

Uniformity in rates, however, was not the stated objective of the Federal Reserve Act. The original Glass bill provided that rates should be fixed with a view to accommodating the commerce of the country. In the Senate, the Owen bill referred to the accommodation of commerce and business, and the Hitchcock bill referred in addition to the objective of promoting stability in business. The final version of the Act followed the Owen bill, and accommodating commerce and business has ever since remained the statutory purpose of discount rates.

That purpose, indeed, has been carried over to other provisions of the statute and has become one of the few objectives expressly set forth in the Federal Reserve Act. In 1923, when the nonstatutory Federal Open Market Investment Committee was created by the Board, the Board laid down the principle that "the time, manner, character, and volume of openmarket investments purchased by the Federal reserve banks be governed with primary regard to the accommodation of commerce and business and to the effect of such purchases or sales on the general credit situation." <sup>15</sup> When the Federal Open Market Committee was made a statutory body in 1933, essentially the same

language was used in prescribing the objectives of open market operations.<sup>16</sup>

# IMPLEMENTATION OF CREDIT POLICIES

Federal Reserve discount rates were the earliest means by which the System sought to influence general credit conditions. Along with reserve requirements and open market operations, discount rates still constitute one of the three major tools available to the System for implementing credit and monetary policies. Indeed, changes in discount rates have generally been regarded as the most dramatic signal of shifts in System policy, and they have

had more significance in this respect since the revival of emphasis on the discounting functions of the Federal Reserve Banks that followed the so-called Treasury-Federal Reserve accord in 1951.<sup>17</sup>

It may be noted, however, that in 1968 a System committee appointed to reappraise the Federal Reserve discount mechanism recommended, among other things, that the discount rate should be changed more frequently in order to maintain it at a level "reasonably close to rates on alternative instruments of reserve adjustment." <sup>18</sup> If this recommendation should be put into practice, it is likely that changes in the discount rate would tend to lose a large part of their announcement effect.

### LEGAL BASIS AND DISCRETIONARY NATURE

In a published opinion dated May 1, 1915, the Board's General Counsel, on the basis of Supreme Court decisions relating to national banks, expressed the view that Congress may delegate to the Federal Reserve Banks and the Federal Reserve Board the power to fix discount rates without regard to State usury laws.<sup>19</sup>

The constitutional validity of the statutory authority for fixing Federal Reserve discount rates appears to be beyond question. It was firmly established in 1929 by the decision of the Circuit Court of Appeals for the Second Circuit in the case of Raichle v. Federal Reserve Bank of New York.20 In that case the New York Bank was charged with wrongfully spreading propaganda concerning an alleged money shortage, restricting the supply of credit through open market operations, arbitrarily and unreasonably raising discount rates, and denying rediscounts to certain member banks pending liquidation of collateral loans. The suit was dismissed for failure to join the Federal Reserve Board as an indispensable party. On the merits, however, the court upheld the Reserve Bank on all grounds. With particular reference to discount rates, the court said, "It is not contended that the provision for fixing rates of discount is unconstitutional, nor would it seem even reasonable to argue that it is, \* \* \*."

The court also held that discount rates fixed by the Reserve Bank, subject to review and determination of the Board, were within the discretion of those agencies and not subject to judicial review. The court stated: <sup>21</sup>

\* \* It would be an unthinkable burden upon any banking system if its open-market sales and discount rates were to be subject to judicial review. Indeed, the correction of discount rates by judicial decree seems almost grotesque when we remember that conditions in the money market often change from hour to hour and the disease would ordinarily be over long before a judicial diagnosis could be made.

We can see no basis for the contention that it is a tort for a Federal reserve bank \* \* \* to fix discount rates which are unreasonably high, or to refuse to discount eligible paper, even though its policy may be mistaken and its judgment bad. The remedy sought would make the courts, rather than the Federal Reserve Board, the supervisors of the Federal reserve system and would involve a cure worse than the malady. The bank, under the

\* \* \* \*

supervision of the board, must determine whether there is danger of financial stringency and whether the credit available for "commerce and business" is sufficient or insufficient. If it proceeds in good faith through open-market operations and control of discount rates to bring about a reduction of brokers' loans, it commits no legal wrong. A reduction of brokers' loans may best accommodate "commerce and business."

# DISTRIBUTION OF AUTHORITY

In authorizing the establishment of discount rates by the Federal Reserve Banks, subject to review and determination of the Board, section 14(d) of the original Federal Reserve Act clearly reflected the intent of Congress that the System should be a regional and decentralized system, but at the same time a system operating under the general supervision of a single governmental agency with power to determine questions of national policy. Nearly 40 years later, this basic concept was expressed by Chairman Martin of the Board when, in 1952, he stated in answer to a questionnaire by the Joint Committee on the Economic Report that: 22

\* \* \* The law clearly contemplates that the establishment of discount rates shall involve joint action by the Federal Reserve Banks and the Board of Governors of the Federal Reserve System. \* \*

In the same statement, Chairman Martin asserted the statutory authority of the Board to make the ultimate determination of discount rates. This position is supported by the legislative history of the statute, as well as by an opinion of the Attorney General of the United States.

When the House Banking and Currency Committee reported the original Federal Reserve bill on September 9, 1913, it stated: 23

\* \* The power granted in subsection (d) to fix a rate of discount is an obvious incident to the existence of reserve banks, but the power has been vested in the Federal reserve board to review this rate of discount when fixed by the local reserve bank at its discretion. This is intended to provide against the possibility that the local

bank might be establishing a dangerously low rate of interest, which the reserve board, familiar as it would be with credit conditions throughout the country, would deem best to raise.

In the Senate, Senator Owen declared that "the final determination of the rate is put in the hands of the Federal Reserve board," <sup>21</sup> and that "the bank rate may be fixed by the Government board." <sup>25</sup> Senator Shafroth pointed out that the Board was "vested with the power to raise or lower the rate of discount." <sup>26</sup> In answer to arguments that the rate should be made uniform by statute, Mr. Phelan urged that there might be reasons for variations in the rate in different sections of the country, but that under the Glass bill the Board could make the rate uniform "if ever necessary or desirable." <sup>27</sup>

The language of the law as finally enacted contained evidence of the intent of Congress that final determination of rates should be vested in the Board. Section 11(c) included a provision, since repealed, to the effect that whenever a Reserve Bank had to pay a graduated tax on its deficient reserves against Federal Reserve notes, it must add an amount equal to such tax to the rate of interest and discount "fixed by the Board of Governors of the Federal Reserve System."

Clearly, the Board itself assumed that under the original Act it possessed the final power to determine rates. In its first Annual Report to Congress, in discussing discount rates, the Board stated that it was satisfied that "at the start and until the banks could get a firm footing it [the Board] should act with prudence and conservatism\* \* \*." 28

In 1916 the legal authority of the Board to

overrule a Federal Reserve Bank and to determine a discount rate was put to the test. One of the Reserve Banks had voted to increase its rates. The Board, however, withheld its approval because the Treasury Department felt that such an increase would adversely affect its program for marketing Liberty Bonds and Victory Notes. When the Treasury's financing program was completed, the proposed increase in rates was approved by the Board.20 In the meantime, the Board's General Counsel had expressed the view that the Board had legal authority to fix rates different from those established by a Federal Reserve Bank. However, the then-Secretary of the Treasury, Carter Glass, requested the Attorney General of the United States for his opinion on the question. In making the request, Mr. Glass himself stated that there could be "no question of the intention of Congress to give the Federal Reserve Board complete power in the matter of fixing the rate of discount."

In an opinion dated December 9, 1919, the Acting Attorney General, Alex King, held that the Board had the "right to determine what rates of discount should be charged from time to time by a Federal Reserve Bank, and under their powers of review and supervision, to require such rates to be put into effect by such Bank." <sup>30</sup> In reaching this conclusion, he pointed out that unless the Board had this power, the words "and determination" used in the statute would be wholly without significance.

The intent of Congress that the Board should have final control over discount rates was confirmed by the legislative history of the Banking Act of 1935. Early drafts of that bill would have placed open market operations as well as discount rates in the hands of the Board, but with a requirement that the Board should consult with a "Federal Open Market Advisory Committee" before the Board made "any changes on its own initiative in the open market policy, in the rates of interest or discount to be charged by the Federal Reserve Banks, or in the reserve balances required to be maintained by member banks." [Emphasis added.] While this provision was not adopted, there was much discussion in Congress of the power of the Board over discount rates, which clearly indicated the assumption in Congress that the Board had authority under existing law to initiate such rates.

In its report on the Banking Act of 1935, the House Banking and Currency Committee stated that it was essential that the Federal Reserve Board be given the same "definite responsibility and final authority" over open market operations "as it already possesses with respect to the discount rates of the Federal Reserve Banks." The committee gave the reasons for which such authority over discount rates was vested in the Board:

\* \* It has a national viewpoint and has long been accustomed to considering matters as they affect the country as a whole, without regard to the special interests of any particular group or locality. It was created for the purpose of supervising and coordinating the activities by the 12 Federal Reserve Banks "in order that they may pursue a banking policy which shall be uniform and harmonious for the country as a whole." \* \* It is for this reason that the original Federal Reserve Act gave the Federal Reserve Board final authority over discount rates.

With respect to the relative authority of the Board and the Reserve Banks over discount rates, Chairman Martin of the Board reasserted the Board's power to initiate rates in his replies to the 1952 Patman Questionnaire; at the same time he explained how present procedures were designed to avoid any serious conflict in this connection. His statement is pertinent here:32

\* \* Since prospective changes in rates are ordinarily discussed in advance between the Board and the Reserve Banks, it is only rarely that action taken by a Federal Reserve Bank for the setting of discount rates is not promptly approved by the Board. On occasion, however, the Board may fail to approve or defer its approval pending discussions of System credit and monetary policies and Treasury financing policies with the Presidents of all Federal Reserve Banks or with the Federal Open Market Committee. The matter is usually discussed also with the Secretary of the Treasury.

Since the Board's authority is not limited to mere approval of rates established by the Reserve Banks, but includes the power to review and determine such rates, the Board, as previously noted, has legal authority to initiate discount rates. However, methods evolved through experience for the taking of action on discount rates are calculated to avoid the development of procedural issues in this respect.

Despite Chairman Martin's statement regarding the avoidance of procedural issues, the Reserve Banks and the Board of Governors have occasionally had different views as to what the discount rate should be at a particular time, and procedural issues have inevitably arisen. If the board of directors of a Reserve Bank acts to increase or decrease its existing discount rate and such action is not agreeable to the Board, the Board has two alternatives: (1) It can take no action to approve the rate fixed by the Reserve Bank, in which event the existing rate continues in effect; or (2) it can formally act to disapprove the rate proposed by the Reserve

Bank, in which event, again, the existing rate remains unchanged. The first alternative—non-action by the Board—could subject the Board to the charge that it is failing to perform its statutory responsibility of reviewing and determining discount rates established by the Reserve Banks. Consequently, in such circumstances the second alternative course of action is usually followed, as it was on several occasions in 1971 and 1972,33

If, on the other hand, a Reserve Bank recstablishes its existing discount rate and the Board feels that the rate should be raised or lowered, the Board has the legal authority to determine a new rate despite the Reserve Bank's unwillingness to act. Such an action by the Board, however, could involve delicate problems of relationships between the Board and the Reserve Banks and is avoided if at all possible. Usually, in such circumstances, the reluctant Reserve Bank eventually acts to establish the new rate favored by the Board.

# CLASSIFICATION OF PAPER FOR RATE PURPOSES

# APPLICABILITY TO ADVANCES

Section 14(d) of the Federal Reserve Act refers to the fixing of discount rates to be charged for each class of paper. Presumably, this means that a Reserve Bank may not, like a commercial bank, establish a different rate of discount or interest for each individual loan, but must apply the same rate to all loans of the same class, irrespective of the credit soundness of the loan or the general creditworthiness of the borrower.

Two general questions arise at once: (1) Does section 14(d) apply not only to discounts under the original provisions of section 13 of the Federal Reserve Act but also to advances authorized by later amendments to the Act? And (2) exactly what is meant by each class of paper?

The third paragraph of section 13, added in 1932, provides that discounts for individuals,

partnerships, and corporations in emergency circumstances shall be made at rates established in accordance with section 14(d) of the Act: consequently, there can be no doubt that the class-of-paper requirement applies to such discounts. On the other hand, paragraphs 8 and 13 of section 13, relating respectively to advances to member banks on paper eligible for discount or for purchase by the Reserve Banks and to advances to individuals, partnerships, and corporations on obligations of the United States and Government agencies, provide only that such advances shall be made at rates established or fixed by the Reserve Banks, subject to review and determination by the Federal Reserve Board; they do not, like the third paragraph of section 13, specifically incorporate the requirements of section 14(d). Section 10(b) of the Act requires only that advances to member banks on any satisfactory assets shall be at rates at least one-half of 1 per cent above the Reserve Bank's highest discount rate; it contains no express provision for the fixing of such rates by the Reserve Banks or for their review and determination by the Board.

Technically, it may be argued that the classof-paper requirement in section 14(d) applies only to Reserve Bank loans that take the form of discounts under the second paragraph of section 13, or discounts of agricultural paper under section 13(a), or discounts of paper for individuals, partnerships, and corporations under the third paragraph of section 13. Such an argument, however, would seem patently absurd. It would make no sense to assume that Congress intended to apply the class-of-paper requirement only to discounts and not to advances. Moreover, the requirement of section 14(d) that discount rates be established at least every 14 days has consistently been interpreted as applying also to the rates on advances.

# THE CLASS-OF-PAPER QUESTION

The second and more difficult general question relates to the meaning of the term "class of paper." Does it mean that different rates may be fixed only on the basis of differences in the nature of the paper, for example, agricultural or commercial paper? Does it permit the fixing of different rates on the basis of maturities, the nature of the borrower, or the purposes for which the proceeds of the Reserve Bank loan will be used? This point will be discussed in subsequent sections of this chapter. For now, it suffices to note that the Board apparently has followed a liberal construction of the authority to fix different rates for different classes of paper. The so-called eligible paper bill recommended by the Board in 1963 would have removed all question on this point by expressly permitting the establishment of different rates on any reasonable basis.

#### **MATURITIES**

In the early years of the System it was clearly assumed that different rates could properly be fixed on the basis of different maturities. The first rates approved by the Board (on Novem-

ber 16, 1914) covered four maturity categories of paper: (1) 30 days or less; (2) 30 to 60 days; (3) 60 to 90 days; and (4) over 90 days. The fourth category necessarily covered only agricultural and livestock paper, since the law itself set a maximum maturity of 90 days for commercial paper.

In 1915 the Board adopted an additional maturity classification for paper maturing within 10 days. Thowever, after the law was amended on September 7, 1916, to authorize advances to member banks on their 15-day notes secured by eligible paper or Government obligations, the Board suggested that the Reserve Banks eliminate the 10-day maturity classification and adopt a uniform 15-day rate for both discounts of commercial paper and advances on secured notes of member banks. Since that time, different rates have never been established on the basis of different maturities of paper offered for discount or as collateral for advances.

## CHARACTER OF PAPER; PREFERENTIAL RATES

Along with the maturity classifications, there also developed during the early years of the System additional classifications of paper based on the special nature of the paper involved. Certain kinds of paper were considered to be entitled to preferential rates, that is, rates lower than those charged for ordinary commercial paper of the same maturities.

Trade acceptances with maturities of 90 days or less and commodity paper maturing within 6 months were the first classes of paper to be accorded preferential rates.<sup>37</sup> During World War I, notes secured by Government obligations were given preferential rate treatment.<sup>38</sup> Bankers' acceptances, considered the most liquid of all investments, were also determined to be entitled to a substantial rate preference.<sup>38</sup>

In general, such preferential rates did not long continue. The preferred rate for commodity paper was merged with the ordinary rate in 1917. Nevertheless, in that year the number of categories of paper for discount rate purposes—according to both maturities and character of paper—had reached a total of 13. In April 1917 an attempt at standardization of

rates was made, and the number of categories was reduced to eight.<sup>11</sup> For many years, however, the structure of discount rates was complicated by the effort of the System to fix rates for different classes of paper both according to maturities and according to the nature of the paper itself.

# FREQUENCY OF BORROWING; PROGRESSIVE RATES

The amount or frequency of borrowing by a particular member bank obviously does not have any relation to the class of paper representing such borrowing; consequently, excessive borrowing alone is not a justification for a higher discount rate. This fact was a cause for concern to the Systoo shortly after World War I during a period of credit expansion when some member banks were borrowing heavily from the Reserve Banks.

The Board considered this problem in its Annual Report for 1919. It observed that, although the law imposed no specific limitation on the amount of borrowings by member banks at the Federal Reserve Bank, there was at least an implied potential limitation in the provision of section 4 of the Act requiring that credit accommodations be extended "with due regard to the claims of other member banks." It was felt that if all member banks should seek accommodations proportionate to those sought by a few, a Federal Reserve Bank would not be able to meet the demands of all of its member banks. The Board noted, however, that the situation could not be met by charging higher rates to excessive borrowers, because section 14(d) required rates to be fixed for each class of paper. It stated that there was no authority in the law: 42

or establishing graduated rates based upon the total borrowings of a member bank, and consequently when it becomes necessary to advance the discount rate in order to curb the demands of those banks rediscounting with the Federal Reserve Banks in very large amounts, the same rate would have to apply to the moderate requirements of other member banks who may rediscount with the Federal Reserve Banks infrequently and never excessively. Thus the application of rate

advances as a corrective or deterrent to certain banks tends to raise the level of current rates to all.

To meet this problem, the Board recommended an amendment to section 14(d) so as to permit a Reserve Bank, with the Board's approval, to determine by uniform rule applicable to all its member banks the "normal maximum discount line" of each member bank and to fix "graduated rates on an ascending scale to apply equally and ratably to all its member banks rediscounting amounts in excess of the normal line so determined." In this way the Board felt it would be possible to reduce excessive borrowings without raising the basic rate.

Congress promptly adopted the Board's recommendation. By an Act of April 13, 1920,<sup>43</sup> the following language was added to section 14(d) of the Federal Reserve Act immediately after the original language authorizing the establishment of discount rates for each class of paper with a view to accommodating commerce and business:

and which, subject to the approval, review, and determination of the Federal Reserve Board, may be graduated or progressed on the basis of the amount of the advances and discount accommodations extended by the Federal reserve bank to the borrowing bank.

Four Reserve Banks adopted the progressive rates.<sup>41</sup> Three of them determined the basic discount line as being an amount equal to 2½ times a sum equal to 65 per cent of the reserve balance of a member bank, plus its paid-in Federal Reserve Bank stock; the fourth fixed the basic line as the combined capital and surplus of the member bank. In all four instances, discounts in excess of the basic line were made subject to a progressive rate of one-half of 1 per cent, in addition to the normal rate, for each 25 per cent by which the amount of the discount exceeded the basic line.

While some beneficial results followed the adoption of the progressive rates at these four Reserve Banks, the Board conceded that the results were not as effective as the flat 7 per cent rate established by other Reserve Banks in June 1920. As a matter of fact, one of the four progressive-rate Reserve Banks abandoned

the plan on November 1, 1920, and adopted the flat 7 per cent rate.<sup>45</sup>

In 1921 excessive borrowings declined substantially. Whereas the ratio of total borrowings of all member banks to their aggregate discount line was 78 per cent on May 20, 1920, the ratio at the end of 1921 was only 37 per cent. The decline apparently resulted from large imports of gold, the general recession of business, and a decline in prices.

Presumably, the graduated-rate authority was no longer considered necessary. It was repealed by the Act of March 4, 1923,17 which restored section 14(d) of the Federal Reserve Act to its original form. However, the enactment of the 1920 amendment and its repeal in 1923 apparently evidenced the intent of Congress that, in the absence of such specific statutory authority for graduated rates, there is no basis in the law for fixing discount rates according to the extent to which a member bank makes use of the credit facilities of the Federal Reserve Banks. Moreover, in the absence of specific statutory authority, the fixing of higher discount rates for continuous borrowers would seem to sanction an abuse of the lending facilities of the Federal Reserve Banks. As indicated in a subsequent chapter, continuous borrowing is not regarded as an appropriate use of Federal Reserve credit.

### STATUTORY BASIS FOR CREDIT

During the first few years of the System's existence, differentiation in rates was based, as has been noted, on maturities and nature of paper; for a short period in 1920 and 1921, a further differentiation was made on the basis of amount of borrowings. After 1921, however, the principal basis for different rates was simply the type of credit extended, as determined by its statutory source; in recent years the maturity or character of the paper offered as a basis for Federal Reserve credit has had little or no bearing on the rate of discount or interest charged.

In contrast to the 13 different rates that prevailed in early 1917—according to maturities and nature of paper—there was only one rate (4½ per cent) for all classes and maturities of paper at the end of 1923. A single classification for rate purposes prevailed until 1932, al-

though the rate varied to some extent at different times among the different Federal Reserve Banks. Thus, at the end of 1931, the only discount rate was that for commercial and agricultural paper under sections 13 and 13a, a rate of 3½ per cent at 10 Reserve Banks and 4 per cent at 2 Reserve Banks; by January 25, 1932, a uniform rate of 3½ per cent was in effect at all Federal Reserve Banks.

Differences in rates, however, were the result of the enactment of provisions for special types of credit during the depression years of the early 1930's. Thus, when section 10(b), authorizing advances to member banks on any satisfactory security, was enacted in February 1932, all Federal Reserve Banks fixed a separate rate of 51/2 per cent for advances under that section. This action was made necessary by the new provision itself, because at that time the law required the rate to be at least 1 per cent higher than the regular discount rate. In 1935, the law was amended to require a penalty rate of at least one-half of 1 per cent on advances under section 10(b), and since then the Reserve Banks have automatically established a rate for such advances that is one-half of 1 per cent above the regular discount rate.

In July 1932 when Congress enacted the third paragraph of section 13 to authorize emergency discounts for individuals, partnerships, and corporations, a rate of 6 per cent was fixed by all of the Reserve Banks for such discounts. When authority for discounts under that paragraph was activated by the Board in 1966, the Board indicated that if resort to the authority should appear imminent, the Reserve Banks might wish to establish the same rate as that fixed for advances under the thirteenth paragraph of section 13-a rate higher than the regular discount rate. Similarly, when the authority was again activated in 1969, the Board suggested that the rate should be the same as that for advances under the thirtcenth paragraph; but the Board went on to suggest that the latter rate be fixed at 71/2 per cent-a rate 11/2 per cent above the regular discount rate for advances to member banks. Neither in 1966 nor in 1969 was the third paragraph of section 13 actually used as a means of extending credit to individuals, partnerships, or corporations and so no rate was ever fixed for discounts under that paragraph. However, it has always been understood that if any rate should be fixed, it would, as in 1932, be considerably higher than the regular rate for discounts and advances for member banks under section 13.

In 1933 the addition of the last paragraph of section 13, authorizing advances on Government obligations to individuals, partnerships, and corporations, gave rise to a new rate applicable to such advances, again somewhat higher than the regular discount rate. As will be noted later, however, there have been times since 1933 when the rate on advances under that paragraph to nonmember banks has been the same as the rate for advances to member banks on Government obligations, that is, the regular discount rate.

In June 1934 new authority for direct and indirect extensions of credit to commercial and industrial businesses provided by section 13b of the Federal Reserve Act (discussed in Chapter 11) called for the establishment of five separate rates under that section: an interest rate on loans to businesses made directly or in participation with financing institutions; rates on discounts for and purchases from financing institutions, one for that portion of the loan for which the financing institution was obligated and one for the remaining portion of the loan; and rates on commitments to make loans to businesses and financing institutions.

During World War II a preferential rate was established for advances to member banks on Government obligations under section 13; and, under the last paragraph of that section, a rate was fixed for advances to nonmember banks on Government obligations lower than the rate set for advances to others—nonbanking corporations, individuals, and partnerships—under that paragraph.

The result of these developments was that during World War II there was again a multiple rate structure, with differentials based upon the statutory source of the credit, together with a preference for advances on Government obligations to both member and nonmember banks. Thus, at the end of 1942 there were different rates for advances to member banks on Government obligations; discounts and advances for

member banks under sections 13 and 13a on security other than Government obligations; advances to member banks under section 10(b); advances to nonmember banks on Government obligations; advances to individuals, partnerships, and corporations other than banks on Government obligations; and, as previously indicated, five different rates on loans and commitments under section 13b.<sup>49</sup>

After the end of the war the preferential rate on advances to member banks under section 13 on the security of Government obligations was eliminated and so also was the lower rate charged on advances to nonmember banks on Government obligations under the last paragraph of section 13, Effective August 21, 1959, section 13b of the Act, relating to loans and commitments to businesses, was repealed. As a result, only three different rates were left: the basic or regular rate fixed for discounts and advances for member banks under sections 13 and 13a: the rate for advances to member banks on any satisfactory assets under section 10(b), automatically fixed at one-half of 1 per cent above the regular discount rate; and the rate for advances to individuals, partnerships, and corporations-including nonmember banks-on the security of Government obligations under the last paragraph of section 13. Of these rates, which differ according to the provisions of law under which Reserve Bank loans are made, the most significant, of course, has always been the regular rate for discounts and advances for member banks under sections 13 and 13a.

## NATURE OF BORROWER

Although, in general, differentiation in rates is now based upon the statutory source of lending authority, it should be noted that even for Reserve Bank loans under a particular statutory authority there may be different rates according to the nature of the borrower. As has been seen, during World War II advances to nonmember banks on the security of Government obligations under the last paragraph of section 13 were allowed to be made at a lower rate of interest than advances to others under the same paragraph on the same type of security. In September 1972, when the Board acted to mitigate any possible hardships that might be suf-

fered by nonmember banks because of amendments to the Board's Regulation J, the Board indicated that the Reserve Banks should be prepared to provide credit to such banks on substantially the same terms as those applicable to member banks. It specifically referred to the possibility of direct extensions of credit to nonmember banks under the last paragraph of section 13 and expressed the view that the rate paid by a nonmember bank in such a case should be no higher than the rate applicable to member banks under paragraph 8 of section 13, that is, the regular discount rate. In accordance with this suggestion, six of the Reserve Banks established a special rate of 41/2 per cent for such advances to nonmember banks—the same as the regular discount rate for member banks and 2 per cent less than the rate established for all other advances under the last paragraph of section 13.50

Although the third paragraph of section 13, relating to discounts of eligible paper for individuals, partnerships, and corporations in emergency circumstances, has not been utilized since 1936, it was activated by the Board in 1966 and again in 1969 as a possible means through which Reserve Bank credit might be extended to nonmember deposit-type institutions such as savings and loan associations and mutual savings banks, as well as to nonmember commercial banks. No rate was fixed for such discounts on either of those occasions, although in 1969 the Board suggested to the Reserve Banks, as previously noted, that if it appeared that any loans were to be made under that paragraph, the rate should be the same as that for advances under the last paragraph of section 13. It is conceivable that, in certain emergency circumstances, the System may be called upon as a lender of last resort to provide credit under the third paragraph of section 13 for business enterprises as well as nonmember financial institutions. In such a situation, it is possible that the System might find it appropriate to charge different rates for loans to different types of borrowers, for example, a higher rate for a loan to a nonfinancial business enterprise than for a loan to a financial institution such as a savings and loan association.

Such a differentiation in rates according to the nature of the borrower could be regarded as not being in conformity with the apparent intent of section 14(d) of the Act that different rates may be established only for different classes of paper. On the other hand, plausible arguments can be made in support of the conclusion that a loan under the third paragraph of section 13 to an aircraft manufacturer is essentially different from a loan under that paragraph to a savings and loan association, even though the collateral security may be the same.

### PURPOSE OF CREDIT

If a differentiation in rates according to the nature of the borrower seems somewhat remote from a differentiation according to class of paper, one might suppose that the fixing of different rates according to the purpose of the Reserve Bank loan would be even more remote. Nevertheless, such a differentiation according to purpose of the credit was made in 1972. The Board anticipated possible hardships upon some nonmember banks because of changes in Regulation J requiring payment of checks in immediately available funds on the day of presentation. Therefore, it suggested, and half of the Reserve Banks concurred in, the establishment of a special rate to be charged on advances to nonmember banks on the security of Government obligations under the last paragraph of section 13. But this rate was to be used only when the change in Regulation J would result in a significant impairment of the liquidity of a nonmember bank or would impair its ability to serve its community. Thus, even though such advances would be made on the same type of security (Government obligations) as any other advances to other types of corporations, a preferential rate was given not only on the basis of the nature of the borrower but also according to the purpose of the loan.

### TIME AND MANNER OF DETERMINATION

Aside from the graduated-rates amendment of 1920, which was repealed 3 years later, the only amendment that has been made to section 14(d) since the enactment of the Federal Reserve Act was the addition of the following language by the Banking Act of 1935: "but each such [Federal Reserve] bank shall establish such rates every fourteen days, or oftener if deemed necessary by the Board." 51

The legislative history of this amendment throws no light on its intent. The amendment was not contained in the bill that passed the House on May 9, 1935. It first appeared in section 205 of the bill that was reported by the Senate Banking and Currency Committee. That committee's report stated only: 52

\* \* \* Section 205 also amends existing law with respect to rates of discount to be established by the Federal Reserve banks, providing that such rate shall be established every 14 days or oftener if deemed necessary by the Board of Governors of the Federal Reserve System.

There was no reference to the provision in the Senate debates. The conference report of August 17, 1935, 53 merely mentioned the provision without explanation.

Presumably-and one is limited to presumptions—the purpose of this amendment was to provide assurance that the Federal Reserve Banks and the Board would give more constant and regular attention to discount rates and to the need for changing such rates than had been the practice in the past. Whether so frequent a review of discount rates should be mandatory may be open to question; but, as the law now stands, the board of directors of each Reserve Bank must establish the discount rate every 14 days and the Board must review and determine the rate so established. Unless credit policy at the time suggests the need for a change in the rate, the practice is for each Reserve Bank to establish the same rate as that previously established and for the Board to approve the reestablishment of the existing rate.

It may be noted that while section 14(d) literally refers only to discount rates, the procedure prescribed by that section for the fixing of rates every 14 days has been applied in practice not only to discount rates but also to interest rates established for advances to member banks and others under the eighth and thirteenth paragraphs of section 13 and section 10(b) of the Act.

In his replies to the Patman Questionnaire in 1952, Chairman Martin of the Board made the following statement regarding the procedure that was followed in determining discount rates: 54

At the present time, the procedure for the setting of discount rates, as it has evolved over the years, is generally as follows:

Each Friday the Board considers all actions taken by the Federal Reserve Banks during the preceding week to establish discount rates, usually action to reestablish the existing rates. The possible desirability of any prospective change in discount rates is usually considered in advance by the Board with the Presidents of the Federal Reserve Banks and the Federal Open Market Committee in the light of changing credit conditions, including the Government's financing needs and current trends in the economy generally. Whenever it is determined that as a matter of policy there should be a change in rates, action to establish such a change usually is taken uniformly by the boards of directors (or executive committees) of the several Federal Reserve Banks at their next meetings following such determination. Thus, in August 1950, after consultation between the Board and the Federal Open Market Committee, as one measure for restraining credit and monetary expansion, a discount rate of 134 percent-initially proposed by the Federal Reserve Bank of New York-was established at all of the Federal Reserve Banks and that rate prevailed at the end of 1951.

In accordance with the procedures established many years ago, as previously indicated, whenever discount rates are changed, the action is announced simultaneously by the Board and the Reserve Bank at the end of the day on which the Board acts and the new rates are made effective on the next business day following the day of the announcement.

In general, the procedure described by Mr. Martin prevails at the time of this writing. How-

ever, the Board no longer considers rates only on Friday of each week; normally, it acts on rates established by the Reserve Banks promptly after receipt of advice of a Reserve Bank's action. In addition, changes in rates are usually made effective on the day after the Board's action whether or not that happens to be a business day.

### COMPUTATION

As has been noted, the Federal Reserve Act authorizes both discounts and advances, with discounts subject to a discount rate and advances subject to an interest rate. Until 1971, however, interest on all Reserve Bank loans, advances as well as discounts, was computed on a discount basis; that is, interest was deducted at the time the loan was made. If the member bank repaid a borrowing before maturity, it received a rebate of a portion of the interest deducted when the loan was made. Most of the Reserve Banks computed the rebate at the rate at which the advance was made, but some Reserve Banks followed a practice of computing the rebate at the rate prevailing at the time of the rebate if the discount rate at that time was less than it was at the time the advance was made.

Since February 1971 interest on advances by the Reserve Banks has been computed on an accrual basis and paid at the time of repayment of the loan. In addition, any changes in the discount rate are made immediately applicable to all outstanding borrowings.<sup>55</sup> With this change in the method of computing interest, the need for a rebate in the event of payment before maturity no longer exists. It should be noted in passing that computation of interest on an accrual basis rather than on a discount basis results in a small mathematical advantage to the

borrowing member bank. For this reason, although legally a member bank could still discount eligible paper with its Federal Reserve Bank, it seems unlikely that it would ever wish to do so.

Interest on Reserve Bank loans is computed for the period of the loan on the basis of 365 days to the year.<sup>56</sup> If the maturity date falls on a Sunday or a holiday, the computation follows applicable State law relating to such cases.<sup>57</sup>

In the early days of the System, when the applicable discount rate depended upon the maturity of the paper, questions sometimes arose that would not arise under present law. For example, in 1916 when 90-day paper carried a higher rate than 30-day paper, question was raised as to the applicable rate in a case in which the paper discounted had a maturity of 90 days at the time of discount but in which the member bank, by a side agreement, had agreed to repurchase the paper in 30 days. The Board's Counsel ruled that the 90-day rate was nevertheless applicable.58 Again, a question arose as to the rate of rebate in a case in which a 90-day loan was prepaid within 30 days of maturity. It was held that the rebate should be at the lower rate prevailing for paper running the same length of time as the unexpired term rather than at the higher 90-day rate charged when the loan was made.59

# Relation to Credit Policy

# THE EARLY YEARS: ACCOMMODATION OF CREDIT NEEDS

Although this study is not primarily concerned with the economic aspects of the lending functions of the Federal Reserve Banks, it is nevertheless appropriate to consider briefly how the law and the Board's regulations have reflected changes in the concept of the role of the discount mechanism as an instrument of credit and monetary control.

The original Federal Reserve Act contained little, if any, suggestion that the discount function would be employed as a tool for implementing credit policies in the sense in which it is considered as such a tool today. There was no mention of any such objective in the title of the Act. It is true that one of the stated purposes was to afford means of rediscounting commercial paper, but it appears that this purpose was related not to the control of general credit conditions but rather to the meeting of the particular credit needs of business and commerce.

As indicated earlier, one of the principal aims of the Act was to create a market for short-term

For NOTES AND REFERENCES, see p. 265.

commercial paper. Section 14(d) of the Act provided that discount rates should be fixed "with a view of accommodating commerce and business." The key word was accommodation rather than regulation of credit.

In keeping with this purpose, emphasis was placed in the early years of the System not upon regulation of the amount or kinds of credit extended by member banks themselves but upon the ability of the Reserve Banks to assist member banks in meeting their credit requirements in normal and extraordinary times. Thus, in its first Annual Report to Congress, the Board stated that it was necessary to enlist "the hearty cooperation of all the member banks" in "the adoption of a discount policy which would prevent the accumulated strength of the [Federal Reserve] banks from being dissipated and protect their resources from being used to finance operations not calculated to add to the strength or solidity of general banking conditions." 1 In its 1919 Annual Report, the Board similarly stated that the Federal Reserve Banks should not encourage rediscounting for the sake of profit, "but that their own resources should be kept liquid and their reserve position strong." 2

Very plainly, the Board did not consider the discounting authority of the Reserve Banks as a means of controlling the credit policies of member banks. In its 1921 Annual Report, the Board emphasized that the System had "no control over member bank loans" and pointed out that there was "nothing in the Federal Reserve Act which gives either the Federal Reserve Board or a Federal Reserve Bank any control over the loan policy of any member bank." 3 The Board observed that there was "a very general popular misconception" in this respect and that some member banks in declining loans had used the Reserve Banks as a buffer. It was true, the Board said, that a Reserve Bank might have occasion to call the attention of certain member banks to their "large discount lines," but "in no case within the knowledge of the Federal Reserve Board has any Federal Reserve Bank undertaken to say to a member bank what particular loans it should call or ask to have reduced." 4

Some shift away from this concept was evident in 1923 when the Board reported to Con-

gress that, "by maintaining constant, close, and direct contact with the loan policies and operations of its member banks, through examination or otherwise, a reserve bank can do much by other means than changes in discount rates to establish an effective supervision and control of the credit released by it to its member banks." 5 This was an early expression of the concept of direct pressure that became more explicit in the late 1920's. However, it appears that, at least prior to 1933, the influence exercised by the System through the discounting function over the credit policies of member banks was considered only as something "akin in many respects to the bank examinations function" of the System a rather than as a means of regulating national credit conditions or controlling the lending policies of member banks. As previously indicated, major emphasis was placed upon the furnishing of necessary credit assistance to different segments of the economy: the establishment of a market for commercial paper in the early years; credit to agriculture and stimulation of foreign trade through discounting of bankers' acceptances in the 1920's; and assistance to businesses in the early 1930's.

# THE 1930's: PREVENTION OF SPECULATION

The original Federal Reserve Act contemplated that Federal Reserve credit should be based on short-term commercial paper and not on paper drawn for investment or speculative purposes. Section 13 specifically excluded paper "covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities." However, the original Act contained no express statement that one of its purposes was to prevent member banks from diverting their own funds into speculative channels; the original objective was simply to limit Federal Reserve discounts to self-liquidating commercial paper, excluding paper drawn for purposes of investment alone.

In 1929 both the Board and the Reserve Banks became seriously concerned about the volume of bank credit that was being used for the purchase of stocks and for speculative purposes. There was a sharp difference of opinion, however, as to how the problem should be met. The Reserve Banks, particularly the New York Reserve Bank, favored an increase in the discount rate; the Board, on the other hand, insisted on a program of direct pressure, that is, closing the discount window to member banks that appeared to be extending credit for speculative purposes. In the end, the Board agreed to a discount rate increase; but it was this crisis, according to some historians of the System, that marked a shift of power from the New

York Reserve Bank to the Federal Reserve Board.

The stock market debacle of 1929 and the ensuing banking crisis of 1933 focused even greater attention on the dangers inherent in the investment practices of commercial banks. The Banking Act of 1933 sought to prevent recurrence of similar situations by various amendments that were designed to restrict investments by banks in stocks and other securities. Thus, the 1933 act prohibited national banks and State member banks of the Federal Reserve System from dealing in investment securities (subject to certain exceptions) or from purchasing any corporate stocks except as specifically authorized by law. The same act required member banks to divorce themselves from securities companies and prohibited interlocking directorates between such companies and member banks. Member banks were prohibited from paying any interest on demand deposits, a practice that had enabled large banks in New York and other financial centers to attract deposits of country banks-funds that the city banks had used for investment in speculative securities. Finally, the Banking Act of 1933 added three provisions to the Federal Reserve Act relating to the discount functions of the Reserve Banks that were specifically aimed at preventing speculative practices on the part of member banks. These three amendments merit particular attention here.

One of the amendments was to subsection (m) of section 11 of the Act, a paragraph that has had an interesting history because of the various different matters that have been covered by it over many years.8 The 1933 amendment revised this paragraph to authorize the Board to limit the amount of loans that might be made by member banks on the security of stock or bond collateral. The Board was given power to fix, for each Federal Reserve district, the percentage of individual bank capital and surplus that could be represented by loans on stock or bond collateral made by member banks, with a flat prohibition against the making of such loans to any one borrower in excess of 10 per cent of a member bank's capital and surplus. The Board was authorized to change the percentage from time to time, but it was expressly made the duty of the Board to establish such percentages "with a view to preventing the undue use of bank loans for the speculative carrying of securities." Finally, the Board was empowered to direct any member bank to refrain from further increasing its loans on stock or bond collateral for any period up to 1 year "under penalty of suspension of all rediscount privileges at Federal reserve banks."

This amendment went far beyond the original concept that Federal Reserve Banks should not indirectly encourage speculation by discounting paper drawn for investment or speculative purposes; it attempted to restrain directly the making of speculative loans by member banks, regardless of the nature of the paper that might be offered by them as a basis of rediscount by the Reserve Banks. If a member bank persisted in making speculative loans, it was made subject to suspension of all rediscount privileges.

This provision for curbing speculative loans by member banks is still in effect, although it was amended by the Banking Act of 1935 to make loans on U.S. Government obligations subject to the more liberal percentage limitation prescribed by section 5200 of the Revised Statutes rather than the 10 per cent limitation fixed for loans on other securities.

Another amendment made by the Banking Act of 1933 added certain new provisions to the eighth paragraph of section 13 of the Federal Reserve Act relating to advances to member banks on their secured promissory notes; it was designed to restrain speculative loans by member banks. The amendment 10 provided that if, during the life of any such advance and after a warning by the Reserve Bank or the Board, a member bank should increase its loans secured by stocks or other securities or its loans to dealers in securities, such advance should become immediately due and payable and the member bank should be "ineligible as a borrower at the reserve bank" for such period as the Board should determine. Exceptions were made with respect to loans on Government obligations and temporary carrying loans to facilitate the purchase or delivery of securities offered for public subscription.

A third amendment—the most important for the purpose of preventing speculative bank loans—grew out of a recommendation made by the Board in a letter to the chairman of the Senate Banking and Currency Committee, dated March 29, 1932.<sup>11</sup> In that letter the Board stated: <sup>12</sup>

Member banks as a rule do not borrow to relend, but to make up deficiencies in reserves arising from withdrawals of deposits or from other causes. It is therefore usually impossible to say that a loan to a member bank is granted for this or that specific purpose. However, it would be possible to determine whether the loan and investment policies of a bank are inconsistent with the purposes of the Federal reserve act, and, if so, to refuse accommodation to such bank or in aggravated cases to suspend it from the privilege of using the system's credit facilities.

To accomplish this end, the Board recommended an amendment to section 4 of the Federal Reserve Act, and the language suggested by the Board appeared in the Banking Act of 1933 as finally enacted.

The eighth paragraph of section 4, from the time of the original enactment of the Federal Reserve Act, had provided that the directors of each Federal Reserve Bank should administer the affairs of the Reserve Bank fairly and impartially and without discrimination against any member bank or banks and that the directors should extend to each member bank "such discounts, advancements, and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks." To this language the 1933 amendment added language requiring that due regard be given also to "the maintenance of sound credit conditions, and the accommodation of commerce, industry, and agriculture." In addition, the amendment authorized the Federal Reserve Board to prescribe regulations further defining the conditions under which discounts, advancements, and accommodations might be extended to member banks. The amendment then added the following significant provisions: 13

\* \* \* Each Federal Reserve bank shall keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit for the speculative carrying of or trading in securities, real estate, or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions; and, in determining whether to grant or refuse advances, rediscounts or other credit accommodations, the Federal reserve bank shall give consideration to such information. The chairman of the Federal reserve bank shall report to the Federal Reserve Board any such undue use of bank credit by any member bank, together with his recommendation. Whenever, in the judgment of the Federal Reserve Board, any member bank is making such undue use of bank credit, the Board may, in its discretion, after reasonable notice and an opportunity for a hearing, suspend such bank from the use of the credit facilities of the Federal Reserve System and may terminate such suspension or may renew it from time to time.

With reference to the section of the 1933 act that added these provisions, the report of the Senate Banking and Currency Committee stated that that section: 14

\* \* places general restrictions upon the operating policy of Federal reserve banks with the intent to limit them to the extension of credit for ordinary business purposes and to make plain that their resources are not to be used to support speculation. The Reserve Board is given power to oversee and direct such use of the resources of banks.

In explaining these provisions on the floor of the Senate, Senator Glass observed that some Federal Reserve Banks might be reluctant to inquire as to what member banks were doing with funds borrowed from the Reserve Bank and that neither the Reserve Banks nor the Board had any control over a member bank while it was not seeking Federal Reserve credit. He pointed out, however, that under the new provisions "the instant a member bank wants to recoup itself at the Federal Reserve Bank, it is the business of the Federal Reserve Bank to know the reason why." He then stated: 15

\* \* \* in this section we require a Federal reserve bank to keep itself informed and we require the agent of the Federal Reserve

Board at that bank to keep the Federal Reserve Board informed. If at any time it shall appear that the member bank seeking the privileges of the Federal reserve bank is inordinately extended in stock-market transactions or unsound and unsafe loans, we empower the Federal Reserve Board, upon due notice and hearing, to suspend the facilities of the Federal reserve bank to that offending bank.

Similarly, in the House, Chairman Steagall of the Banking and Currency Committee declared: 16

We propose to see to it that hereafter the credit facilities of the Federal Reserve System shall be devoted primarily to the purposes to which that great act was dedicated at the outset.

Amendment of the Federal Reserve Act is made to provide for supervision by Federal Reserve banks to see whether any member bank is making undue use of its funds for speculative purposes. If such is found to be the case the Federal Reserve bank is empowered to suspend such member bank from the privilege of rediscounting.

The three 1933 amendments to the Federal Reserve Act—to section 11(m), section 13, and section 4—had a common objective: to place upon the Board and the Reserve Banks a responsibility for seeing that member banks did not engage in undue use of their funds for speculative purposes, with suspension of their rediscounting privilege as the penalty. The significance of the 1933 amendments lies in the fact that they contemplated the exercise by the Federal Reserve System of a direct influence upon the credit policies of member banks, in contrast to the earlier concept that the lending authority of the Reserve Banks was intended only to accommodate the credit requirements of member banks with but incidental effect upon the lending practices of the member banks themselves.

# SINCE 1951: AN INSTRUMENT OF CREDIT CONTROL

So far in this chapter it has been suggested that in the early years of the System, particularly in the 1920's, the lending functions of the Federal Reserve Banks were related to credit policy primarily as a means of enabling member banks to supply the credit needs of commerce and agriculture, and that in the 1930's such functions were aimed primarily at the prevention of speculative loans by member banks. It would be wholly inaccurate, however, to assume that there was any clear line of demarcation between the two periods: The idea of preventing speculative loans was not lacking during the 1920's; and the Banking Act of 1933, despite its preoccupation with speculative lending practices, did not contemplate that the Reserve Banks should not still seek to accommodate commerce and agriculture, as well as business enterprises, through the exercise of their lending powers. It would be equally wrong to assume from the heading of the present section that the lending functions of the Reserve Banks were regarded as a tool of credit control only after 1951. As in the two previous sections, the heading is meant only to indicate a shift in emphasis.

The importance of the discount powers of the Reserve Banks in affecting general credit conditions was clearly recognized in the early years of the System. In its first Annual Report the Board declared that "the question of a discount policy immediately became urgent." <sup>17</sup> Even then, the Board contemplated that the System should be prepared to exert its influence to protect the economy against both inflation and deflation. Thus, the Board stated: <sup>18</sup>

The ready availability of its resources is of supreme importance in the conduct of a Reserve Bank. Only then can it become a safe and at the same time flexible instrument

of guidance and control, a regulator of interest rates and conditions. Only then will it constantly carry the promise of being able to protect business against the harmful stimulus and consequences of ill-advised expansions of credit on the one hand, or against the menace of unnatural restrictions and unnecessary contractions on the other, with exorbitant rates of interest and artificial stringencies.

Nevertheless, the System was mainly concerned in the early years with affording necessary credit to commerce and agriculture; and the concern in the 1930's with prevention of speculative loans was not based upon the idea of using the discount mechanism as a means of influencing the money supply in general.

From the early 1930's until about 1952, member bank borrowings from the Reserve Banks were relatively small, at times almost insignificant; consequently, the lending functions of the Reserve Banks had little effect upon national credit policy during that period. The reasons for lack of borrowings during those years were set forth in the Board's reply to the Patman Questionnaire in 1952: 19 principally, the volume of excess reserves held by member banks as the result of a large inflow of gold and a slack demand for bank credit, the open market policy of the System during World War II that provided the banking system with ample reserves, and the strong liquidity position of member banks as a result of their large holdings of Government securities.

The situation began to change after World War II. The rapid expansion of private bank credit during the postwar years brought about a reduction in over-all bank liquidity, with more frequent occasions for borrowings by member banks from their Federal Reserve Banks.<sup>20</sup>

The chief factor, however, in the revival of the importance of the discount mechanism as an instrument of credit policy was the Treasury-Federal Reserve accord of March 1951, when the System ceased to purchase Government bonds in order to support their prices.<sup>21</sup> Before that time, member banks, in view of the steady prices of Government obligations, had been able to adjust their reserve positions through sales of such obligations, which they had held in large volume since World War II; after the

accord, they frequently found it more profitable to borrow from the Reserve Banks. The effect was described in the Board's 1951 Annual Report as follows: 22

The closer relationship of short-term market rates to the discount rate was an important factor in a greater use of the Federal Reserve discount window in making temporary adjustments of member bank reserve positions. When the Federal Reserve, by refraining from open market purchases of Government securities, limits the availability of reserves through the open market, a member bank that has temporary need for additional reserves has a choice of borrowing from the Federal Reserve at the discount rate or selling Treasury bills or other securities at interest rates determined in the market. Depending on the excess reserve position of other banks, the bank may also have the choice of borrowing such funds through the Federal funds market, at a rate determined in this market. \* \* \* As the year progressed, increasing numbers of member banks elected to borrow from the Federal Reserve in meeting shortages of reserve funds. This development reflected re-establishment of the discount function as a complement to open market operations in Federal Reserve influence on monetary and credit conditions.

The increased importance of the discount mechanism in relation to credit policy was emphasized in the Board's reply to the Patman Questionnaire in 1952. The Board pointed out that the reluctance of member banks to be continually in debt to the Federal Reserve made the discount mechanism a potentially powerful influence in affecting general credit conditions, especially when used in conjunction with other measures of credit and monetary policy. Describing the complementary workings of open market operations and discount policy, the Board stated: <sup>23</sup>

When occasion makes it desirable from the standpoint of over-all credit and monetary objectives, the System can make it necessary for an increasing number of member banks to rely temporarily on borrowing from the Reserve Banks. It can accomplish this by decreasing the availability of reserve funds by such means as open market sales of Govern-

ment securities or the imposition of higher reserve requirements. When such an increase in member bank recourse to borrowing occurs, usually accompanied by a rise in the volume of rediscounts, the System is put in a position to exert an additional restrictive influence on the expansion of bank reserves and of bank credit generally by increasing the cost of member bank borrowing, that is, by raising the discount rate.

Concluding its discussion of the subject, the Board told the Patman subcommittee that the "discount mechanism is an important instrument of Federal Reserve policy."

Greater resort by member banks to Federal Reserve discounts after the 1951 accord resulted in the focusing of more attention upon the discount functions of the Reserve Banks than had existed since the 1920's. Renewed interest in the subject impelled the Board to revise its Regulation A in 1955. In a foreword to the revised regulation, the Board explicitly recognized the role of the discount mechanism as one of the three major instruments of credit policy. Thus, the first two paragraphs of that foreword read: <sup>24</sup>

A principal function of the Federal Reserve Banks under the law is to provide credit assistance to member banks, through advances and discounts, in order to accommodate commerce, industry, and agriculture. This function is administered in the light of the basic objective which underlies all Federal Reserve credit policy, i.e., the advancement of the public interest by contributing to the greatest extent possible to economic stability and growth.

The Federal Reserve System promotes this objective largely by influencing the availability and cost of credit through action affecting the volume and cost of reserves available to the member banks. Through open market operations and through changes in reserve requirements of member banks, the Federal Reserve may release or absorb reserve funds in accordance with the credit and monetary needs of the economy as a whole. An individual member bank may also obtain reserves by borrowing from its Federal Reserve Bank at a discount rate which is raised or lowered from time to time to adjust to the credit and economic situation. The effects of

borrowing from the Federal Reserve Banks by individual member banks are not localized, as such borrowing adds to the supply of reserves of the banking system as a whole. Therefore, use of the borrowing facility by member banks has an important bearing on the effectiveness of System credit policy.

The role of the discount function as an instrument of monetary policy "under presentday conditions" was fully and clearly described in the Board's Annual Report to Congress for 1957.25 At certain periods, and for specific member banks, the lending authority of the Federal Reserve Banks still serves the purpose for which it was originally intended-the accommodation of the needs of business and commerce. It can still be used as a means of restraining speculative lending practices on the part of member banks, although not so effectively when member banks are not borrowing extensively from the Reserve Banks. In recent years, however, and especially since 1951, the discount mechanism has been most important as a complement to open market operations in the effectuation of monetary policy.

One episode will serve to illustrate the use of the discount window as a tool of monetary policy. In the latter part of 1966, the Board concluded that credit-financed business spending "had tended toward unsustainable levels and had added appreciably to current inflationary pressures." On September 1, 1966, at the Board's suggestion, the president of each Reserve Bank sent a letter to each member bank in his district urging restraint in the making of business loans. The letter also said that this objective would be "kept in mind by the Federal Reserve Banks in their extensions of credit to member banks through the discount window." 26 Here was a new form of direct pressure like that exerted in 1929, but this time it was used not to prevent speculative loans by member banks but to discourage loans to businesses. This effort was abandoned in December 1966 when it was announced that, because of changes in credit conditions, the special discount arrangements set forth in the letter of September 1 had been terminated.

The 1968 Report of a System Committee stated that discounting of paper by the Reserve Banks can "serve as an important adjunct to

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open market operations in the implementation of monetary policy." <sup>27</sup> One of the results of that committee's recommendations was the Board's adoption in 1973 of a complete revision of its Regulation A. In a section relating to

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general principles, the regulation states that the effects of borrowings by member banks from their Reserve Banks do not remain localized but have "an important bearing on overall monetary and credit conditions." <sup>28</sup>

# General Principles: A Summary

# STATUTORY AND REGULATORY BASIS

Throughout this study attention has been focused principally on legislation and on regulations and interpretations of the Board with respect to various types of Reserve Bank loans. This chapter describes briefly some of the general principles that have governed the lending operations of the Reserve Banks. It provides, in effect, a partial summary of this history.

In the law itself, Congress has set forth some—but not very comprehensive—policy guide-lines. It has indicated that Reserve Bank loans are designed to accommodate commerce, industry, and agriculture; that they should be made with due regard for the maintenance of sound credit conditions; that ordinarily they should have short maturities; that the proceeds of such

For NOTES AND REFERENCES, see p. 266.

loans should not be used for speculative purposes; and that in exceptional or emergency circumstances loans may be made not only to member banks but also to nonmember banks and even to individuals, partnerships, and corporations.

These statutory principles have been reflected in regulations and rulings of the Board, and from time to time the Board has articulated additional principles or guidelines to be followed in administration of the Federal Reserve discount window. In its 1955 revision of Regulation A, the Board for the first time sought to state general principles governing Reserve Bank loans. These principles are restated, but with different emphasis, in a section of the 1973 revision of the regulation.

# ACCOMMODATION OF COMMERCE, INDUSTRY, AND AGRICULTURE

As indicated in the preceding chapter, it has always been a fundamental though very general principle that the lending authority of the Reserve Banks is to be used for the purpose of accommodating commerce, industry, and agriculture. One of the purposes of the Federal Reserve Act, as stated in its title, was "to afford a means of rediscounting commercial paper." Section 13 of the original Act provided, and still provides,1 that a Reserve Bank "may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes." Section 14(d) of the Act provided, and still provides,2 that discount rates "shall be fixed with a view of accommodating commerce and business."

In 1933, what is now the eighth paragraph of section 4 of the Act 3 was amended to reflect certain guidelines regarding Reserve Bank lending to member banks. One of the guidelines was that Reserve Bank loans should be made "with due regard for \* \* \* the accommodation of commerce, industry, and agriculture."

In the foreword to the 1955 revision of Regulation A, the Board stated: 4

A principal function of the Federal Reserve Banks under the law is to provide credit assistance to member banks, through advances and discounts, in order to accommodate commerce, industry, and agriculture.

The 1973 revision similarly provides: \*

Extending credit to member banks to accommodate commerce, industry, and agriculture is a principal function of Reserve Banks.

In the early years of the System, the ability of the Reserve Banks to accommodate commerce, industry, and agriculture was limited by the fact that the law authorized loans only to member banks, by the Board's adherence to the real-bills doctrine, and by narrow interpretations of what constituted paper drawn for agricultural, industrial, or commercial purposes. Fortunately, the real-bills doctrine was soon discarded and both Congress and the Board in later years acted to enable the Reserve Banks to play a much more expanded role in accommodating the needs of the economy.

In the 1920's, amendments to the law gave the Reserve Banks broader scope in providing credit assistance to agriculture and in developing a market for bankers' acceptances. Congress also authorized advances to member banks on U.S. Government obligations as well as on commercial paper. In the 1930's, the depression gave rise to radical departures from the original philosophy of the law, as reflected by amendments authorizing loans to member banks on any satisfactory security (though at a higher rate) and extensions of credit to nonmember banks, business enterprises, and to individuals, partnerships, and corporations in general.

Within statutory limits, the Board has taken actions over the years to liberalize requirements as to the types of paper that are eligible for discount or as collateral for Federal Reserve Bank advances. For example, while the framers of the original Act undoubtedly considered commercial paper to be only that paper arising out of what they termed business transactions, the Board in 1937 took the position that any purchase and sale of goods, including the purchase of automobiles or radios by individuals, was a commercial transaction. In addition to such consumer paper, the Board also held, contrary to its earlier position, that finance paper, that is, paper the proceeds of which were to be re-lent to third persons, could likewise be regarded as eligible for discount. In its 1973 revision of Regulation A, the Board has treated even real estate mortgages and other permanent investment paper as commercial paper eligible for discount if it meets statutory maturity requirements and if the proceeds are not used merely for investment.

# THE REAL-BILLS DOCTRINE: AN ABANDONED PRINCIPLE

The original Federal Reserve Act reflected a belief that only short-term, self-liquidating paper should be eligible as a basis for Federal Reserve credit. It was felt that this was necessary to assure the liquidity of commercial banks. It was also believed that the pledging of such paper as security for the issuance of Federal Reserve notes would guarantee an elastic currency; it was expected that the volume of currency would expand and contract directly in response to the varying credit needs of the economy as reflected by the volume of shortterm borrowings by commercial and agricultural enterprises. For these reasons, the Board expounded the principle that all paper offered for discount should be essentially self-liquidating; in other words, that it "should represent in every case some distinct step in the production or distribution process—the progression of goods from producer to consumer." 6

It was not long before this philosophy—the real-bills doctrine—underwent drastic erosion. The story of the demise of the doctrine was told in the Board's letter of August 21, 1963, to Congress recommending legislation to authorize Reserve Bank loans on any satisfactory security. That letter stated:

The principle that Federal Reserve credit should be extended only on the basis of short-term, self-liquidating paper was departed from as early as 1916, during the First World War, when the law was amended to authorize the Reserve Banks to make 15-day advances to member banks, not only on the security of "eligible paper" but also on the security of direct obligations of the United States. A more significant departure occurred in 1932, when Congress authorized the Reserve Banks to make advances to member banks in exceptional and unusual circumstances on any security satisfactory to the Reserve Banks, although at a penalty rate of interest. This authority, at first temporary, was made permanent in 1935, and it is no longer limited to exceptional and unusual circumstances, although such advances continue to carry a penalty rate of interest.

The concept that limitation of discounts to short-term, self-liquidating paper would serve automatically to regulate the volume of Federal Reserve notes in circulation has also been breached by amendments to the law and has been refuted by experience. In 1932, Congress authorized the issuance of Federal Reserve notes on the security of Government obligations in addition to eligible paper and gold. This authority was originally of a temporary nature, but it was made permanent in 1945. The volume of Federal Reserve notes today fluctuates with the changing demands of the economy without regard to the nature of the paper offered as collateral for Federal Reserve credit or pledged as security for Federal Reserve notes.

Each of these legislative changes took place during a period of economic stress that served to make clear the inadequacy of the original framework for Federal Reserve credit extension. The credit needs of American businessmen, farmers, and consumers were evolving in many ways that could not be adequately handled by the old instrument of short-term, commercial-type paper; and the rapid growth of both private and Governmental economic activity generated credit requirements far in excess of those that could be supported by the relatively small volume of "eligible paper."

Despite changes in the character of paper held by commercial banks and the repeated and necessary departures from the original concept that discounts should be based only on short-term, self-liquidating paper, the law continues to impose unduly restrictive requirements as to the nature and maturity of the paper that may be discounted by the Reserve Banks or offered as security for advances by the Reserve Banks.

For many years, it has been generally recognized that the concept of an elastic currency based on short-term, self-liquidating paper is no longer in consonance with banking practice and the needs of the economy.

It has long been apparent that the narrow requirements of the law regarding "eligible paper" serve no useful purpose and that it would be preferable to place emphasis on the soundness of the paper offered as security for advances and the appropriateness of the purposes for which member banks borrow. The one-year paper of many bank customers that is not now eligible for discount may be as satisfactory collateral as the 90-day notes of other customers. Moreover, the nature of the collateral provides no assurance that the borrowing bank will use the proceeds for an appropriate purpose.

Despite the Board's recommendation, repeated in subsequent years, the law has not been changed to repeal the vestiges of the real-bills doctrine. The principle of that doctrine has been rejected and it is now recognized that the soundness of paper offered as a basis for Reserve Bank credit is more important than compliance with maturity requirements and limitations as to the nature of the transactions giving rise to the paper. The principle has been rejected, but these requirements and limitations continue to inhibit the ability of the Reserve Banks to extend credit to member banks in order to accommodate commerce, industry, and agriculture. Only if a member bank is willing or compelled by circumstances to pay a higher rate of interest may a Reserve Bank extend credit, under section 10(b) of the Federal Reserve Act, without regard to such requirements and limitations.

# MAINTENANCE OF SOUND CREDIT CONDITIONS

As was soon demonstrated by experience during the early years of the System, one of the difficulties with the real-bills doctrine was that the discounting by the Reserve Banks of short-term, self-liquidating paper growing out of productive commercial transactions gave no assurance that the credit extended to member banks would actually be used by them for productive purposes. The Board became concerned during the 1920's by the apparent fact that member banks were using the proceeds of Reserve Bank loans for speculative purposes, and efforts were made through direct pressure to make certain that the proceeds of such loans were being used for appropriate purposes.

Thus, a new general principle emerged: Federal Reserve credit, regardless of the nature of the paper offered for discount, should not be used in a manner inconsistent with the maintenance of sound credit conditions. This principle was reflected in amendments made by the Banking Act of 1933 to the eighth paragraph of section 4 of the Federal Reserve Act. It was provided that, in extending credit to its member banks, each Reserve Bank should give due regard not only to the accommodation of com-

merce, industry, and agriculture but also to the maintenance of sound credit conditions. In addition, but along the same line, each Reserve Bank was required to "keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit for the speculative carrying of or trading in securities, real estate, or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions." In determining whether to grant credit accommodations, the Reserve Bank was required to give consideration to such information. If the Board of Governors found that any member bank was making unduc use of bank credit, the Board was authorized, after opportunity for hearing, to suspend such bank from use of the credit facilities of the System.6

Reflecting the intent of the 1933 amendments to the law, the Board in its 1955 revision of Regulation A stated that, in determining whether to extend credit, a Reserve Bank should give due regard to "the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to

the individual institution and the economy generally." As revised in 1973, the regulation notes that the law requires every Reserve Bank to keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining

whether undue use is being made of bank credit for any purpose "inconsistent with the maintenance of sound credit conditions" and that, in determining whether to extend credit, the Reserve Bank shall give consideration to such information.

# INAPPROPRIATE USES OF FEDERAL RESERVE CREDIT

### SPECULATION OR INVESTMENT

As has been indicated, amendments to the Federal Reserve Act in 1933 made explicit the principle that Federal Reserve credit should not be used by member banks for speculative purposes. This principle, of course, has been recognized since the earliest days of the System. For example, in 1923, referring to the Federal Reserve discount window, the Board stated: <sup>8</sup>

It is not a system of credit for either investment or speculative purposes \* \* \*. The exclusion of the use of Federal reserve credit for speculative and investment purposes and its limitation to agricultural, industrial, or commercial purposes thus clearly indicates the nature of the tests which are appropriate as guides in the extension of Federal reserve credit.

Even though the proceeds of Federal Reserve Bank loans are not used for purely speculative purposes, they are not to be used merely for investment purposes or for the purpose of trading in securities other than obligations of the United States. Section 13 of the original Federal Reserve Act expressly provided that while the Board should have the right to define the character of paper eligible for discount, no such definition should include paper covering "merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States." This provision is still in the law.

It has been noted in an earlier chapter that, as a corollary of the real-bills doctrine, the Board until 1973 had always prohibited Reserve Bank loans on paper drawn to cover permanent or fixed investments, such as real estate, buildings, or machinery. This position was reversed in the revision of Regulation A adopted in 1973. Under that revision, fixed- or permanent-investment paper is regarded as commercial paper eligible as collateral for Federal Reserve credit provided the proceeds are not to be used merely for investment purposes and provided, of course, that the paper meets applicable maturity requirements.

### USE FOR PROFIT

Federal Reserve credit should not be used by a member bank in order to take advantage of differential rates, for example, a difference between the discount rate and the bank's own lending rates. In 1928 the Board stated: "It is a generally recognized principle that reserve bank credit should not be used for profit, \* \* \* " 11

This principle was recognized by the Board in its 1955 revision of Regulation A. The revised regulation provided that, in considering a request for credit accommodation, a Reserve Bank should consider whether the borrowing member bank "is borrowing principally for the purpose of obtaining a tax advantage or profiting from rate differentials." The reference to borrowing for a tax advantage grew out of a situation during the early 1950's in which member banks were borrowing from their Reserve Banks in order to avoid higher taxes under the then-existing excess profits tax. In fact, it was primarily this development that prompted the Board to revise its regulation in 1955 in order

to include a statement of principles regarding the proper use of Federal Reserve credit.

In recent years, with the rapid development of the Federal funds market, it has been the policy of the System to discourage member banks from being net sellers of Federal funds while borrowing from a Reserve Bank. As stated in the Report of a System Committee in July 1968, this restriction is intended "to preclude a large day-to-day retailing operation in Federal Reserve credit obtained through the discount window." 12

### CONTINUOUS BORROWING

In an earlier chapter it was noted that in 1920 the Federal Reserve Act was amended to provide for progressive discount rates as a deterrent to continuous borrowings by member banks. Although that expedient was not effective and the amendment was later repealed, the System has consistently emphasized a policy of discouraging continuous borrowings. The reasons for that policy were set forth in the Board's 1926 Annual Report.13 In 1952 Chairman Martin stated that "continuous indebtedness to the Reserve Banks should be avoided." 14 When Regulation A was revised in 1955, it contained a statement that, under "ordinary circumstances, the continuous use of Federal Reserve credit by a member bank over a considerable period of time is not regarded as appropriate." 15

One of the reasons for the policy against continuous borrowing apparently has been that it could be inconsistent with the provisions of paragraph 8 of section 4 of the Federal Reserve Act that require the board of directors of a Reserve Bank to administer the Bank's affairs "fairly and impartially and without discrimination in favor of or against any member bank or banks" and, in extending credit accommodations, to give due regard to "the claims and demands of other member banks." Presumably, it was felt that continued and excessive loans to a particular member bank "would not be fair to the other member banks which may be active competitors of the borrowing member bank." 16

Another reason for the policy against continuous borrowing is that it could impair the ability of the borrowing member bank in case of insolvency to meet its obligations to depositors; in other words, it would not be consistent with prudent banking practice. Still another reason for the policy is that extended borrowings by a member bank from its Reserve Bank would in effect constitute a use of Federal Reserve credit as a substitute for the member bank's capital. Thus, the 1973 revision of Regulation A states, as a general principle, that "Federal Reserve credit is not a substitute for capital and ordinarily is not available for extended periods."

It should be noted that this principle is qualified by the word "ordinarily" and that, as indicated later, it is not intended to preclude borrowings for extended periods in order to meet unusually long seasonal needs of member banks or to assist member banks in emergency circumstances.

### SHIFT IN EMPHASIS

The principles just discussed with respect to inappropriate uses of Federal Reserve credit are still being followed. Nevertheless, there has been evidence in recent years of a tendency to place less emphasis on inappropriate borrowings and to give greater emphasis to the use of Federal Reserve credit for appropriate purposes.

When Regulation A was revised in 1955, one of the objectives was to reinforce a limited use of the discount window; at that time most member banks were in heavily liquid positions, and it was felt that banks should resort to Reserve Bank credit only on a short-term basis when other sources of funds fell short of their appropriate needs.17 Thus, although the revision referred briefly to extension of Federal Reserve credit on a short-term basis to enable a member bank to adjust its asset position when necessary and to the availability of such credit for longer periods to meet unusual situations, it emphasized the fact that access to the discount window was a privilege of membership and that continuous use of Federal Reserve credit, as well as borrowing to obtain a tax advantage or to profit from rate differentials, was inappropriate.

The 1968 Report of a System Committee evidenced a subtle change in attitude. It began with a statement that the redesign of the discount window proposed by that committee had

as its chief objective "increased use of the discount window." In 1968 member banks were in a much less liquid position than they had been in 1955, and the revision of Regulation A that grew out of the committee's recommendations included more liberal provisions

for seasonal credit for extended periods of time. In brief, the 1968 proposal, as well as the 1973 revision of the regulation, reflected an intent to encourage greater use of the discount window. Further indications of this shift in policy will be mentioned in later sections of this chapter.

## APPROPRIATE USES OF FEDERAL RESERVE CREDIT

# SHORT-TERM ADJUSTMENT CREDIT

As a general principle, one of the most appropriate uses of Federal Reserve credit is to enable member banks to make short-term adjustments in their reserve positions. The 1968 Report of a System Committee stated that "one of the basic functions of the Federal Reserve System has been to provide temporary additions to commercial bank reserves through loans to member banks, in order to cushion the process of adjustment within the financial mechanism." 19

The foreword to the 1955 revision of Regulation A provided:

Federal Reserve credit is generally extended on a short-term basis to a member bank in order to enable it to adjust its asset position when necessary because of developments such as a sudden withdrawal of deposits or seasonal requirements for credit beyond those which can reasonably be met by use of the bank's own resources.

The revision of the regulation adopted in 1973 contemplates that loans to member banks to meet seasonal requirements for credit might be on a longer-term basis than ordinary adjustment credit loans. With respect to adjustment credits, the regulation provides:

Federal Reserve credit is available on a short-term basis to a member bank, under such rules as may be prescribed, to such extent as may be appropriate to assist such bank in meeting temporary requirements for funds or to cushion more persistent outflows

of funds pending an orderly adjustment of the bank's assets and liabilities.

Since the beginning of the System, it has been contemplated that each Federal Reserve extension of credit normally will mature over a short period of time. The original Act authorized the discounting of commercial paper for member banks only if it had a maturity of not more than 90 days at the time of discount. Under subsequent amendments to the Act, advances to member banks in general may be made only for periods of not more than 90 days. An exception has been made with respect to agricultural paper, which, under present law, is eligible for discount if it has a maturity of not more than 9 months at the time of discount.

It has already been noted that amendments to the law have authorized loans to member banks on any satisfactory security for periods up to 4 months, but only at a penalty interest rate. Loans with maturities of up to 5 years to commercial and industrial businesses were authorized in 1934 but that authority was repealed in 1958.

In general, therefore, advances to member banks at the discount rate may not be made with maturities of more than 90 days. Moreover, a Reserve Bank cannot legally commit itself to renew a loan at maturity although it may indicate that it will give sympathetic consideration to a requested renewal in certain circumstances.

Even though loans may be made to member banks for up to the maximum maturity permitted by the law, it has been the policy of the System to limit maturities according to the individual bank's circumstances; as a matter of general practice, loans to member banks for adjustment purposes usually are made to mature in less than 30 days, with renewals as necessary. Also as a matter of practice, some member banks, particularly the larger banks, prefer to keep the maturity of their borrowings to 1 or 2 days in order to have flexibility in managing their reserve accounts.

### SEASONAL CREDIT

As previously indicated, the 1955 revision of Regulation A stated that Federal Reserve credit would be extended on a short-term basis in order to enable a member bank to adjust its asset position when necessary because of developments such as a sudden withdrawal of deposits or seasonal requirements for credit beyond those that could reasonably be met by use of the bank's own resources. That language would suggest that all Reserve Bank loans to meet the seasonal credit requirements of member banks are for short periods of time.

In 1968, however, the System Committee studying the discount mechanism proposed that arrangements be permitted under which seasonal credit accommodations might be extended to a member bank for such period of time as would be necessary to enable the bank to meet such needs. This is another instance in which the Board's attitude in recent years toward use of the discount window apparently has become more liberal than the attitude reflected in 1955.

The recommendations of the System Committee in 1968 with respect to a seasonal borrowing privilege were reflected in the revision of Regulation A adopted by the Board in 1973. Under the new regulation, Federal Reserve credit is available to a member bank that "lacks reasonably reliable access to national money markets" in order to assist it in meeting seasonal needs if the credit is arranged in advance and if the Reserve Bank is satisfied that such needs will persist for at least eight consecutive weeks. The revision contemplates that, although a Reserve Bank could not make an advance for more than 90 days, it would normally be pre-

pared to consider further credit extensions if the member bank's seasonal needs should persist beyond that period. As a limitation upon such a seasonal borrowing privilege, the new regulation limits seasonal credit in ordinary circumstances to the amount by which the borrowing bank's seasonal needs exceed 5 per cent of its average total deposits in the preceding calendar year.

### **EMERGENCY CREDIT**

In addition to short-term adjustment credit and longer-term seasonal credit, it is an accepted principle that a Reserve Bank may extend credit to a member bank in unusual or emergency situations and, if need be for that purpose, for extended periods of time. The 1968 Report of a System Committee stated that the Federal Reserve System "has a clear responsibility to lend to member banks in both isolated and widespread emergency situations" and that this constitutes one of the benefits of Federal Reserve membership.<sup>20</sup>

The 1955 revision of Regulation A stated that Federal Reserve credit was available "when necessary in order to assist member banks in meeting unusual situations, such as may result from national, regional, or local difficulties or from exceptional circumstances involving only particular member banks." Similarly, the revision of the regulation adopted in 1973 states as a general principle that "Federal Reserve credit is available to assist member banks in unusual or emergency circumstances such as may result from national, regional, or local difficulties or from exceptional circumstances involving only a particular member bank."

It has been recognized that in most cases in which member banks require emergency credit from the Reserve Banks, the credit will be required for a period longer than would be permitted under the ordinary rules of the discount window. Even so, if the member bank's difficulties arise from an internal problem, it may be necessary for the Reserve Bank to arrange a daily maturity for the loan so that it may follow the member bank's progress throughout the borrowing span.

# LENDER OF LAST RESORT

The original Federal Reserve Act contemplated that Federal Reserve credit would be extended only to member banks, although a provision of the Act apparently envisaged the possibility of indirect extension of credit to a nonmember bank through the medium of a member bank if approved by the Board.

Over the years, as has been noted in this study, the Act has been amended to authorize the Reserve Banks to make loans directly to individuals, partnerships, and corporations on the security of U.S. Government and agency obligations or, in exigent or unusual circumstances, on the security of paper that would be eligible for discount in the hands of a member bank. The nature of these special authorizations has been discussed in detail in earlier chapters. As noted, the authority to make direct loans to business enterprises and any other corporations in unusual or exigent circumstances was utilized for several years during the 1930's, although not to any great extent. In 1966 and again in 1969, the Board took measures under which the Reserve Banks were placed in a position, if it became necessary, to extend credit directly to nonmember banks and other depositary-type financial institutions such as savings and loan associations.

In recent years, it has become customary to refer to the Federal Reserve System as the lender of last resort to all segments of the economy. Thus, the 1968 System Committee Report stated: <sup>21</sup>

The role of the Federal Reserve as the "lender of last resort" to other financial sectors of the economy may, under justifiable circumstances, require loans to institutions other than member banks. The apparent general approval of recent instances of lending and offering to lend to nonmember institutions has strengthened the belief that the System's ability to carry out this function should be readily available for use when needed. In contrast to the case of member banks, however, justification for Federal Reserve assistance to nonmember institutions must be in terms of the probable impact of failure on the economy's financial structure. It would be most unusual for the failure of a single institution or small group of institutions to have such significant repercussions as to justify Federal Reserve action.

The 1955 revision of Regulation A, while referring to extensions of credit to member banks in exceptional circumstances, contained no reference to the extension of emergency credit to others. In contrast, the revision of the regulation adopted in 1973 expressly provides for the extension of Federal Reserve credit to individuals, partnerships, and corporations in emergency circumstances on the security of U.S. Government obligations if, in a Reserve Bank's judgment, "credit is not practicably available from other sources and failure to obtain such credit would adversely affect the economy."

# PROTECTION OF RESERVE BANKS

Although the Reserve Banks are organized and operated for public purposes and not for profit, their operations are nevertheless like those of commercial banks to the extent that they have stockholders and directors and are expected to conduct their business on a sound basis. Their loans are made on a businesslike basis—with interest and with security.

The discount provisions of the original Federal Reserve Act required—and still require that paper offered by member banks for discount be endorsed by the borrowing member bank, thus affording the lending Reserve Bank recourse against the member bank.22 When the law was amended to authorize advances to member banks on their own notes, such advances were required to be secured, at first by paper eligible for discount or Government obligations and later by any paper eligible for discount or for purchase by the Reserve Banks. In 1932 the Reserve Banks were authorized to make advances to member banks on any security satisfactory to the lending Reserve Bank. Loans to individuals, partnerships, or corporations must be secured by obligations of the United States or agencies of the United States if credit is extended under the thirteenth paragraph of section 13; or if, under that paragraph, emergency loans are made on eligible paper, the paper must be endorsed or otherwise secured to the satisfaction of the Reserve Bank.

In brief, it has always been understood that the Reserve Banks should make only loans that are adequately secured. At one time the Board's Regulation A specifically authorized the Reserve Banks to require additional collateral when deemed desirable. The 1955 revision, however, stated that a Reserve Bank in general should limit such collateral to "the minimum consistent with safety," and the 1973 revision

provides that a Reserve Bank should "require only such amount of collateral as it deems necessary or desirable."

The Board's regulation until recent years required that commercial or agricultural paper offered for discount or as collateral for advances should be negotiable. Although some added protection was afforded by negotiability, this requirement was eliminated in 1970, partly in recognition of the increasing practice of making interest on notes dependent on changes in the prime rate—a practice that made the notes nonnegotiable in a technical sense. Shortly afterward, the Board amended its regulation to permit advances to member banks pursuant to lending agreements already in effect without the execution of a traditional promissory note in connection with each advance.

From these changes in practice emerged the concept that the Reserve Banks, while they should make only sound and well-secured loans, should be allowed to extend credit, in the public interest, without having to take all possible precautions to avoid loss. In some instances, it may be difficult to ascertain how far a Reserve Bank should go in extending credit to member banks (or to others) when the borrower is in a difficult situation and the Reserve Bank would be subject to possible loss. In such cases, there is a delicate balance between avoidance of loss and the desirability of preserving the financial stability of the borrower.

# DISCRETION OF FEDERAL RESERVE BANKS

### LEGISLATIVE INTENT

A fundamental principle underlying the lending authority of the Federal Reserve Banks is that this authority is purely discretionary. A Reserve Bank is not obliged or required to extend credit in any particular case, even though the loan may be for a purpose contemplated by the law and may be secured by eligible paper.

The Reserve Bank may refuse to make a loan if it is not satisfied as to the soundness of the loan or if it believes that the loan would result in an improper use of Federal Reserve credit that would be inconsistent with the general principles heretofore mentioned. In the final analysis, the decision in each case rests in the judgment of the Federal Reserve Bank.

So well established is the discretionary nature of the lending authority of the Reserve Banks that it is now almost impossible to believe that the framers of the original Federal Reserve Act came very close to making it mandatory. Senator Hitchcock, who led the minority section of the Senate Banking and Currency Committee, had urged that a member bank should be entitled as of right to obtain discounts at least up to the amount of its capital stock.23 In support of this proposal, it was argued that if the lending authority were discretionary, a Reserve Bank might refuse to extend credit for any of the plausible reasons that bankers are in the habit of giving; 21 that if a member bank were required to carry reserves with its Federal Reserve Bank, it was only right that it should be entitled to discounts in time of need up to the amount of its capital stock; 25 and finally, that mandatory discounting of eligible paper would insure an adequate supply of the new Federal Reserve currency that was expected to be issued on the basis of such paper.26

In opposition to these arguments, the majority section of the Senate committee led by Senator Owen pointed out that "many unlooked-for conditions" might arise that would make it unwise to compel the Reserve Banks to discount paper in particular cases even though legally eligible for discount; 27 also, that the eligibility of paper offered for discount should be only the first step and that the law should not take away from the directors of a Reserve Bank the right to investigate the soundness of that paper.28 In answer to arguments that compulsory discounting would prevent discrimination between member banks, advocates of the Owen bill pointed to the provision of that bill that required the directors of each Reserve Bank to administer its affairs "fairly and impartially and without discrimination in favor of or against any member bank or banks." Senator Shafroth explained: 29

\* \* \* We thought that [the compulsory discount provision of the Hitchcock bill] was too extreme a provision; it was thought wise that there might be conditions of the bank that would not justify the discounting of its

paper. For that reason we put in a clause, which to a large extent is advisory to them, but which, nevertheless, indicates the policy that should be pursued by them in making these discounts where they fairly can.

Senator Pomerene likewise felt that the provision of the Owen bill would adequately prevent discrimination.<sup>30</sup> He, as well as Senator Owen, pointed out that, in view of this provision, any member bank that felt it had been discriminated against could appeal to the Federal Reserve Board. In this connection, Senator Owen made the following succinct statement regarding the contemplated relationship between the Board and the Federal Reserve Banks: <sup>31</sup>

I take it that the Federal reserve board, under its general supervisory control of the system, would have a right to hear such a complaint, to call the attention of the board of directors to the complaint, and exact of them fair treatment of the member bank who might have been discriminated against; but I do not take it that the Federal reserve board would pass upon the question of the security or upon the particular transaction or take it out of the hands of the local board. It would only instruct them to discharge their duty properly under the provisions of the bill.

In the end, Senator Hitchcock's amendment to substitute his compulsory-discount provision for the Owen bill's nondiscrimination provision was defeated by a close vote of 37 to 31.32 The provision of the Owen bill was accepted by the conference committee and became a part of the original Act.

In keeping with its rejection of the Hitchcock proposal for mandatory discounts, Congress has deliberately used permissive language in provisions of the Federal Reserve Act relating to this subject. For example, the word "may" is used in those provisions that deal with discounts of commercial and agricultural paper, discounts of bankers' acceptances, advances on Government obligations, and advances under section 10(b) on any satisfactory security. Moreover, the Supreme Court of the United States has stated that the word "may," as used in the Federal Reserve Act, is not to be construed as

"shall," since "throughout the act the distinction is clearly made between what the Board and the reserve banks 'shall' do and what they 'may' do." <sup>33</sup> In this connection, it is significant that when the eighth paragraph of section 4 of the Federal Reserve Act was amended by the Banking Act of 1933, the language of that paragraph relating to extensions of Federal Reserve credit was rephrased to change the word "shall" to "may."

### RECOGNITION BY THE BOARD

The principle that the Federal Reserve Banks must exercise their own judgment and discretion in deciding whether to discount paper for member banks was recognized by the Federal Reserve Board in the early years of the System. In 1920 the Board ruled that, even though paper might be legally eligible for discount, a Federal Reserve Bank was under no obligation to discount such paper, but might accept it or refuse it "in the exercise of its discretionary power." 34 In the same year the Board held that, although a banker's acceptance might be technically eligible for discount, a Federal Reserve Bank might, in its discretion, decline to discount the acceptance on the ground that it was not a desirable investment.35

The Board's 1955 revision of Regulation A specifically referred to access to the Federal Reserve discount window as "a privilege of membership in the Federal Reserve System" and stated that applications for credit accommodation are considered by a Reserve Bank "in the light of its best judgment" in conformity with the principles stated in the regulation and with the provisions of the law.

## JUDICIAL CONFIRMATION

In 1929 the discretion of the Reserve Banks in granting discount accommodations was judicially confirmed by a Federal Circuit Court of Appeals. In Raichle v. Federal Reserve Bank of New York,<sup>36</sup> suit had been brought to enjoin the Reserve Bank from engaging in open market operations, declining to discount eligible paper, and raising the discount rate. Specifically, it was charged that the Reserve Bank had

wrongfully refused to discount paper for certain member banks unless they liquidated loans to brokers. The suit was dismissed because the Federal Reserve Board, as an indispensable party, had not been joined. The court pointed out, however, that a Federal Reserve Bank "is not under any compulsion to rediscount eligible paper, for the words of the act in respect to rediscounting are wholly permissive." With respect to the charge that the Reserve Bank had wrongfully coerced member banks to call collateral loans by refusing to discount eligible paper for such banks, the court declared: "Such a refusal was not a wrong, because no provision of the act requires the [Federal Reserve] bank to discount unless so ordered by the Board." [Emphasis in original.] The court's use of the words "unless so ordered by the Board" could be misleading. The only provision of law under which a Reserve Bank may be ordered by the Board to extend credit is that contained in section 11(b) of the Federal Reserve Act, which authorizes the Board to require a Reserve Bank to rediscount the discounted paper of another Reserve Bank. As a matter of law, the Board cannot require any Reserve Bank to make loans to member banks or to individuals, partnerships, and corporations.

# QUASI-AUTOMATIC ACCESS TO FEDERAL RESERVE CREDIT

In July 1968 a System Committee proposed a redesign of the Federal Reserve discount window, a major feature of which was a suggestion that member banks be given a "basic borrowing privilege." Under that proposal, a Reserve Bank would extend credit on a virtually automatic basis to member banks within certain limitations on amounts and frequency of borrowing. It was contemplated that such an arrangement would enable member banks to use the discount window more readily when they needed funds for short-term adjustment purposes and that this privilege would be particularly attractive to the great majority of small member banks that were making no recourse to the discount window.37 This proposal, however, has not been implemented by the Board.

# THE BASIC PRINCIPLE: ECONOMIC STABILITY AND GROWTH

Underlying all of the general principles discussed in this chapter is the basic objective of utilizing Federal Reserve credit facilities to assure a sound financial system and to promote economic stability and growth.

Thus, the foreword to the Board's 1955 revision of Regulation A stated, with respect to the discount function of the Reserve Banks, that it "is administered in the light of the basic objective which underlies all Federal Reserve credit policy, i.e., the advancement of the public interest by contributing to the greatest extent possible to economic stability and growth."

The revision of Regulation A adopted in 1973 specifically states that the lending functions of the System "are conducted with due regard to the basic objectives of the Employment Act of 1946 and the maintenance of a sound and orderly financial system."

To sum up, the lending functions of the Reserve Banks, like all other functions of the Federal Reserve System, are in the nature of a public trust to be exercised always in the interest of the general welfare. No better statement of this principle can be found than that contained in the Board's first *Annual Report* to Congress, for the year 1914, when, in discussing the "place and function of the Federal Reserve Banks in our banking and credit system," the Board said: 38

\* \* It [a Federal Reserve Bank] should at all times be a steadying influence, leading when and where leadership is requisite, but never allowing itself to become an instrument for the promotion of the selfish interest of any private or sectional group, be their aims and methods open or disguised. It should never be lost to sight that the Reserve Banks are invested with much of the quality of a public trust. They were created because of the existence of certain common needs and interests, and they should be administered for the common welfare—for the good of all.



# Textual Changes in Provisions of the Federal Reserve Act

# **EXPLANATION**

The following compilation sets forth provisions relating to the lending functions of the Federal Reserve Banks as contained in the original Federal Reserve Act or in later amendments to that Act and indicates textual changes in such provisions made by amendatory statutes.

Italics indicate new language inserted or added by amendments; cancelled words indicate old language stricken out.

Three asterisks indicate the omission of language of a paragraph not changed by a particular amendment; five asterisks indicate the omission of an intervening paragraph or paragraphs not affected by an amendment.

"Original Act" means the Federal Reserve Act of December 23, 1913 (38 Stat. 251).

A bracketed number preceding a paragraph of a section of the Act indicates the number of the corresponding paragraph, if any, contained in that section as of May 1, 1973.

A bracketed citation at the end of a paragraph indicates where the paragraph, if still in force, may be found in the United States Code.

#### **SECTION 4**

# Original Act

- [6] Every Federal reserve bank shall be conducted under the supervision and control of a board of directors. [12 U.S.C. § 301]
- [7] The board of directors shall perform the duties usually appertaining to the office of directors of banking associations and all such duties as are prescribed by law. [12 U.S.C. § 301]
- [8] Said board shall administer the affairs of said bank fairly and impartially and without discrimination in favor of or against any member bank or banks and shall, subject to the provisions of law and the orders of the Federal Reserve Board, extend to each member bank such discounts, advancements and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks.

# Act of June 16, 1933 (48 Stat. 162):

Said board of directors shall administer the affairs of said bank fairly and impartially and without discrimination in favor of or against any member bank or banks and shall may, subject to the provisions of law and the orders of the Federal Reserve Board, extend to each member bank such discounts, advancements, and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks, the maintenance of sound credit conditions, and the accommodation of commerce, industry, and agriculture. The Federal Reserve Board may prescribe regulations further defining within the limitations of this Act the conditions under which discounts, advancements, and the accommodations may be extended to member banks. Each Federal reserve bank shall keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit for the speculative carrying of or trading in securities, real estate, or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions; and, in determining whether to grant or refuse advances, rediscounts or other credit accommodations, the Federal reserve bank shall give consideration to such information. The chairman of the Federal reserve bank shall report to the Federal Reserve Board any such undue use of bank credit by any member bank, together with his recommendation. Whenever, in the judgment of the Federal Reserve Board, any member bank is making such undue use of bank credit, the Board may, in its discretion, after reasonable notice and an opportunity for a hearing, suspend such bank from the use of the credit facilities of the Federal Reserve System and may terminate such suspension or may renew it from time to time. [12 U.S.C. § 301]

<sup>\*</sup>The Banking Act of 1935 provided that after the date of that Act the words "Federal Reserve Board", wherever they formerly appeared in the Federal Reserve Act or other acts of Congress, were changed to read "Board of Governors of the Federal Reserve System."

#### SECTION 9

# Act of June 21, 1917 (40 Stat. 232):

[13] \* \* \* Subject to the provisions of this Act and to the regulations of the board made pursuant thereto, any bank becoming a member of the Federal Reserve System shall retain its full charter and statutory rights as a State bank or trust company, and may continue to exercise all corporate powers granted it by the State in which it was created, and shall be entitled to all privileges of member banks: Provided, however, That no Federal reserve bank shall be permitted to discount for any State bank or trust company notes, drafts, or bills of exchange of any one borrower who is liable for borrowed money to such State bank or trust company in an amount greater than ten per centum of the capital and surplus of such State bank or trust company, but the discount of bills of exchange drawn against actually existing value and the discount of commercial or business paper actually owned by the person negotiating the same shall not be considered as borrowed money within the meaning of this section. The Federal reserve bank, as a condition of the discount of notes, drafts, and bills of exchange for such State bank or trust company, shall require a certificate or guaranty to the effect that the borrower is not liable to such bank in excess of the amount provided by this section, and will not be permitted to become liable in excess of this amount while such notes, drafts, or bills of exchange are under discount with the Federal reserve bank.

# Act of July 1, 1922 (42 Stat. 821):

\* \* \* Subject to the provisions of this Act and to the regula-[13] tions of the board made pursuant thereto, any bank becoming a member of the Federal Reserve System shall retain its full charter and statutory rights as a State bank or trust company, and may continue to exercise all corporate powers granted it by the State in which it was created, and shall be entitled to all privileges of member banks: Provided, however, That no Federal reserve bank shall be permitted to discount for any State bank or trust company notes, drafts, or bills of exchange of any one borrower who is liable for borrowed money to such State bank or trust company in an amount greater than ten per centum of the capital and surplus of such State bank or trust company, but the discount of bills of exchange drawn against actually existing value and the discount of commercial or business paper actually owned by the person negotiating the same shall not be considered as borrowed money within the meaning of this section that which could be borrowed lawfully from such State bank or trust company were it a national banking association. \* \* \* [12 U.S.C. § 330]

#### SECTION 10(a)

# Act of February 27, 1932 (47 Stat. 56):

- Sec. 10. (a) Upon receiving the consent of not less than five [1] members of the Federal Reserve Board, any Federal reserve bank may make advances, in such amount as the board of directors of such Federal reserve bank may determine, to groups of five or more member banks within its district, a majority of them independently owned and controlled, upon their time or demand promissory notes, provided the bank or banks which receive the proceeds of such advances as herein provided have no adequate amounts of eligible and acceptable assets available to enable such bank or banks to obtain sufficient credit accommodations from the Federal reserve bank through rediscounts or advances other than as provided in section 10(b). The liability of the individual banks in each group must be limited to such proportion of the total amount advanced to such group as the deposit liability of the respective banks bears to the aggregate deposit liability of all banks in such group, but such advances may be made to a lesser number of such member banks if the aggregate amount of their deposit liability constitutes at least 10 per centum of the entire deposit liability of the member banks within such district. Such banks shall be authorized to distribute the proceeds of such loans to such of their number and in such amount as they may agree upon, but before so doing they shall require such recipient banks to deposit with a suitable trustee, representing the entire group, their individual notes made in favor of the group protected by such collateral security as may be agreed upon. Any Federal reserve bank making such advance shall charge interest or discount thereon at a rate not less than 1 per centum above its discount rate in effect at the time of making such advance. No such note upon which advances are made by a Federal reserve bank under this section shall be eligible under section 16 of this Act as collateral security for Federal reserve notes. [12 U.S.C. § 347a]
- [2] No obligations of any foreign government, individual, partnership, association, or corporation organized under the laws thereof shall be eligible as collateral security for advances under this section. [12 U.S.C. § 347a]
- [3] Member banks are authorized to obligate themselves in accordance with the provisions of this section. [12 U.S.C. § 347a]

#### SECTION 10(b)

# Act of February 27, 1932 (47 Stat. 56):

[1] Sec. 10. (b) Until March 8, 1933, and in exceptional and exigent circumstances, and when any member bank, having a capital of not exceeding \$5,000,000, has no further eligible and acceptable assets

available to enable it to obtain adequate credit accommodations through rediscounting at the Federal reserve bank or any other method provided by this Act other than that provided by section 10(a), any Federal reserve bank, subject in each case to affirmative action by not less than five members of the Federal Reserve Board, may make advances to such member bank on its time or demand promissory notes secured to the satisfaction of such Federal reserve bank: Provided, That (1) each such note shall bear interest at a rate not less than 1 per centum per annum higher than the highest discount rate in effect at such Federal reserve bank on the date of such note; (2) the Federal Reserve Board may by regulation limit and define the classes of assets which may be accepted as security for advances made under authority of this section; and (3) no note accepted for any such advance shall be eligible as collateral security for Federal reserve notes.

No obligations of any foreign government, individual, partnership, association, or corporation organized under the laws thereof shall be eligible as collateral security for advances under this section.

# Act of February 3, 1933 (47 Stat. 794):

Sec. 10. (b) Until March 3, 1933, 1934, and in exceptional and exigent circumstances, and when any member bank, having a capital of not exceeding \$5,000,000, has no further eligible and acceptable assets available to enable it to obtain adequate credit accommodations through rediscounting at the Federal reserve bank or any other method provided by this Act other than that provided by section 10 (a), any Federal reserve bank, subject in each case to affirmative action by not less than five members of the Federal Reserve Board, may make advances to such member bank on its time or demand promissory notes secured to the satisfaction of such Federal reserve bank: Provided, That (1) each such note shall bear interest at a rate not less than 1 per centum per annum higher than the highest discount rate in effect at such Federal reserve bank on the date of such note; (2) the Federal Reserve Board may by regulation limit and define the classes of assets which may be accepted as security for advances made under authority of this section; and (3) no note accepted for any such advance shall be eligible as collateral security for Federal reserve notes.

#### Act of March 9, 1933 (48 Stat. 1):

[1] Sec. 10:(b). Until March 3; 1934; and iIn exceptional and exigent circumstances, and when any member bank; having a capital of not exceeding \$5,000,000; has no further eligible and acceptable assets available to enable it to obtain adequate credit

accommodations through rediscounting at the Federal reserve bank or any other method provided by this Act other than that provided by section 10(a), any Federal reserve bank, subject in each case to affirmative action by not less than five members of under rules and regulations prescribed by the Federal Reserve Board, may make advances to such member bank on its time or demand promissory notes secured to the satisfaction of such Federal reserve banks. Provided, That (1) e Each such note shall bear interest at a rate not less than 1 per centum per annum higher than the highest discount rate in effect at such Federal reserve bank on the date of such note: (2) the Federal Reserve Board may by regulation limit and define the classes of assets which may be accepted as security for advances made under authority of this section; and (3) no note accepted for any such advance shall be eligible as collateral security for Federal reserve notes. No advance shall be made under this section after March 3, 1934, or after the expiration of such additional period not exceeding one year as the President may prescribe.

No obligations of any foreign government, individual, partnership, association, or corporation organized under the laws thereof shall be eligible as collateral security for advances under this section.

# Act of August 23, 1935 (49 Stat. 684):

Sec. 10(b). In exceptional and exigent eircumstances, and [1] when any member bank has no further eligible and acceptable assets available to enable it to obtain adequate credit accommodations through rediscounting at the Federal reserve bank or any other method provided by this Act other than that provided by section 10(a), aAny Federal rReserve bank, under rules and regulations prescribed by the Federal Reserve Board of Governors of the Federal Reserve System, may make advances to such any member bank on its time or demand notes having maturiles of not more than four months and which are secured to the satisfaction of such Federal rReserve bank. Each such note shall bear interest at a rate not less than one-half of 1 per centum per annum higher than the highest discount rate in effect at such Federal \*Reserve bank on the date of such note. No advance shall be made under this section after March 3, 1934, or after the expiration of such additional period not exceeding one year as the President may prescribe. [12 U.S.C. § 347b]

#### SECTION 11

# Original Act:

[1] Sec. 11. The Federal Reserve Board shall be authorized and empowered: [12 U.S.C. § 248]

\* \* \* \* \*

- [3] (b) To permit, or, on the affirmative vote of at least five members of the Reserve Board to require Federal reserve banks to rediscount the discounted paper of other Federal reserve banks at rates of interest to be fixed by the Federal Reserve Board.
  [12 U.S.C. § 248(b)]
- (c) To suspend for a period not exceeding thirty days, and from time to time to renew such suspension for periods not exceeding fifteen days, any reserve requirements specified in this Act: Provided, That it shall establish a graduated tax upon the amounts by which the reserve requirements of this Act may be permitted to fall below the level hereinafter specified: And provided further, That when the gold reserve held against Federal reserve notes falls below forty per centum, the Federal Reserve Board shall establish a graduated tax of not more than one per centum per annum upon such deficiency until the reserves fall to thirty-two and one-half per centum, and when said reserve falls below thirtytwo and one-half per centum, a tax at the rate increasingly of not less than one and one-half per centum per annum upon each two and one-half per centum or fraction thereof that such reserve falls below thirty-two and one-half per centum. The tax shall be paid by the reserve bank, but the reserve bank shall add an amount equal to said tax to the rates of interest and discount fixed by the Federal Reserve Board.

#### Act of September 7, 1916 (39 Stat. 752):

[14] (m) Upon the affirmative vote of not less than five of its members the Federal Reserve Board shall have power, from time to time, by general ruling, covering all districts alike, to permit member banks to carry in the Federal reserve banks of their respective districts any portion of their reserves now required by section nineteen of this Act to be held in their own vaults.

# Act of March 3, 1919 (40 Stat. 1314, 1315):

[14] (m) Upon the affirmative vote of not less than five of its members the Federal Reserve Board shall have power, from time to time, by general ruling, covering all districts alike, to permit member banks to earry in the Federal reserve banks of their respective districts any portion of their reserves now required by section nineteen of this Act to be held in their own vaults to discount for any member bank notes, drafts, or bills of exchange bearing the signature or endorsement of any one borrower in excess of the amount permitted by section nine and section thirteen of this Act, but in no case to exceed twenty per centum of the member bank's capital and surplus: Provided, however, That all such notes, drafts, or bills of exchange discounted for any member bank in excess of the amount permitted under such sections shall be secured by not less than a like face amount of bonds or notes of the United States issued since April twenty-fourth, nineteen

hundred and seventeen, or certificates of indebtedness of the United States: Provided further, That the provisions of this subsection (m) shall not be operative after December thirty-first, nineteen hundred and twenty.

# Act of February 27, 1921 (41 Stat. 1146):

(m) Upon the affirmative vote of not less than five of its members, the Federal Reserve Board shall have power to permit Federal reserve banks to discount for any member bank notes, drafts, or bills of exchange bearing the signature or endorsement of any one borrower in excess of the amount permitted by section nine 9 and section thirteen 13 of this Act, but in no case to exceed twenty 20 per centum of the member bank's capital and surplus: Provided, however, That all such notes, drafts, or bills of exchange discounted for any member bank in excess of the amount permitted under such sections shall be secured by not less than a like face amount of bonds or notes of the United States issued since April twenty-fourth, nineteen hundred and seventeen, 24, 1917, for which the borrower shall in good faith prior to January 1, 1921, have paid or agreed to pay not less than the full face amount thereof, or certificates of indebtedness of the United States: Provided further, That the provisions of this subsection (m) shall not be operative after December thirty-first, nineteen hundred and twenty October 31, 1921.

#### Act of June 16, 1933 (48 Stat. 162, 167):

[14] (m) Upon the affirmative vote of not less than five six of its members, the Federal Reserve Board shall have power to permit Federal reserve banks to discount for any member bank notes, drafts, or bills of exchange bearing the signature or endorsement of any one borrower in excess of the amount permitted by section 9 and section 13 of this Act, but in no case to exceed 20 per centum of the member bank's capital and surplus: Provided, however, That all such notes, drafts, or bills of exchange discounted for any member bank in excess of the amount permitted under such sections shall be secured by not less than a like face amount of bonds or notes of the United States issued since April 24, 1917, for which the borrower shall in good faith prior to January 1, 1921, have paid or agreed to pay not less than the full face amount thereof, or certificates of indebtedness of the United States: Provided further, That the provisions of this subsection (m) shall not be operative after October 31, 1921 fix from time to time for each Federal reserve district the percentage of individual bank capital and surplus which may be represented by loans secured by stock or bond collateral made by member banks within such district, but no such loan shall be made by any such bank to any person in an amount in excess of 10 per centum of the unimpaired capital and surplus of such bank. Any percentage so fixed by the Federal Reserve Board shall be subject to change from time to time upon ten days' notice, and it shall be the duty of the Board

to establish such percentages with a view to preventing the undue use of bank loans for the speculative carrying of securities. The Federal Reserve Board shall have power to direct any member bank to refrain from further increase of its loans secured by stock or bond collateral for any period up to one year under penalty of suspension of all rediscount privileges at Federal reserve banks.

# Act of August 23, 1935 (49 Stat. 684, 713):

(m) Upon the affirmative vote of not less than six of its members the Federal Reserve Board of Governors of the Federal Reserve System shall have power to fix from time to time for each Federal reserve district the percentage of individual bank capital and surplus which may be represented by loans secured by stock or bond collateral made by member banks within such district, but no such loan shall be made by any such bank to any person in an amount in excess of 10 per centum of the unimpaired capital and surplus of such bank: Provided, That with respect to loans represented by obligations in the form of notes secured by not less than a like amount of bonds or notes of the United States issued since April 24, 1917, certificates of indebtedness of the United States, Treasury bills of the United States, or obligations fully guaranteed both as to principal and interest by the United States, such limitation of 10 per centum on loans to any person shall not apply, but State member banks shall be subject to the same limitations and conditions as are applicable in the case of national banks under paragraph (8) of section 5200 of the Revised Statutes, as amended (U. S. C., Supp. VII, title 12, sec. 84). Any percentage so fixed by the Federal Reserve Board of Governors of the Federal Reserve System shall be subject to change from time to time upon ten days' notice, and it shall be the duty of the Board to establish such percentages with a view to preventing the undue use of bank loans for the speculative carrying of securities. The Federal Reserve Board of Governors of the Federal Reserve System shall have power to direct any member bank to refrain from further increase of its loans secured by stock or bond collateral for any period up to one year under penalty of suspension of all rediscount privileges at Federal reserve banks.

#### Act of June 12, 1945 (59 Stat. 237):

[4] (c) \* \* \* And provided further, That when the gold reserve held against Federal reserve notes falls below forty 25 per centum, the Board of Governors of the Federal Reserve System shall establish a graduated tax of not more than one 1 per centum per annum upon such deficiency until the reserves fall to thirty-two and one-half 20 per centum, and when said reserve falls below thirty-two and one-half 20 per centum, a tax at the rate increasingly of not less than one and one-half 1 1/2 per centum per annum upon each two and one-half 2 1/2 per centum or fraction thereof that such reserve falls below thirty-two and one-half 20 per centum. The tax

shall be paid by the #Reserve bank, but the #Reserve bank shall add an amount equal to said tax to the rates of interest and discount fixed by the Board of Governors of the Federal Reserve System.

# Act of September 9, 1959 (73 Stat. 487, 488):

(m) \* \* \* Provided, That with respect to loans represented by obligations in the form of notes secured by not less than a like amount of bonds or notes of the United States issued since April 24, 1917, certificates of indebtedness of the United States, Treasury bills of the United States, or obligations fully guaranteed both as to principal and interest by the United States, such limitations of 10 per centum on loans to any person shall not apply, but State member banks shall be subject to the same limitations and conditions as are applicable in the case of national banks under paragraph (8) of section 5200 of the Revised Statutes, as amended (U.S.C., Supp. VII, title 12, sec. 84). \* \* \* [12 U.S.C. § 248(m)]

#### Act of March 18, 1968 (82 Stat. 50):

(c) To suspend for a period not exceeding thirty days, and from time to time to renew such suspension for periods not exceeding fifteen days, any reserve requirements specified in this Act: Provided, That it shall establish a graduated tax upon the amounts by which the reserve requirements of this Act may be permitted to fall below the level hereinafter specified: And provided further, That when the reserve held against Federal reserve notes falls below 25 per centum, the Board of Governors of the Federal Reserve System shall establish a graduated tax of not more than 4 per centum per annum upon such deficiency until the reserves fall to 20 per centum; and when said reserve falls below 20 per centum, a tax at the rate increasely of not less than 1 1/2 per centum per annum upon each 2 1/2 per centum or fraction thereof that such reserve falls below 20 per centum. The tax shall be paid by the Reserve bank, but the Reserve bank shall add an amount equal to said tax to the rates of interest and discount fixed by the Board of Governors of the Federal Reserve System: [12 U.S.C. § 248(c)]

#### SECTION 13

#### Original Act

Upon the indorsement of any of its member banks, with a [2] waiver of demand, notice and protest by such bank, any Federal reserve bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, in-

dustrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes, the Federal Reserve Board to have the right to determine or define the character of the paper thus eligible for discount, within the meaning of this Act. Nothing in this Act contained shall be construed to prohibit such notes, drafts, and bills of exchange, secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount; but such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States. Notes, drafts, and bills admitted to discount under the terms of this paragraph must have a maturity at the time of discount of not more than ninety days: Provided, That notes, drafts, and bills drawn or issued for agricultural purposes or based on live stock and having a maturity not exceeding six months may be discounted in an amount to be limited to a percentage of the capital of the Federal reserve bank, to be ascertained and fixed by the Federal Reserve Board.

- [6] Any Federal reserve bank may discount acceptances which are based on the importation or exportation of goods and which have a maturity at time of discount of not more than three months, and indorsed by at least one member bank. The amount of acceptances so discounted shall at no time exceed one-half the paid-up capital stock and surplus of the bank for which the rediscounts are made.
- [5] The aggregate of such notes and bills bearing the signature or indorsement of any one person, company, firm, or corporation rediscounted for any one bank shall at no time exceed ten per centum of the unimpaired capital and surplus of said bank; but this restriction shall not apply to the discount of bills of exchange drawn in good faith against actually existing values.
- [7] Any member bank may accept drafts or bills of exchange drawn upon it and growing out of transactions involving the importation or exportation of goods having not more than six months sight to run; but no bank shall accept such bills to an amount equal at any time in the aggregate to more than one-half its paid-up capital stock and surplus.
- [9] Section fifty-two hundred and two of the Revised Statutes of the United States is hereby amended so as to read as follows: No national banking association shall at any time be indebted, or in any way liable, to an amount exceeding the amount of its capital stock at such time actually paid in and remaining undiminished by losses or otherwise, except on account of demands of the nature following:

Fifth. Liabilities incurred under the provisions of the Federal Reserve Act.

[10] The rediscount by any Federal reserve bank of any bills receivable and of domestic and foreign bills of exchange, and of

acceptances authorized by this Act, shall be subject to such restrictions, limitations, and regulations as may be imposed by the Federal Reserve Board.

#### Act of March 3, 1915 (38 Stat. 958):

- [6] Any Federal reserve bank may discount acceptances which are based on the importation or exportation of goods and which have a maturity at time of discount of not more than three months, and indorsed by at least one member bank. The amount of acceptances so discounted shall at no time exceed one-half the paid up and unimpaired capital stock and surplus of the bank for which the rediscounts are made, except by authority of the Federal Reserve Board, under such general regulations as said board may prescribe, but not to exceed the capital stock and surplus of such bank.
- [7] Any member bank may accept drafts or bills of exchange drawn upon it and growing out of transactions involving the importation or exportation of goods having not more than six months' sight to run; but no bank shall accept such bills to an amount equal at any time in the aggregate to more than one-half of its paid-up and unimpaired capital stock and surplus, except by authority of the Federal Reserve Board, under such general regulations as said board may prescribe, but not to exceed the capital stock and surplus of such bank, and such regulations shall apply to all

banks alike regardless of the amount of capital stock and surplus.

# Act of September 7, 1916 (39 Stat. 752):

[2] Upon the indorsement of any of its member banks, with which shall be deemed a waiver of demand, notice and protest by such bank as to its own indorsement exclusively, any Federal reserve bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes, the Federal Reserve Board to have the right to determine or define the character of the paper thus eligible for discount, within the meaning of this Act. Nothing in this Act contained shall be construed to prohibit such notes, drafts, and bills of exchange, secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount; but such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States. Notes, drafts, and bills admitted to discount under the terms of this paragraph must have

- a maturity at the time of discount of not more than ninety days, exclusive of days of grace: Provided, That notes, drafts, and bills drawn or issued for agricultural purposes or based on live stock and having a maturity not exceeding six months, exclusive of days of grace, may be discounted in an amount to be limited to a percentage of the eapital assets of the Federal reserve bank, to be ascertained and fixed by the Federal Reserve Board.
- [5] The aggregate of such notes, drafts, and bills bearing the signature or indorsement of any one borrower, whether a person, company, firm, or corporation, rediscounted for any one bank shall at no time exceed ten per centum of the unimpaired capital and surplus of said bank; but this restriction shall not apply to the discount of bills of exchange drawn in good faith against actually existing values.
- [6] Any Federal reserve bank may discount acceptances which are based on the importation or expertation of goods and of the kinds hereinafter described, which have a maturity at the time of discount of not more than three months' sight, exclusive of days of grace, and which are indorsed by at least one member bank. The amount of acceptances so discounted shall at no time exceed one half the paid up and unimpaired capital stock and surplus of the bank for which the rediscounts are made, except by authority of the Federal Reserve Board, under such general regulations as said board may prescribe, but not to exceed the capital stock and surplus of such bank.
- Any member bank may accept drafts or bills of exchange drawn upon it having not more than six months' sight to run, exclusive of days of grace, and growing which grow out of transactions involving the importation or exportation of goods having not more than six months' eight to run; or which grow out of transactions involving the domestic shipment of goods provided shipping documents conveying or securing title are attached at the time of acceptance; or which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples. No member bank shall accept, whether in a foreign or domestic transaction, for any one person, company, firm, or corporation to an amount equal at any time in the aggregate to more than ten per cent of its paid-up and unimpaired capital stock and surplus unless the bank is secured either by attached documents or by some other actual security growing out of the same transaction as the acceptance but and no bank shall accept such bills to an amount equal at any time in the aggregate to more than one-half of its paid-up and unimpaired capital stock and surplus, except by authority of the Federal Reserve Board, under such general regulations as said board may prescribe, but not to exceed the capital stock and surplus of such bank, and such regulations shall apply to all banks alike regardless of the amount of capital stock and surplus.
- [8] 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 banks, 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.

. . . . .

[10] The discount and rediscount and the purchase and sale by any Federal reserve bank of any bills receivable and of domestic and foreign bills of exchange, and of acceptances authorized by this Act, shall be subject to such restrictions, limitations, and regulations as may be imposed by the Federal Reserve Board.

. . . . .

Any member bank may accept drafts or bills of exchange [12] drawn upon it having not more than three months' sight to run, exclusive of days of grace, drawn under regulations to be prescribed by the Federal Reserve Board by banks or bankers in foreign countries or dependencies or insular possessions of the United States for the purpose of furnishing dollar exchange as required by the usages of trade in the respective countries, dependencies, or insular possessions. Such drafts or bills may be acquired by Federal reserve banks in such amounts and subject to such regulations, restrictions, and limitations as may be prescribed by the Federal Reserve Board: Provided, however, That no member bank shall accept such drafts or bills of exchange referred to \* this paragraph for any one bank to an amount exceeding in the aggregate ten per centum of the paid-up and unimpaired capital and surplus of the accepting bank unless the draft or bill of exchange is accompanied by documents conveying or securing title or by some other adequate security: Provided further, That no member bank shall accept such drafts or bills in an amount exceeding at any time the aggregate of one-half of its paid-up and unimpaired capital and surplus.

# Act of June 21, 1917 (40 Stat. 232):

[7] Any member bank may accept drafts or bills of exchange drawn upon it having not more than six months sight to run, exclusive of days of grace, which grow out of transactions involving the importation or exportation of goods; or which grow out of transactions involving the domestic shipment of goods provided shipping documents conveying or securing title are attached at the time of acceptance; or which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples. No member bank shall accept, whether in a foreign or domestic transaction, for any one

person, company, firm, or corporation to an amount equal at any time in the aggregate to more than ten per centum of its paid-up and unimpaired capital stock and surplus, unless the bank is secured either by attached documents or by some other actual security growing out of the same transaction as the acceptance; and no bank shall accept such bills to an amount equal at any time in the aggregate to more than one-half of its paid-up and unimpaired capital stock and surplus: Provided, however, That the Federal Reserve Board, under such general regulations as it may prescribe, which shall apply to all banks alike regardless of the amount of capital stock and surplus, may authorize any member bank to accept such bills to an amount not exceeding at any time in the aggregate one hundred per centum of its paid-up and unimpaired capital stock and surplus: Provided, further, That the aggregate of acceptances growing out of domestic transactions shall in no event exceed fifty per centum of such capital stock and surplus. [12 U.S.C. § 372]

# Act of March 4, 1923 (42 Stat. 1454):

- \* \* \* Nothing in this Act contained shall be construed to prohibit such notes, drafts, and bills of exchange, secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount, and the notes, drafts, and bills of exchange of factors issued as such making advances exclusively to producers of staple agricultural products in their raw state shall be eligible for such discount; but such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States. Notes, drafts, and bills admitted to discount under the terms of this paragraph must have a maturity at the time of discount of not more than ninety 90 days, exclusive of days of grace: Provided, That notes, drafts, and bills drawn or issued for agricultural purposes or based on live etock and having a maturity not exceeding six months, exclusive of days of grace; may be discounted in an amount to be limited to a percentage of the assets of the Federal reserve bank, to be ascertained and fixed by the Federal Reserve Board. [12 U.S.C. § 343]
- [4] Upon the indorsement of any of its member banks, which shall be deemed a waiver of demand, notice, and protest by such bank as to its own indorsement exclusively, and subject to regulations and limitations to be prescribed by the Federal Reserve Board, any Federal reserve bank may discount or purchase bills of exchange payable at sight or on demand which are drawn to finance the domestic shipment of nonperishable, readily marketable staple agricultural products and are secured by bills of lading or other shipping documents conveying or securing title to such staples: Provided, That all such bills of exchange shall be forwarded

promptly for collection, and demand for payment shall be made with reasonable promptness after the arrival of such staples at their destination: Provided further, That no such bill shall in any event be held by or for the account of a Federal reserve bank for a period in excess of 90 days. In discounting such bills Federal reserve banks may compute the interest to be deducted on the basis of the estimated life of each bill and adjust the discount after payment of such bills to conform to the actual life thereof.

[6] Any Federal reserve bank may discount acceptances of the kinds hereinafter described, which have a maturity at the time of discount of not more than three months? 90 days' sight, exclusive of days of grace, and which are indorsed by at least one member bank: Provided, That such acceptances if drawn for an agricultural purpose and secured at the time of acceptance by warehouse receipts or other such documents conveying or securing title covering readily marketable staples may be discounted with a maturity at the time of discount of not more than six months' sight exclusive of days of grace.

# Act of May 29, 1928 (45 Stat. 975): [12 U.S.C. § 346]

Upon the indorsement of any of its member banks, which shall be deemed a waiver of demand, notice, and protest by such bank as to its own indorsement exclusively, and subject to regulations and limitations to be prescribed by the Federal Reserve Board, any Federal reserve bank may discount or purchase bills of exchange payable at sight or on demand which are drawn to finance grow out of the domestic shipment or the exportation of nonperishable, readily marketable staple agricultural products and other staples and are secured by bills of lading or other shipping documents conveying or securing title to such staples: Provided, That all such bills of exchange shall be forwarded promptly for collection, and demand for payment shall be made with reasonable promptness after the arrival of such staples at their destination: Provided further, That no such bill shall in any event be held by or for the account of a Federal reserve bank for a period in excess of 90 ninety days. In discounting such bills Federal reserve banks may compute the interest to be deducted on the basis of the estimated life of each bill and adjust the discount after payment of such bills to conform to the actual life thereof. [12 U.S.C. § 344]

# Act of April 12, 1930 (46 Stat. 162):

[5] The aggregate of such notes, drafts, and bills bearing the signature or indersement of any one borrower, whether a person, company, firm, or corporation upon which any person, copartnership, association, or corporation is liable as maker, acceptor, inderser, drawer, or guaranter, rediscounted for any one member bank, shall at no time exceed ten per centum of the unimpaired capital and

surplus of said bank; but this restriction shall not apply to the discount of bills of exchange drawn in good faith against actually existing values the amount for which such person, copartnership, association, or corporation may lawfully become liable to a national banking association under the terms of section 5200 of the Revised Statutes, as amended: Provided, however, That nothing in this paragraph shall be construed to change the character or class of paper now eligible for rediscount by Federal reserve banks.

# Act of May 19, 1932 (47 Stat. 159):

[8] 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 banks, 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 cligible 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, or by the deposit or pledge of debentures or other such obligations of Federal intermediate credit banks which are eligible for purchase by Federal reserve banks under section 13(a) of this Act.

# Act of July 21, 1932 (47 Stat. 709):

In unusual and exigent circumstances, the Federal Reserve Board, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange of the kinds and maturities made eligible for discount for member banks under other provisions of this Act when such notes, drafts, and bills of exchange are indorsed and otherwise secured to the satisfaction of the Federal reserve bank: Provided, That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Federal Reserve Board may prescribe.

# Act of March 9, 1933 (48 Stat. 1):

[13] Subject to such limitations, restrictions and regulations as the Federal Reserve Board may prescribe, any Federal reserve bank may make advances to any individual, partnership or corporation

on the promissory notes of such individual, partnership or corporation secured by direct obligations of the United States. Such advances shall be made for periods not exceeding 90 days and shall bear interest at rates fixed from time to time by the Federal reserve bank, subject to the review and determination of the Federal Reserve Board.

#### Act of May 12, 1933 (48 Stat. 31):

[8] 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 banks, 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, or by the deposit or pledge of debentures or other such obligations of Federal intermediate credit banks which are eligible for purchase by Federal reserve banks under section 13(a) of this Act, or by the deposit or pledge of bonds issued pursuant to the paragraph added to section 32 of the Federal Farm Loan Act, as amended by section 21 of the Emergency Farm Mortgage Act of 1983.

#### Act of June 16, 1933 (48 Stat. 162):

Any Federal reserve bank may make advances for periods not exceeding fifteen days to its member banks on their promissory notes for a period not exceeding fifteen days at rates to be established by such Federal reserve banks; 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, certificates of indebtedness, or Treasury bills of the United States, or by the deposit or pledge of debentures or other such obligations of Federal intermediate credit banks which are eligible for purchase by Federal reserve banks under section 13(a) of this Act;; and any Federal reserve bank may make advances for periods not exceeding ninety days to its member banks on their promissory notes 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 issued pursuant to the paragraph added to section 32 of the Federal Farm Loan Act, as amended by section 21 of the Emergency Farm Mortgage Act of 1933. All such advances shall be made at rates to be established by such

Federal reserve banks, such rates to be subject to the review and determination of the Federal Reserve Board. If any member bank to which any such advance has been made shall, during the life or continuance of such advance, and despite an official warning of the reserve bank of the district or of the Federal Reserve Board to the contrary, increase its outstanding loans secured by collateral in the form of stocks, bonds, debentures, or other such obligations, or loans made to members of any organized stock exchange, investment house. or dealer in securities, upon any obligation, note, or bill, secured or unsecured, for the purpose of purchasing and/or carrying stocks. bonds, or other investment securities (except obligations of the United States) such advance shall be deemed immediately due and payable, and such member bank shall be ineligible as a borrower at the reserve bank of the district under the provisions of this paragraph for such period as the Federal Reserve Board shall determine: Provided, That no temporary carrying or clearance loans made solely for the purpose of facilitating the purchase or delivery of securities offered for public subscription shall be included in the loans referred to in this paragraph.

# Act of January 31, 1934 (48 Stat. 344):

[8] Any Federal reserve bank may make advances for periods not exceeding fifteen days to its member banks on their promissory notes secured by the deposit or pledge of bonds, notes, certificates of indebtedness, or Treasury bills of the United States, or by the deposit or pledge of debentures or other such obligations of Federal intermediate credit banks which are eligible for purchase by Federal reserve banks under section 13(a) of this Act, or by the deposit or pledge of Federal Farm Mortgage Corporation bonds issued under the Federal Farm Mortgage Corporation Act; and any Federal reserve bank may make advances for periods not exceeding nincty days to its member banks on their promissory notes 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. \*\*\*

# Act of April 27, 1934 (48 Stat. 643):

[8] Any Federal reserve bank may make advances for periods not exceeding fifteen days to its member banks on their promissory notes secured by the deposit or pledge of bonds, notes, certificates of indebtedness, or Treasury bills of the United States, or by the deposit or pledge of debentures or other such obligations of Federal intermediate credit banks which are eligible for purchase by Federal reserve banks under section 13(a) of this Act, or by the deposit or pledge of Federal Farm Mortgage Corporation bonds issued under the Federal Farm Mortgage Corporation Act, or by the deposit or pledge of bonds issued under the provisions of sub-

section (c) of section 4 of the Home Owners' Loan Act of 1933, as amended; and any Federal reserve bank may make advances for periods not exceeding ninety days to its member banks on their promissory notes 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.

# Act of June 19, 1934 (48 Stat. 1105):

[9] \* \* \*

Tenth. Liabilities incurred under the provisions of section 13b of the Federal Reserve Act. [12 U.S.C. § 82]

# Act of August 23, 1935 (49 Stat. 684):

In unusual and exigent circumstances, the Federal Reserve Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange of the kinds and maturities made eligible for discount for member banks under other provisions of this Act when such notes, drafts, and bills of exchange are indorsed and or otherwise secured to the satisfaction of the Federal \*Reserve bank: Provided, That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Federal Reserve Board of Governors of the Federal Reserve System may prescribe. [12 U.S.C. § 343]

#### Act of September 21, 1968 (82 Stat. 856):

[8] \* \* \* and any Federal reserve bank may make advances for periods not exceeding ninety days to its member banks on their promissory notes 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 secured by such obligations as are eligible for purchase under section 14(b) of this Act. \* \* \* [12 U.S.C. § 347]

\* \* \* \* \*

[13] Subject to such limitations, restrictions and regulations as the Board of Governors of the Federal Reserve System may prescribe, any Federal reserve bank may make advances to any individual,

partnership or corporation on the promissory notes of such individual, partnership or corporation secured by direct obligations of the United States or by any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States. Such advances shall be made for periods not exceeding 90 days and shall bear interest at rates fixed from time to time by the Federal reserve bank, subject to the review and determination of the Board of Governors of the Federal Reserve System.

#### SECTION 13a

# Act of March 4, 1923 (42 Stat. 1454):

- Sec. 13a. Upon the indorsement of any of its member banks, which shall be deemed a waiver of demand, notice, and protest by such bank as to its own indorsement exclusively, any Federal reserve bank may, subject to regulations and limitations to be prescribed by the Federal Reserve Board, discount notes, drafts, and bills of exchange issued or drawn for an agricultural purpose, or based upon live stock, and having a maturity, at the time of discount, exclusive of days of grace, not exceeding nine months, and such notes, drafts, and bills of exchange may be offered as collateral security for the issuance of Federal reserve notes under the provisions of section 16 of this Act: Provided, That notes, drafts, and bills of exchange with maturities in excess of six months shall not be eligible as a basis for the issuance of Federal reserve notes unless secured by warehouse receipts or other such negotiable documents conveying or securing title to readily marketable staple agricultural products or by chattel mortgage upon live stock which is being fattened for market. [12 U.S.C. § 348]
- [2] That any Federal reserve bank may, subject to regulations and limitations to be prescribed by the Federal Reserve Board, rediscount such notes, drafts, and bills for any Federal Intermediate Credit Bank, except that no Federal reserve bank shall rediscount for a Federal Intermediate Credit Bank any such note or obligation which bears the indorsement of a nonmember State bank or trust company which is eligible for membership in the Federal reserve system, in accordance with section 9 of this Act.
- [3] Any Federal reserve bank may also buy and sell debentures and other such obligations issued by a Federal Intermediate Credit Bank or by a National Agricultural Credit Corporation, but only to the same extent as and subject to the same limitations as those upon which it may buy and sell bonds issued under Title I of the Federal Farm Loan Act. [12 U.S.C. § 350]
- [4] Notes, drafts, bills of exchange or acceptances issued or drawn by cooperative marketing associations composed of producers of agricultural products shall be deemed to have been issued or drawn for an agricultural purpose, within the meaning of this section, if

the proceeds thereof have been or are to be advanced by such association to any members thereof for an agricultural purpose, or have been or are to be used by such association in making payments to any members thereof on account of agricultural products delivered by such members to the association, or if such proceeds have been or are to be used by such association to meet expenditures incurred or to be incurred by the association in connection with the grading, processing, packing, preparation for market, or marketing of any agricultural product handled by such association for any of its members: Provided, That the express enumeration in this paragraph of certain classes of paper of cooperative marketing associations as eligible for rediscount shall not be construed as rendering ineligible any other class of paper of such associations which is now eligible for rediscount. [12] U.S.C. § 351]

[5] The Federal Reserve Board may, by regulation, limit to a percentage of the assets of a Federal reserve bank the amount of notes, drafts, acceptances, or bills having a maturity in excess of three months, but not exceeding six months, exclusive of days of grace, which may be discounted by such bank, and the amount of notes, drafts, bills, or acceptances having a maturity in excess of six months, but not exceeding nine months, which may be rediscounted by such bank. [12 U.S.C. § 352]

# Act of May 19, 1932 (47 Stat. 159):

That any Federal reserve bank may, subject to regulations and [2] limitations to be prescribed by the Federal Reserve Board, rediscount such notes, drafts, and bills for any Federal Intermediate Credit Bank, except that no Federal reserve bank shall rediscount for a Federal Intermediate Credit Bank any such note or obligation which bears the indorsement of a nonmember State bank or trust company which is eligible for membership in the Federal reserve system, in accordance with section 9 of this Act. Any Federal reserve bank may also, subject to regulations and limitations to be prescribed by the Federal Reserve Board, discount notes payable to and bearing the indorsement of any Federal intermediate credit bank, covering loans or advances made by such bank pursuant to the provisions of section 202 (a) of Title II of the Federal Farm Loan Act, as amended (U. S. C., title 12, ch. 8, sec. 1031), which have maturities at the time of discount of not more than nine months, exclusive of days of grace, and which are secured by notes, drafts, or bills of exchange eligible for rediscount by Federal Reserve banks. [12 U.S.C. § 349]

#### SECTION 13b

# Act of June 19, 1934 (48 Stat. 1105):

Sec. 13b. (a) In exceptional circumstances, when it appears to the satisfaction of a Federal Reserve bank that an established industrial or commercial business located in its district is unable to obtain requisite financial assistance on a reasonable basis from the usual sources, the Federal Reserve bank, pursuant to authority granted by the Federal Reserve Board, may make loans to, or purchase obligations of, such business, or may make commitments with respect thereto, on a reasonable and sound basis, for the purpose of providing it with working capital, but no obligation shall be acquired or commitment made hereunder with a maturity exceeding five years.

- (b) Each Federal Reserve bank shall also have power to discount for, or purchase from, any bank, trust company, mortgage company, credit corporation for industry, or other financing institution operating in its district, obligations having maturities not exceeding five years, entered into for the purpose of obtaining working capital for any such established industrial or commercial business; to make loans or advances direct to any such financing institution on the security of such obligations; and to make commitments with regard to such discount or purchase of obligations or with respect to such loans or advances on the security thereof, including commitments made in advance of the actual undertaking of such obligations. Each such financing institution shall obligate itself to the satisfaction of the Federal Reserve bank for at least 20 per centum of any loss which may be sustained by such bank upon any of the obligations acquired from such financing institution, the existence and amount of any such loss to be determined in accordance with regulations of the Federal Reserve Board: Provided, That in lieu of such obligation against loss any such financing institution may advance at least 20 per centum of such working capital for any established industrial or commercial business without obligating itself to the Federal Reserve bank against loss on the amount advanced by the Federal Reserve bank: Provided, however, That such advances by the financing institution and the Federal Reserve bank shall be considered as one advance, and repayment shall be made pro rata under such regulations as the Federal Reserve Board may prescribe.
- (c) The aggregate amount of loans, advances, and commitments of the Federal Reserve banks outstanding under this section at any one time, plus the amount of purchases and discounts under this section held at the same time. shall not exceed the combined surplus of the Federal Reserve banks as of July 1, 1934, plus all amounts paid to the Federal Reserve banks by the Setretary of the Treasury under subsection (e) of this section, and all operations of the Federal Reserve banks under this section shall be subject to such regulations as the Federal Reserve Board may prescribe.
- (d) For the purpose of aiding the Federal Reserve banks in carrying out the provisions of this section, there is hereby established in each Federal Reserve district an industrial advisory committee, to be appointed by the Federal Reserve bank subject to the approval and regulations of the Federal Reserve Board, and to be composed of not less than three nor more than five members as

determined by the Federal Reserve Board. Each member of such committee shall be actively engaged in some industrial pursuit within the Federal Reserve district in which the committee is established, and each such member shall serve without compensation but shall be entitled to receive from the Federal Reserve bank of such district his necessary expenses while engaged in the business of the committee, or a per diem allowance in lieu thereof to be fixed by the Federal Reserve Board. Each application for any such loan, advance, purchase, discount, or commitment shall be submitted to the appropriate committee and, after an examination by it of the business with respect to which the application is made, the application shall be transmitted to the Federal Reserve bank, together with the recommendation of the committee.

(e) In order to enable the Federal Reserve banks to make the loans, discounts, advances, purchases, and commitments provided for in this section, the Secretary of the Treasury, upon the date this section takes effect, is authorized, under such rules and regulations as he shall prescribe, to pay to each Federal Reserve bank not to exceed such portion of the sum of \$139,299,557 as may be represented by the par value of the holdings of each Federal Reserve bank of Federal Deposit Insurance Corporation stock, upon the execution by each Federal Reserve bank of its agreement (to be endorsed on the certificate of such stock) to hold such stock unencumbered and to pay to the United States all dividends, all payments on liquidation, and all other proceeds of such stock, for which dividends, payments, and proceeds the United States shall be secured by such stock itself up to the total amount paid to each Federal Reserve bank by the Secretary of the Treasury under this section. Each Federal Reserve bank, in addition, shall agree that, in the event such dividends, payments, and other proceeds in any calendar year do not aggregate 2 per centum of the total payment made by the Secretary of the Treasury, under this section, it will pay to the United States in such year such further amount, if any, up to 2 per centum of the said total payment, as shall be covered by the net earnings of the bank for that year derived from the use of the sum so paid by the Secretary of the Treasury, and that for said amount so due the United States shall have a first claim against such earnings and stock, and further that it will continue such payments until the final liquidation of said stock by the Federal Deposit Insurance Corporation. The sum so paid to each Federal Reserve bank by the Secretary of the Treasury shall become a part of the surplus fund of such Federal Reserve bank within the meaning of this section. All amounts required to be expended by the Secretary of the Treasury in order to carry out the provisions of this section shall be paid out of the miscellaneous receipts of the Treasury created by the increment resulting from the reduction of the weight of the gold dollar under the President's proclamation of January 31, 1934; and there is hereby appropriated, out of such receipts, such sum as shall be required for such purpose.

# Act of August 23, 1935 (49 Stat. 684):

(e) In order to enable the Federal Reserve banks to make the loans, discounts, advances, purchases, and commitments provided for in this section, the Secretary of the Treasury, upon the date this section takes effect on and after June 19, 1934, is authorized, under such rules and regulations as he shall prescribe, to pay to each Federal Reserve bank not to exceed such portion of the sum of \$139,299,557 as may be represented by the par value of the holdings of each Federal Reserve bank of Federal Deposit Insurance Corporation stock the amount paid by each Federal Reserve bank for stock of the Federal Deposit Insurance Corporation, upon the execution by each Federal Reserve bank of its agreement (to be endorsed on the certificate of such stock) to hold such stock unencumbered and to pay to the United States all dividends, all payments on liquidation, and all other proceeds of such stock, for which dividends, payments, and proceeds the United States shall be secured by such stock itself up to the total amount paid to each Federal Reserve bank by the Secretary of the Treasury under this section. \* \* \*

# Act of August 21, 1958 (72 Stat. 689):

[The above cited Act repealed section 13b of the Federal Reserve Act, effective August 21, 1959, with the stipulation that such repeal would not affect the power of any Federal Reserve bank to carry out, or protect its interest under, any agreement theretofore made or transaction entered into in carrying on operations under that section.]

# **SECTION 14**

#### Original Act:

- [1] Sec. 14. Any Federal reserve bank may, under rules and regulations prescribed by the Federal Reserve Board, purchase and sell in the open market, at home or abroad, either from or to domestic or foreign banks, firms, corporations, or individuals, cable transfers and bankers' acceptances and bills of exchange of the kinds and maturities by this Act made eligible for rediscount, with or without the indorsement of a member bank. [12 U.S.C. § 353]
- [2] Every Federal reserve bank shall have power: [12 U.S.C. § 354]

\* \* \* \* \*

[3] (b) To buy and sell, at home or abroad, bonds and notes of the United States, and bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county,

- district, political subdivision, or municipality in the continental United States, including irrigation, drainage and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Federal Reserve Board;
- [4] (c) To purchase from member banks and to sell, with or without its indorsement, bills of exchange arising out of commercial transactions, as hereinbefore defined; [12 U.S.C. § 356]
- [5] (d) To establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount to be charged by the Federal reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business;

# Act of April 13, 1920 (41 Stat. 550):

[5] (d) To establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount to be charged by the Federal reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business; and which, subject to the approval, review, and determination of the Federal Reserve Board, may be graduated or progressed on the basis of the amount of the advances and discount accommodations extended by the Federal reserve bank to the borrowing bank.

# Act of March 4, 1923 (42 Stat. 1454):

- [5] (d) To establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount to be charged by the Federal reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business; and which, subject to the approval, review, and determination of the Federal Reserve Board, may be graduated or progressed on the basis of the amount of the advances and discount accommodations extended by the Federal reserve bank to the borrowing bank.
- [7] (f) To purchase and sell in the open market, either from or to domestic banks, firms, corporations, or individuals, acceptances of Federal Intermediate Credit Banks and of National Agricultural Credit Corporations, whenever the Federal Reserve Board shall declare that the public interest so requires. [12 U.S.C. § 359]

# Act of January 31, 1934 (48 Stat. 344):

[3] (b) To buy and sell, at home or abroad, bonds and notes of the United States, bonds of the Federal Farm Mortgage Corporation having maturities from date of purchase of not exceeding six months, and bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued

in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipality in the continental United States, including irrigation, drainage and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Federal Reserve Board:

# Act of April 27, 1934 (48 Stat. 643):

[3] (b) To buy and sell, at home or abroad, bonds and notes of the United States, bonds of the Federal Farm Mortgage Corporation having maturities from date of purchase of not exceeding six months, bonds issued under the provisions of subsection (c) of section 4 of the Home Owners' Loan Act of 1933, as amended, and having maturities from date of purchase of not exceeding six months, and bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenue by any State, county, district, political subdivision, or municipality in the continental United States, including irrigation, drainage and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Federal Reserve Board;

# Act of August 23, 1935 (49 Stat. 684):

- (b) To buy and sell, at home or abroad, bonds and notes of the United States, bonds of the Federal Farm Mortgage Corporation having maturities from date of purchase of not exceeding six months, bonds issued under the provisions of subsection (c) of section 4 of the Home Owners' Loan Act of 1933, as amended, and having maturities from date of purchase of not exceeding six months, and bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipality in the continental United States, including irrigation, drainage and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Federal Reserve Board of Governors of the Federal Reserve System: Provided, That any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities but only in the open market;
- [5] (d) To establish from time to time, subject to review and determination of the Federal Reserve Board of Governors of the Federal Reserve System, rates of discount to be charged by the Federal reserve bank for each class of paper, which shall be

fixed with a view of accommodating commerce and business; but each such bank shall establish such rates every fourteen days, or oftener if deemed necessary by the Board; [12 U.S.C. § 357]

# Act of March 27, 1942 (56 Stat. 176):

[3] (b) \* \* \* Provided, That any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities but only either in the open market or directly from or to the United States; but all such purchases and sales shall be made in accordance with the provisions of section 12A of this Act and the aggregate amount of such obligations acquired directly from the United States which is held at any one time by the twelve Federal reserve banks shall not exceed \$5,000,000,000.

[NOTE.—The above amendment was originally made by Title IV of the Second War Powers Act of March 27, 1942, to remain in force only until December 31, 1944; but the termination date of Title IV of that Act and therefore of the amendment to section 14(b) of the Federal Reserve Act was extended by the Act of December 20, 1944 (58 Stat. 827) until December 31, 1945, was further extended by the Act of December 28, 1945 (59 Stat. 658) until June 30, 1946, and was further extended by the Act of June 29, 1946 (60 Stat. 354) until March 31, 1947. On the latter date the amendment ceased to have effect and consequently section 14(b) of the Federal Reserve Act after March 31, 1947 read as it had read prior to enactment of the Act of March 27, 1942, until the enactment of the Act of April 28, 1947 (61 Stat. 56) as set forth below.]

#### Act of April 28, 1947 (61 Stat. 56):

(b) \* \* \* Provided, That, notwithstanding any other provision of this Act, (1) until July 1, 1950, any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities but only either in the open market or directly from or to the United States; but all such purchases and sales shall be made in accordance with the provisions of section 12A of this Act and the aggregate amount of such obligations acquired directly from the United States which is held at any one time by the twelve Federal Reserve banks shall not exceed \$5,000,000,000; and (2) after June 30, 1950, any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities but only in the open market. The Board of Governors of the Federal Reserve System shall include in their annual report to Congress detailed information with respect to direct purchases and sales from or to the United States under the provisions of the preceding proviso.

#### Act of June 30, 1950 (64 Stat. 307):

[3] [The above-cited Act extended the authority contained in the proviso in this paragraph by substituting, in two places, reference to the year 1952 in place of reference to the year 1950.]

# Act of June 23, 1952 (66 Stat. 154):

[3] [The above-cited Act extended the authority contained in the proviso in this paragraph by substituting, in two places, reference to the year 1954 in place of reference to the year 1952.]

#### Act of June 29, 1954 (68 Stat. 329):

[3] [The above-cited Act extended the authority contained in the proviso in this paragraph by substituting, in two places, reference to the year 1956 in place of reference to the year 1954.]

#### Act of June 25, 1956 (70 Stat. 339):

[3] [The above-cited Act extended the authority contained in the provise in this paragraph by substituting, in two places, reference to the year 1958 in place of reference to the year 1956.]

#### Act of June 30, 1958 (72 Stat. 261):

[3] [The above-cited Act extended the authority contained in the proviso in this paragraph by substituting, in two places, reference to the year 1960 in place of reference to the year 1958.]

#### Act of July 1, 1960 (74 Stat. 295):

[3] [The above-cited Act extended the authority contained in the proviso in this paragraph by substituting, in two places, reference to the year 1962 in place of reference to the year 1960.]

# Act of October 4, 1961 (75 Stat. 773):

[3] (b) To buy and sell, at home or abroad, bonds and notes of the United States, bonds of the Federal Farm Mortgage Corporation having maturities from date of purchase of not exceeding six months, bonds issued under the provisions of subsection (c) of section 4 of the Home Owners' Loan Act of 1933, as amended, and having maturities from date of purchase of not exceeding six months, \* \* \*.

#### Act of June 28, 1962 (76 Stat. 112):

[3] [The above-cited Act extended the authority contained in the proviso in this paragraph by substituting, in two places, reference to the year 1964 in place of reference to the year 1962.]

# Act of June 30, 1964 (78 Stat. 235):

[3] [The above-cited Act extended the authority contained in the proviso in this paragraph by substituting, in two places, reference to the year 1966 in place of reference to the year 1964.]

#### Act of June 30, 1966 (80 Stat. 235):

[3] [The above-cited Act extended the authority contained in the proviso in this paragraph by substituting, in two places, reference to the year 1968 in place of reference to the year 1966.]

#### Act of September 21, 1966 (80 Stat. 823, 825):

[NOTE:—The amendments reflected below were originally for one year. By Act of September 21, 1967 (81 Stat. 226) their effectiveness was extended until September 21, 1968. By Act of September 21, 1968 (82 Stat. 856) they were made permanent.]

- (b) (1) To buy and sell, at home or abroad, bonds and notes of the United States, bonds issued under the provisions of subsection (c) of section 4 of the Home Owners' Loan Act of 1933, as amended, and having maturities from date of purchase of not exceeding six months, and bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipality in the continental United States, including irrigation, drainage and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Board of Governors of the Federal Reserve System: Provided, That, notwithstanding any other provision of this Act, (1) until July 1, 1968, any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities either in the open market or directly from or to the United States; but all such purchases and sales shall be made in accordance with the provisions of section 12A of this Act and the aggregate amount of such obligations acquired directly from the United States which is held at any one time by the twelve Federal Reserve banks shall not exceed \$5,000,000,000; and (2) after June 30, 1968, any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities but only in the open market. The Board of Governors of the Federal Reserve System shall include in their annual report to Congress detailed information with respect to direct purchases and sales from or to the United States under the provisions of the preceding proviso.
  - (2) To buy and sell in the open market, under the direction and regulations of the Federal Open Market Committee, any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States. [12 U.S.C. § 355]

# Act of May 4, 1968 (82 Stat. 113):

[3] [The above-cited Act extended the authority contained in the proviso in this paragraph by substituting, in two places, reference to the year 1970 in place of reference to the year 1968.]

# Act of July 31, 1970 (84 Stat. 668):

[3] [The above-cited Act extended the authority contained in the proviso in this paragraph by substituting, in two places, reference to the year 1971 in place of reference to the year 1970.]

# Act of July 2, 1971 (85 Stat. 100):

[3] [The above-cited Act extended the authority contained in the proviso in this paragraph by substituting, in two places, reference to the year 1973 in place of reference to the year 1971.]

#### SECTION 19

#### Original Act:

[5] • • • No member bank shall act as the medium or agent of a nonmember bank in applying for or receiving discounts from a Federal reserve bank under the provisions of this Act except by permission of the Federal Reserve Board. [12 U.S.C. § 374]

#### **SECTION 24**

# Act of June 27, 1934 (48 Stat. 1246):

Loans made to finance the construction of residential or farm buildings and having maturities of not to exceed six months, whether or not secured by a mortgage or similar lien on the real estate upon which the residential or farm building is being constructed, shall not be considered as loans secured by real estate within the meaning of this section but shall be classed as ordinary commercial loans: Provided, That no national banking association shall invest in, or be liable on, any such loans in an aggregate amount in excess of 50 per centum of its actually paid-in and unimpaired capital. Notes representing such loans shall be eligible for discount as commercial paper within the terms of the second paragraph of section 13 of the Federal Reserve Act, as amended, if accompanied by a valid and binding agreement to advance the full amount of the loan upon the completion of the building entered into by an individual, partnership, association, or corporation acceptable to the discounting bank.

#### Act of August 11, 1955 (69 Stat. 633):

[3] Loans made to finance the construction of residential or farm buildings and having maturities of not to exceed six nine months, whether or not secured by a mortgage or similar lien on the real estate upon which the residential or farm building is being constructed, shall not be considered as loans secured by real estate within the meaning of this section but shall be classed as ordinary commercial loans: \* \* \*

# Act of September 9, 1959 (73 Stat. 487):

[3] Loans made to finance the construction of industrial or commercial buildings and having maturities of not to exceed eighteen

months where there is a valid and binding agreement entered into by a financially responsible lender to advance the full amount of the bank's loan upon the completion of the buildings and loans made to finance the construction of residential or farm buildings and having maturities of not to exceed nine months, whether or not secured by a mortgage or similar lien on the real estate upon which the residential or farm building is being constructed, shall not be considered as loans secured by real estate within the meaning of this section but shall be classed as ordinary commercial loans whether or not secured by a mortgage or similar lien on the real estate upon which the building or buildings are being constructed: Provided, That no national banking association shall invest in, or be liable on, any such loans in an aggregate amount in excess of 50 100 per centum of its actually paid-in and unimpaired capital plus 100 per centum of its unimpaired surplus fund. Notes representing such loans made under this section to finance the construction of residential or farm buildings and having maturities of not to exceed nine months shall be eligible for discount as commercial paper within the terms of the second paragraph of section 13 of the Federal Reserve this Act, as amended, if accompanied by a valid and binding agreement to advance the full amount of the loan upon the completion of the building entered into by an individual, partnership, association, or corporation acceptable to the discounting bank.

# Act of September 28, 1962 (76 Stat. 662):

Loans made to finance the construction of industrial or com-[3] mercial buildings and having maturities of not to exceed eighteen months where there is a valid and binding agreement entered into by a financially responsible lender to advance the full amount of the bank's loan upon the completion of the buildings and loans made to finance the construction of residential or farm buildings and having maturities of not to exceed nine eighteen months, shall not be considered as loans secured by real estate within the meaning of this section but shall be classed as ordinary commercial loans whether or not secured by a mortgage or similar lien on the real estate upon which the building or buildings are being constructed: Provided, That no national banking association shall invest in, or be liable on, any such loans in an aggregate amount in excess of 100 per centum of its actually paid-in and unimpaired capital plus 100 per centum of its unimpaired surplus fund. \* \* \*

# Act of August 10, 1965 (79 Stat. 451, 465):

[3] Loans made to finance the construction of industrial or commercial buildings and having maturities of not to exceed eighteen twenty-four months where there is a valid and binding agreement entered into by a financially responsible lender to advance the

full amount of the bank's loan upon the completion of the buildings and loans made to finance the construction of residential or farm buildings and having maturities of not to exceed eighteen twenty-four months, shall not be considered as loans secured by real estate within the meaning of this section but shall be classed as ordinary commercial loans whether or not secured by a mortgage or similar lien on the real estate upon which the building or buildings are being constructed: Provided, That no national banking association shall invest in, or be liable on, any such loans in an aggregate amount in excess of 100 per centum of its actually paid-in and unimpaired capital plus 100 per centum of its unimpaired surplus fund. \* \* \*

### Act of August 1, 1968 (82 Stat. 476, 518, 609):

[3] Loans made to finance the construction of industrial or commercial buildings and having maturities of not to exceed twenty four thirty-six months where there is a valid and binding agreement entered into by a financially responsible lender to advance the full amount of the bank's loan upon the completion of the buildings and loans made to finance the construction of residential or farm buildings and having maturities of not to exceed twenty four thirty-six months, shall not be considered as loans secured by real estate within the meaning of this section but shall be classed as ordinary commercial loans whether or not secured by a mortgage or similar lien on the real estate upon which the building or buildings are being constructed: Provided, That no national banking association shall invest in, or be liable on, any such loans in an aggregate amount in excess of 100 per centum of its actually paid-in and unimpaired capital plus 100 per centum of its unimpaired surplus fund. \* \* \*

#### Act of July 24, 1970 (84 Stat. 450, 462):

Loans made to finance the construction of industrial or commercial buildings and having maturities of not to exceed thirty-six sixty months where there is a valid and binding agreement entered into by a financially responsible lender to advance the full amount of the bank's loan upon the completion of the buildings and loans made to finance the construction of residential or farm buildings and having maturities of not to exceed thirty-six sixty months, shall not be considered as loans secured by real estate within the meaning of this section but shall be classed as ordinary commercial loans whether or not secured by a mortgage or similar lien on the real estate upon which the building or buildings are being constructed: Provided, That no national banking association shall invest in, or be liable on, any such loans in an aggregate amount in excess of 100 per centum of its actually paid-in and unimpaired capital plus 100 per centum of its unimpaired surplus fund. \* \* \* [12 U.S.C. § 371]



## Regulation A as Currently in Effect

### REGULATION A

(12 CFR 201)

As revised effective April 19, 1973, and in effect May 1, 1973

## EXTENSIONS OF CREDIT BY FEDERAL RESERVE BANKS

#### SECTION 201.1—AUTHORITY AND SCOPE

This Part is issued under section 13 and other provisions of the Federal Reserve Act and relates to extensions of credit by Federal Reserve Banks.

#### SECTION 201.2—GENERAL PRINCIPLES

(a) Accommodation of credit needs of individual banks. Extending credit to member banks to accommodate commerce, industry, and agriculture is a principal function of Reserve Banks. While open market operations and changes in member bank reserve requirements are important means of affecting the overall supply of bank reserves, the lending function of the Reserve Banks is an effective method of supplying reserves to

meet the particular needs of individual member banks.

(b) Effect on overall monetary and credit conditions. The lending functions of the Federal Reserve System are conducted with due regard to the basic objectives of the Employment Act of 1946 and the maintenance of a sound and orderly financial system. These basic objectives are promoted by influencing the overall volume and cost of credit through actions affecting the volume and cost of reserves to member banks. Borrowing by individual member banks, at a rate of interest adjusted from time to time in accordance with general economic and money market conditions, has a direct impact on the reserve positions of the borrowing banks and thus on their ability to meet the needs of their customers. However, the effects of such borrowing do not remain localized but

have an important bearing on overall monetary and credit conditions.

- (c) Short-term adjustment credit. Federal Reserve credit is available on a short-term basis to a member bank, under such rules as may be prescribed, to such extent as may be appropriate to assist such bank in meeting temporary requirements for funds or to cushion more persistent outflows of funds pending an orderly adjustment of the bank's assets and liabilities.
- (d) Seasonal credit. Federal Reserve credit is available for longer periods to assist a member bank that lacks reasonably reliable access to national money markets in meeting seasonal needs for funds arising from a combination of expected patterns of movement in its deposits and loans. Such credit will ordinarily be limited to the amount by which the member bank's seasonal needs exceed 5 per cent of its average total deposits in the preceding calendar year and will be available if (1) the member bank has arranged in advance for such credit for the full period, as far as possible, for which the credit is expected to be required, and (2) the Reserve Bank is satisfied that the member bank's qualifying need for funds is seasonal and will persist for at least eight consecutive weeks. In making such arrangements for seasonal credit, a Reserve Bank may agree to extend such credit for a period of up to 90 days,1 subject to compliance with applicable requirements of law at the time such credit is extended. However, in the event that a member bank's seasonal needs should persist beyond such period, the Reserve Bank will normally be prepared to entertain a request by the member bank for further credit extensions under the seasonal credit arrangement.
- (e) Emergency credit for member banks. Federal Reserve credit is available to assist member banks in unusual or emergency circumstances such as may result from national, regional, or local difficulties or from exceptional circumstances involving only a particular member bank.
- (f) Emergency credit for others. Federal Reserve credit is available to individuals, partnerships, and corporations that are not member banks in emergency circumstances in accordance

- with \$201.7 of this Part if, in the judgment of the Reserve Bank involved, credit is not practicably available from other sources and failure to obtain such credit would adversely affect the economy.
- (g) Credit for capital purposes. Federal Reserve credit is not a substitute for capital and ordinarily is not available for extended periods.
- (h) Compliance with law and regulation. All credit extended pursuant to this Part must comply with applicable requirements of law and of this Part. Among other things, the law requires each Reserve Bank (1) to keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit for the speculative carrying of or trading in securities, real estate, or commodities or for any other purpose inconsistent with the maintenance of sound credit conditions and (2) to give consideration to such information in determining whether to extend credit.

### SECTION 201.3—ADVANCES TO MEMBER BANKS

- (a) Advances on obligations or eligible paper. Reserve Banks may make advances to member banks for not more than 90 days if secured by obligations or other paper eligible under the Federal Reserve Act for discount or purchase by Reserve Banks.
- (b) Advances on other security. A Reserve Bank may make advances to a member bank for not more than four months if secured to the satisfaction of the Reserve Bank, whether or not secured in conformity with \$201.3(a), but the rate on such advances shall be at least one-half of one per cent per annum higher than the rate applicable to advances made under \$201.3(a).

## SECTION 201.4—DISCOUNTS FOR MEMBER BANKS

If a Reserve Bank should conclude that a member bank would be better accommodated by the discount of paper than by an advance on the security thereof, it may discount for such member bank any paper endorsed by the member bank and meeting the following requirements:

(a) Commercial or agricultural paper. A note, draft, or bill of exchange issued or drawn or the

<sup>&</sup>lt;sup>1</sup>As provided in the law and in this Part, the maturity of advances to member banks is limited to 90 days, except as provided in §201.3(b) of this Part.

proceeds of which have been or are to be used (1) in producing, purchasing, carrying, or marketing goods in the process of production, manufacture, or distribution, (2) for the purchase of services, (3) in meeting current operating expenses of a commercial, agricultural, or industrial business, or (4) for the purpose of carrying or trading in direct obligations of the United States; provided that (i) such paper has a period remaining to maturity of not more than 90 days, except that agricultural paper (including paper of cooperative marketing associations) may have a period remaining to maturity of not more than nine months and (ii) the proceeds of such paper have not been and are not to be used merely for the purpose of investment, speculation, or dealing in stocks, bonds, or other such securities, except direct obligations of the United States.

- (b) Bankers' acceptances. A banker's acceptance (1) arising out of an importation or exportation or domestic shipment of goods or the storage of readily marketable staples or (2) drawn by a bank in a foreign country or dependency or insular possession of the United States for the purpose of furnishing dollar exchange; provided that such acceptance complies with applicable requirements of section 13 of the Federal Reserve Act.
- (c) Construction paper. A note representing a loan made to finance construction of a residential or farm building, whether or not secured by a lien upon real estate, which matures not more than nine months from the date the loan was made and has a period remaining to maturity of not more than 90 days, if accompanied by an agreement requiring some person acceptable to the Reserve Bank to advance the full amount of the loan upon completion of such construction.

## SECTION 201.5-GENERAL REQUIREMENTS

- (a) Information. A Reserve Bank shall require such information as it deems necessary to insure that paper tendered as collateral or for discount is acceptable and meets any pertinent eligibility requirements and that the credit granted is used consistently with this Part.
- (b) Amount of collateral. A Reserve Bank shall require only such amount of collateral as it deems necessary or advisable.

- (c) Indirect credit for nonmember banks. Except with the permission of the Board of Governors, no member bank shall act as the medium or agent of a nonmember bank (other than a Federal Intermediate Credit bank) in receiving credit from a Reserve Bank and, in the absence of such permission, a member bank applying for credit shall be deemed to represent and guarantee that it is not so acting.
- (d) Limitation as to one obligor. Except as to credit granted under §201.3(b), a member bank applying for credit shall be deemed to certify or guarantee that as long as the credit is outstanding no obligor on paper tendered as collateral or for discount will be indebted to it in an amount exceeding the limitations in section 5200 of the Revised Statutes (12 U.S.C. §84), which for this purpose shall be deemed to apply to State member as well as national banks.

### SECTION 201.6—FEDERAL INTERMEDIATE CREDIT BANKS

A Reserve Bank may discount for any Federal Intermediate Credit bank (1) agricultural paper, or (2) notes payable to and bearing the endorsement of such Federal Intermediate Credit bank covering loans or advances made under subsections (a) and (b) of §2.3 of the Farm Credit Act of 1971 (12 U.S.C. §2074) which are secured by paper eligible for discount by Reserve Banks. Any paper so discounted shall not have a period remaining to maturity of more than nine months or bear the endorsement of a nonmember State bank

#### SECTION 201.7—EMERGENCY CREDIT FOR OTHERS

In emergency circumstances a Reserve Bank may extend credit for periods of not more than 90 days to individuals, partnerships, and corporations (other than member banks) on the security of direct obligations of the United States or any obligations which are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, at such rate in excess of the rate in effect at the Reserve Bank for advances under §201.3(a) as its board of directors may establish subject to review and determination of the Board of Governors.



# Regulation C as Currently in Effect

#### REGULATION C

(12 CFR 203)

As revised effective August 31, 1946, and in effect May 1, 1973

### ACCEPTANCE BY MEMBER BANKS OF DRAFTS OR BILLS OF EXCHANGE \*

#### SECTION 203.0-SCOPE OF PART

This part is based upon and issued pursuant to various provisions of the Federal Reserve Act, particularly the provisions of the seventh and twelfth paragraphs of section 13 of such Act, the texts of which are published in the appendix hereto. This part relates to the acceptance by member banks of drafts or bills of exchange. Provisions governing the eligibility of bankers' acceptances of member banks for discount by the Federal Reserve Banks are contained in Part 201 of this chapter; and provisions governing the purchase of bankers' acceptances by the Federal Reserve Banks are contained in Part 202 of this chapter.

The text corresponds to the Code of Federal Regulations, Title 12, Chapter II, Part 203;
 cited as 12 CFR 203.

#### SECTION 203.1-ACCEPTANCE OF COMMERCIAL DRAFTS OR BILLS

- (a) Authority.—Any member bank may accept drafts or bills of exchange drawn upon it which grow out of any of the following transactions (referred to in this part as "commercial drafts or bills"):
  - (1) The importation or exportation of goods, that is, the shipment of goods between the United States and any foreign country, or between the United States and any of its dependencies or insular possessions, or between dependencies or insular possessions and foreign countries, or between foreign countries; <sup>1</sup>
  - (2) The shipment of goods within the United States, provided shipping documents conveying or securing title are attached or are in the physical possession of the accepting bank or its agent at the time of acceptance;
  - (3) The storage in the United States or in any foreign country of readily marketable staples: <sup>2</sup> Provided, That the draft or bill of exchange is secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering such readily marketable staples.<sup>3</sup>
- (b) Maturity.—No member banks shall accept any commercial draft or bill unless at the date of its acceptance such draft or bill has not more than six months to run, exclusive of days of grace.
- (c) Acceptances for one person.—No member bank shall accept commercial drafts or bills, whether in a foreign or domestic transaction, for any one person, company, firm, or corporation in an amount equal at any time in the aggregate to more than 10 per cent of its paid-up and unimpaired capital stock and surplus, unless the bank be and remain secured as to the amount in excess of such 10 per cent limitation by either attached documents or some other actual security growing out of the same transaction as the acceptance; but a trust receipt which permits the customer to have access to or control over the goods will not be considered "actual security" within the meaning of this paragraph.
- (d) Limitation on aggregate amount.—No member bank shall accept commercial drafts or bills in an amount equal at any time in the aggregate to more than 50 per cent of its paid-up and unimpaired capital stock and surplus; except that, with the permission of the Board of Governors of the Federal Reserve System as provided in paragraph (e) of this section, any such member bank may accept such drafts or

<sup>&</sup>lt;sup>1</sup> A member bank accepting any commercial draft or bill growing out of a transaction of the kinds described in §203.1(a) (1) will be expected to obtain before acceptance and retain in its files satisfactory evidence, documentary or otherwise, showing the nature of the transactions underlying the credit extended.

 $<sup>^3</sup>$  A readily marketable staple within the meaning of this part means an article of commerce, agriculture, or industry, of such uses as to make it the subject of constant dealings in ready markets with such frequent quotations of price as to make (a) the price easily and definitely ascertainable, and (b) the staple itself easy to realize upon by sale at any time.

<sup>\*</sup>It should be noted that pursuant to Part 201 and 202 of this chapter Federal Reserve Banks may neither discount nor purchase bills arising out of the storage of readily marketable staples unless the acceptor remains secured throughout the life of the bill.

bills in an amount not exceeding at any time in the aggregate 100 per cent of its paid-up and unimpaired capital stock and surplus (hereinafter referred to as "authority to accept commercial drafts or bills up to 100 per cent"); but in no event may the aggregate amount of such acceptances growing out of domestic transactions exceed 50 per cent of such capital and surplus. Commercial drafts or bills accepted by another bank, whether domestic or foreign, at the request of a member bank which agrees to put such other bank in funds to meet such acceptances at maturity shall be considered as part of the acceptance liabilities of the member bank requesting such acceptances as well as of such other bank, if a member bank, within the meaning of the limitations prescribed in this section.

- (e) Authority to accept up to 100 per cent.—(1) Any member bank desiring authority to accept commercial drafts or bills up to 100 per cent shall file with the Board of Governors, through the Federal Reserve Bank of its district, an application for permission to exercise such authority. Such application need not be made in any particular form, but shall show the present and anticipated need of the applicant bank for the authority requested.
- (2) The Board of Governors may at any time rescind any authority granted by it pursuant to this section after not less than 90 days' notice in writing to the bank affected.

### SECTION 203.2--ACCEPTANCE OF DRAFTS OR BILLS TO FURNISH DOLLAR EXCHANGE

- (a) Authority.—(1) Any member bank, after obtaining the permission of the Board of Governors, may accept drafts or bills of exchange drawn upon it by banks or bankers in foreign countries or dependencies or insular possessions of the United States for the purpose of furnishing dollar exchange (referred to in this part as "dollar exchange drafts or bills") as required by the usages of trade in the respective countries, dependencies, or insular possessions, subject to the conditions set forth in this section. Any member bank desiring to obtain such permission shall file with the Board of Governors through the Federal Reserve Bank of its district an application for such permission. Such application need not to be in any particular form but shall show the present and anticipated need for the authority requested.
- (2) The Board of Governors may at any time rescind any permission granted by it pursuant to this section after not less than 90 days' notice in writing to the bank affected.
- (b) Countries with respect to which dollar exchange drafts or bills may be accepted.—(1) Any such foreign country or dependency or insular possession of the United States must be one of those specified in a list published by the Board of Governors for the purposes of this part, with respect to which the Board of Governors has found that the usages of trade are such as to justify banks or bankers therein in drawing on member banks for the purpose of furnishing dollar exchange.

Any member bank desiring to place itself in position to accept drafts or bills of exchange from a country, dependency, or insular possession not specified in such list may request the Board of Governors through the Federal Reserve Bank of its district to add such country, dependency, or insular possession to the list upon a showing that the furnishing of dollar exchange is required by the usages of trade therein.

- (2) The Board of Governors may at any time after 90 days' published notice, remove from such list the name of any country, dependency, or insular possession, contained therein.
- (c) Purpose of transaction.—(1) Any such dollar exchange draft or bill must be drawn and accepted in good faith for the purpose of furnishing dollar exchange as required by the usages of trade in the country, dependency, or insular possession in which the draft or bill is drawn. Drafts or bills drawn merely because dollar exchange is at a premium in the place where drawn or for any speculative purpose or drafts or bills commonly referred to as "finance bills" (i.e., which are not drawn primarily to furnish dollar exchange) will not be deemed to meet the requirements of this section.
- (2) The aggregate of drafts or bills accepted by such member bank for any one foreign bank or banker shall not exceed an amount which the member bank would expect such foreign bank or banker to liquidate within the terms of the agreements under which the drafts or bills were accepted, through the proceeds of export documentary bills or from other sources reasonably available to such foreign bank or banker arising in the normal course of trade.
- (d) Maturity.—Such member bank shall not accept any dollar exchange draft or bill unless at the date of its acceptance it has not more than three months to run, exclusive of days of grace.
- (e) Acceptances for one bank or banker.—Such member bank shall not accept dollar exchange drafts or bills for any one bank or banker in an amount exceeding in the aggregate 10 per cent of the paid-up and unimpaired capital and surplus of the accepting bank, unless it be and remain secured as to the amount in excess of such 10 per cent limitation by documents conveying or securing title or by some other adequate security.
- (f) Limitation on aggregate amount.—Such member bank shall not accept dollar exchange drafts or bills in an amount exceeding at any one time in the aggregate 50 per cent of its paid-up and unimpaired capital and surplus. This limitation is separate and distinct from and not included in the limitations prescribed by § 203.1 (d) with respect to acceptances of commercial drafts or bills. Dollar exchange draft or bills accepted by another bank, whether domestic or foreign, at the request of a member bank which agrees to put such other bank in funds to meet such acceptances at maturity shall be considered as part of the acceptance liabilities of the member bank requesting such acceptances as well as of such other bank, if a member bank, within the meaning of the limitations prescribed in this section.



## Rights and Liabilities of Federal Reserve Banks with Respect to Discounted Paper

In the course of the foregoing history of the development of the lending functions of the Federal Reserve Banks, mention has been made of certain cases in which the courts have had occasion to construe the provisions of law and regulations relating to such functions. In addition, there have been a number of court decisions pertaining to the right of the Reserve Banks to realize upon the paper discounted or offered as collateral when the borrowing member bank becomes insolvent or, for other reasons, fails to repay the loan made by the Reserve Bank. These decisions have turned not upon interpretation of the law or regulations but on issues of general law regarding negotiable instruments that would be equally applicable to loans by commercial banks. However, for the sake of completeness, the more important of these court decisions are summarized briefly in this appendix.

In general, litigation resulting from efforts by the Reserve Banks to realize on paper discounted for member banks involved questions relating to the validity of defenses made by the obligor on such paper, that is, the person who originally gave the paper to the member bank as evidence of a loan made by that bank. In Chapter 3 of this study, it was noted that a borrowing member bank, by virtue of its en-

dorsement of the discounted paper, becomes primarily liable to the Reserve Bank, thus giving the Reserve Bank the right to proceed directly against the member bank rather than against the obligor on the paper discounted. However, if the member bank is insolvent, the Reserve Bank's right of recourse against the member bank is of little value. It is for this reason that the cases hereinafter mentioned usually revolved around the right of the Reserve Bank to enforce the discounted paper against the original obligor.

The most obvious defense to suit by a Reserve Bank against the obligor on discounted paper would be the fact of payment by the obligor. In several cases, this defense was made when the obligor had in fact paid his note to the member bank that had later discounted it with the Reserve Bank. In general, however, the courts have held that this defense will not prevent recovery by the Reserve Bank, as a holder of the paper in due course, if the obligor made payment to the member bank without demanding production of the paper representing his loan and if the member bank did not act as agent for the Reserve Bank in receiving such payment.

In a 1926 Texas case, Federal Reserve Bank of Dallas v. Hanna, 287 S. W. 274, it was held

that there was a reasonable inference that the member bank acted as agent for the Reserve Bank in receiving payment and that, therefore, the question of agency was properly submitted to a jury. Ten years later, a Federal court held that the question was not one for a jury, despite evidence of a practice under which notes pledged with the Reserve Bank were sent to the borrowing member bank for collection. In the case of Federal Reserve Bank of Richmond v. Kalin, 81 Fed. (2) 1003 (C.C.A. 4th, 1936), the court concluded that since the Reserve Bank and the member bank were separate corporate entities, "no agency exists on the part of one to act in behalf of the other, except such as arises from contractual relationships sufficient to establish agency between any other banks." This case was followed in a 1937 New Jersey case, Federal Reserve Bank of Philadelphia v. Gettleman, 189 Atl. 86 (N.J. 1937), in which the court stated:

Ordinarily, in the case of negotiable paper, the person answerable does not pay the original payee if he is not in possession of the note, except at his own risk. \* \* \* No agency to collect arises from the fact that payee bank was a member of the Federal Reserve Bank of Philadelphia \* \* \*.

In the same year, however, the Federal District Court for the District of New Jersey held, as in the *Hanna* case, that the facts were sufficient to imply a custom under which the member bank acted as agent for the Reserve Bank in receiving payment on the discounted note and to justify submission of the agency question to a jury. *Federal Reserve Bank of Philadelphia* v. *Algar*, 22 Fed. Supp. 168 (D.C. N.J. 1937), *aff'd*. 100 Fed. (2) 941 (C.C.A. 3d, 1939), *cert. den.*, 307 U. S. 631 (1939).

Next to the defense of payment, the most frequent defense to liability on a discounted note has been that the maker had sufficient funds on deposit with the discounting member bank to pay the note; in other words, a defense of set-off. In general, such a defense has been held not to prevail against a Federal Reserve Bank that had acquired the note by way of discount.

Thus, in a 1923 Washington case, the maker of the discounted note asserted a right of set-off of his deposit with a failed member bank, predicating his claim on the ground that the Reserve Bank held collateral in excess of the indebtedness of the member bank and that, on the theory of "marshalling of assets," the Reserve Bank should have had recourse to such collateral first. The court, however, ruled that the deposit liability of the failed bank to the maker of the note could not be set off against the note held by the Reserve Bank. Williams v. Duke, 125 Wash. 250, 215 Pac. 372.

A similar position was taken by the United States Supreme Court in 1925 when the maker of the discounted note claimed that the Reserve Bank should have presented the note for payment to the bank at which it was payable and with which the maker had a deposit sufficient to pay the note. Since the maker had expressly waived protest, notice, and diligence in collecting, the Court held that the Reserve Bank was not bound to present the note at the bank at which payable. However, the Court also rejected the theory of marshalling of assets, holding that the Reserve Bank could enforce the note without waiting to determine whether other collateral held by it was sufficient to cover the indebtedness of the discounting member bank. Sowell v. Federal Reserve Bank of Dallas, 268 U.S. 449.

Despite this decision of the Supreme Court, a Mississippi court in 1934 gave recognition to marshalling of assets in the light of the particular circumstances. In this case, the Reserve Bank knew of the maker's right of set-off of his deposit with the member bank. The court held that, because of principles of equity and fair dealing, the Reserve Bank should have resorted first to collateral held by it against which no defenses of set-off existed before it resorted to the defendant's notes and that, therefore, the marshalling of assets theory should apply. Dilworth v. Federal Reserve Bank of St. Louis, 170 Miss. 373, 154 So. 535 (1934).

Nevertheless, there were still later court decisions that denied the right of the obligor on a note given to a member bank and later discounted with a Federal Reserve Bank to set off his deposit with the failed member bank against his liability on the note. Federal Reserve Bank of Richmond v. Duffy, 210 N. C. 598, 188 S. E. 82 (1936); Federal Reserve Bank of Boston v. Gray-United Stores, 194 N. E. 709 (Mass. 1935).

In addition to efforts to set off deposits in the discounting member bank, obligors on discounted paper have offered other defenses against suits by Federal Reserve Banks on such paper, which also have been in the nature of set-off or counterclaim. In one case, for example, the maker of two discounted notes alleged that he had received no consideration for one of the notes and that he was entitled to a counterclaim for the other note. The court held, however, that these defenses were not available against the Federal Reserve Bank as a holder of the notes in due course. Federal Reserve Bank of Richmond v. Atmore, 200 N. C. 437, 157 S. E. 129 (1931).

In another case, a note executed by a city in renewal of a note previously given to a member bank for money borrowed to retire city bonds was held enforceable by a Federal Reserve Bank as a bona fide holder in due course even though the city had no authority to issue negotiable notes. Federal Reserve Bank of Atlanta v. Panama City, 87 Fed. (2) 677 (C.C.A. 5th, 1937).

Again, when the maker of the discounted note claimed that the member bank had evaded the usury law, it was held that this claim could not be made against a Federal Reserve Bank that took the note as a holder in due course. Federal Reserve Bank of Richmond v. Jones, 205 N. C. 648, 172 S. E. 185 (1934). Similarly, when the maker, a married woman, alleged that she had executed a note as surety for her husband's debt and that the note was still in possession of the member bank, it was ruled that the bank held the note only as agent of the Reserve Bank for collection and that she could not assert her defense against the Reserve Bank as a holder in due course. Federal Reserve Bank of Atlanta v. Haynie, 46 Ga. App. 522, 168 S. E. 112 (1933).

In Bragg v. Federal Reserve Bank of Richmond, 164 Va. 30, 178 S. E. 680 (1935), Government bonds deposited with a member bank were pledged by the latter as security for a Federal Reserve Bank loan. When the member bank later failed, the estate of the deceased owner of the bonds brought suit against the Reserve Bank for recovery of the bonds, alleging that they had been deposited with the member bank for safekeeping only. The court held that the evidence was not sufficient to show that the bonds had been deposited merely for safekeeping and that, in any event, recovery was barred by the fact that the Reserve Bank was a holder of the bonds in due course.

On the other hand, when a draft was sent by the seller of goods to a member bank for collection only and the bank discounted the draft with a Reserve Bank and both the member bank and the Reserve Bank knew that the member bank was insolvent, it was held that the Reserve Bank was not a bona fide holder in due course. Federal Reserve Bank of San Francisco v. Idaho Grimm Alfalfa Seed Growers Association, 8 Fed. (2) 922 (C.C.A. 9th, 1925), cert. den., 270 U. S. 646 (1926). Similarly, when a Reserve Bank sold certain stock that had been pledged with it by a member bank that later became insolvent and knew at the time of the sale that an attorney for the member bank had a valid lien on the stock, it was held that the Reserve Bank was guilty of conversion and that the attorney was entitled to assert his claim. It was only because the plaintiff had not alleged with certainty the value of the stock and proved that he had been injured by its sale that a judgment for the plaintiff in the lower court was reversed. Hansbrough v. D. W. Standrod & Co., 49 Idaho 216, 286 Pac. 923 (1930).

In a few instances, the obligor on the discounted paper has set up a defense based upon an offsetting claim against the Federal Reserve Bank itself rather than the discounting member bank. Thus, the *Hansbrough* case last cited gave rise to further litigation in which the Reserve Bank sued Hansbrough, the attorney for the member bank, on a mortgage note and

the attorney claimed that the Reserve Bank had agreed to release the mortgage in consideration of the attorney's assignment of his interest in a judgment for attorney's fees against the member bank. The Reserve Bank contended that since the judgment for attorney's fees had been modified on appeal, there was a failure of consideration. However, the court held for the attorney on the ground that the modification of the judgment had not affected the merits and that the interest assigned to the Reserve Bank was still sufficient to constitute a valuable consideration. Federal Reserve Bank of San Francisco v. Hansbrough, 49 Idaho 747, 292 Pac. 222 (1930).

In another case, the maker of a discounted note alleged that the Reserve Bank had violated its verbal agreement with respect to pasturing cattle on the defendant's land. Despite arguments of the Reserve Bank that newly discovered evidence should be considered in mitigation of damages resulting from violation of the verbal agreement, judgment for the de-

fendant was affirmed. Federal Reserve Bank of Dallas v. Upton, 34 N. M. 509, 285 Pac. 494 (1930).

The cases briefly mentioned here will suffice to illustrate the nature of the questions that have been the subject of litigation arising from efforts of Federal Reserve Banks to enforce payment of paper discounted by member banks or given by member banks as collateral for Reserve Bank loans. The cases cited are in no sense intended to be exhaustive. Among others that might have been mentioned, the reader is referred to Federal Reserve Bank of Richmond v. Crothers, 289 Fcd. 777 (C.C.A. 4th, 1923); Federal Reserve Bank of Richmond v. Meadows, 201 N. C. 832, 160 S. E. 757 (1931); Federal Reserve Bank of New York v. Palin, 79 Fed. (2) 539 (C.C.A. 2d, 1935); Federal Reserve Bank of Philadelphia v. Ocean City, 84 Fed. (2) 657 (C.C.A. 3d, 1936), cert. den., 299 U.S. 584; Federal Reserve Bank of Philadelphia v. Levy, 97 Fed. (2) 50 (C.C.A. 3d, 1938).



## **Notes and References**



#### INTRODUCTION

- Senate Doc. 243, 62d Cong., 2d Sess.
- House Rep. No. 69, 63d Cong., 1st Sess. (Sept. 9, 1913), p. 11.
- *Id.*, p. 48.

- Id., p. 51.
- Senate Rep. No. 133, Part 2, 63d Cong., 1st Sess. (Nov. 22, 1913), p. 7.
- Mr. Tribble, 50 Congressional Record 5044.



#### THE ORIGINAL DISCOUNT PROVISIONS

- House Rep. No. 69, 63d Cong., 1st Sess. (Sept. 9, 1913), p. 16.
- Senate Rep. No. 133, Part 2, 63d Cong., 1st Sess. (Nov. 22, 1913), pp. 7, 8.
- 50 Congressional Record 4880, 4906, 4924.
- 51 Congressional Record 430.
- 50 Congressional Record 4678.
- 50 Congressional Record 4802.
- Mr. Towner, 50 Congressional Record 4897.
- Mr. McKellar, 50 Congressional Record 4830.
- Mr. Callaway, 50 Congressional Record 4868. Mr. Kennedy, 50 Congressional Record 4929.
- House Rep. No. 69, Sept. 9, 1913, p. 51.
- 50 Congressional Record 4678. 51 Congressional Record 533.
- Report of National Monetary Commission, Senate Doc. 243, 62d Cong., 2d Sess. (Jan. 9, 1912), p. 8.

- 50 Congressional Record 5998.
- Mr. Neeley, 50 Congressional Record 4844. At another point, Mr. Beakes said: "Speculation is largely guarded against, as these reserve banks will not rediscount for their member banks paper secured by stocks and bonds, the usual method of securing money for Wall Street gambling." (50 Congressional Record 4906)
- Mr. Thompson, 50 Congressional Record 5012.
- Senator Swanson, 51 Congressional Record 430. 50 Congressional Record 4675. To the same general effect were statements by Messrs. Wilson (50 Congressional Record 4854), Saunders (50 Congressional Record 4880), and Stephens (50 Con-
- gressional Record 4923, 4924). 50 Congressional Record 4905.
- 51 Congressional Record 782.



#### GENERAL LIMITATIONS

- Senate Rep. No. 133, Part 2, 63d Cong., 1st Sess. (Nov. 22, 1913), p. 26.
- House Rep. No. 69, 63d Cong., 1st Sess. (Sept. 9, 1913), p. 18. Similarly, Mr. Phelan during the debates in the House explained that the purpose of the maturity limitation was to prevent the assets of the Reserve Banks from becoming "tied up." (50 Congressional Record 4675)
- 50 Congressional Record 4731. 51 Congressional Record 1056. The National
- Monetary Commission, also following European practice, had recommended a maturity of 28 days but with provision for the discount of paper
- with maturities of up to 90 days if guaranteed by the local national reserve association. (Report of National Monetary Commission, p. 22)
- House Rep. No. 69, Sept. 9, 1913, p. 48.
- 50 Congressional Record 4647. Later in the debates, Mr. Phelan also undertook to dispel this "misapprehension." (50 Congressional Record
- See, for example, statements by Mr. Stephens of Mississippi (50 Congressional Record 4924) and Mr. Thompson of Oklahoma (50 Congressional Record 5007).
- 50 Congressional Record 5053.



- 50 Congressional Record 6016, 6017.
- Senator Pomerene, 51 Congressional Record 523,
- Senator Shafroth, 51 Congressional Record 1056.
- 51 Congressional Record 523, 1055.
- 13 51 Congressional Record 613, 1055.
- 51 Congressional Record 1063.
- 51 Congressional Record 1144.
- Act of Sept. 7, 1916 (39 Stat. 752)
- Letter from Board to Senate Banking and Currency Committee, Mar. 10, 1916, Senate Rep. No. 481, 64th Cong., 1st Sess. (May 18, 1916), p. 10.
- 1915 Federal Reserve Bulletin 37 (hereinafter referred to as Bulletin)
- Reg. A, Series of 1916, § I(a) (1916 Bulletin 530).
- Reg. A, 1955, § 3(a)(4) (1955 Bulletin 10).
- Reg. A, as amended Nov. 13, 1968, § 201.2(a) (1968 Bulletin 1012).
- 1917 Bulletin 378.
- 1966 Bulletin 506.
- Report of National Monetary Commission, p. 37.
- 50 Congressional Record 5065.
- See statement by Senator Weeks, 51 Congressional Record 469. This fear was later proved to be unfounded; banks soon found that a substantial portion of their paper was eligible for discount. (Annual Report of the Federal Reserve Board, 1915, p. 10; hereinafter referred to as Annual Report)
- 51 Congressional Record 1063.
- 51 Congressional Record 1076.
- 50 Congressional Record 5071.
- 50 Congressional Record 5047.
- 50 Congressional Record 5065.
- House Rep. No. 69, Sept. 9, 1913, p. 52.
- Letter to Senate Banking and Currency Committee, Mar. 10, 1916, Senate Rep. No. 481, 64th Cong., 1st Sess. (May 18, 1916), p. 9.
- Act of Sept. 7, 1916 (39 Stat. 752).
- 1916 Bulletin 274.
- Letter to Senate Banking and Currency Committee, Mar. 10, 1916, Senate Rep. No. 481, 64th Cong., 1st Sess. (May 18, 1916), p. 9.
- Act of June 21, 1917 (40 Stat. 232). In addition, the amendment provided that, as a condition of discount, the Reserve Bank should require the State member bank to submit a certificate that the borrower was not liable to such bank in excess of the amount presented.
- Letter from Board to Senate Banking and Currency Committee, set forth in Senate Rep. No. 73, 67th Cong., 1st Sess. (May 25, 1921).
- Act of July 1, 1922 (42 Stat. 821).
- Government bonds had been excepted from the 10 per cent limit of \$5200 of the Act of

- Sept. 24, 1918 (40 Stat. 967), and paper secured by shipping documents, bankers' acceptances, and readily marketable staples by the Act of Oct. 22, 1919 (41 Stat. 296). The section had been further liberalized by the McFadden Act of Feb. 25, 1927 (44 Stat. 1229).
- House Rep. No. 753, 71st Cong., 2d Sess. (Feb. 25, 1930), p. 1.
- Id., p. 2; 1924 Bulletin 275.
- 46 Stat. 162.
  - The proviso was added because a similar provision had been stricken from the McFadden bill 3 years earlier as the result of opposition aroused by the "unwarranted contention" that the amendment was intended to change the character of paper eligible for discount. The Banking and Currency Committees in 1930 declared that there was no basis for this feeling but that the proviso was added "in order to anticipate any similar objection." (Senate Rep. No. 308, 71st Cong., 2d Sess. (Apr. 2, 1930); House Rep. No. 753, 71st Cong., 2d Sess. (Feb. 25, 1930))
- Act of Mar. 3, 1919 (40 Stat. 1314).
- Reg. A, 1955, § 3(j) (1955 Bulletin 12).
- Reg. A, as amended Nov. 23, 1970, § 201.4(a) (1970 Bulletin 940).
- 1919 Bulletin 1055.
- 1930 Bulletin 453.
- 1938 Bulletin 571.
- Act of June 16, 1934 (48 Stat. 971).
- 1934 Bulletin 749.
- 1920 Bulletin 278.
- Senator Weeks, 51 Congressional Record 1074. 54
- House Rep. No. 69, Sept. 9, 1913, p. 48.
- 50 Congressional Record 4675.
- 87 51 Congressional Record 523.
- Reg. No. 2, 1914 (1914 Annual Report 59).
- Reg. B, Series of 1915, § I(a) (1915 Bulletin 37).
- 39 Stat. 752.
- 1916 Bulletin 524.
- 1916 Bulletin 610. Although this is true in most States, there may be some States in which such allonges are not considered sufficient.
- Federal Reserve Bank of Minneapolis v. First National Bank, 277 Fed. 300 (D.C.S.D., 1921).
- 1916 Bulletin 685.
- Reg. A, Series of 1916, \$\$ IV(a) and V(a) (1916 Bulletin 531).
- Reg. A, 1955, § 3(a)(1) (1955 Bulletin 10).
- Reg. A, 1937, as amended Sept. 28, 1942, § 1(h) (1942 Bulletin 989).
  - 1944 Bulletin 879.
- 1949 Bulletin 247.
- 1951 Bulletin 391.
- 1949 Bulletin 247.
- 1915 Bulletin 21.



- 1919 Bulletin 472.
- 74 1917 Bulletin 457.
- 1917 Bulletin 291.
- 1915 Bulletin 219.
- 1918 Bulletin 870.
- 1917 Bulletin 880.

- 1918 Bulletin 745.
- 1917 Bulletin 200.
- 1918 Bulletin 871.
- 1942 Annual Report 98.
- 1970 Bulletin 444.



#### DISCOUNT OF COMMERCIAL PAPER

- House Rep. No. 69, 63d Cong., 1st Sess. (Sept. 9, 1913), p. 48.
- 51 Congressional Record 1074.
- 50 Congressional Record 4675.
- 50 Congressional Record 5046.
- 51 Congressional Record 1074.
- 1914 Annual Report 8.
- Id., p. 9.
- Circular No. 13, 1914 (set forth in 1914 Annual Report 182).
- 1914 Annual Report 58.
- 1915 Bulletin 37.
- 1916 Bulletin 531.
- Reg. A, Series of 1920, \$ II(a) (1920 Bulletin 1180).
- Reg. A, Series of 1923, § II(a) (1923 Bulletin 893).
- Reg. A, effective Oct. 1, 1937 (1937 Bulletin 984).
- 1920 Bulletin 1302,
- Many years later, in 1937, the Board adopted the broader view that a note given by the purchaser of goods is commercial paper even in the hands of the buyer and regardless of whether the goods are bought for resale or for use by the buyer. (1937 Bulletin 1190)
- 17 1921 Bulletin 1199.
- 18 1915 Bulletin 212.
- 1920 Bulletin 949.
- 1918 Bulletin 974.
- 1921 Bulletin 1079.
- 22
- 1917 Bulletin 949.
- 1921 Bulletin 1079. 26
- 1917 Bulletin 949.
- 2.7 Reg. B, Series of 1915 (1915 Bulletin 37).
- Reg. A, Series of 1916 (1916 Bulletin 531).
- Reg. A, Series of 1920 (1920 Bulletin 1180). See 1915 Bulletin 72; 1917 Bulletin 456; 1918
- Bulletin 108; 1921 Bulletin 1314; 1925 Bulletin 737.
- 1917 Bulletin 458.
- 1922 Bulletin 931.

- 1916 Bulletin 66.
- Lucas v. Federal Reserve Bank of Richmond, 50 Fed. (2d) 617 (C.C.A. 4th, 1932) (1932 Bulletin 452).
- Reg. A, 1937 (1937 Bulletin 987).
- Regs. 3 and 4, 1914 (set forth in 1914 Annual Report 60).
- Reg. A, Series of 1915 (1915 Bulletin 36).
- The Board later made it clear that its regulation did not require a member bank to maintain a borrower's financial statement on file. (1915 Bulletin 213)
- Reg. A, Series of 1916 (1916 Bulletin 530).
- 1920 Bulletin 1180.
- Reg. A, Series of 1928, § IV(b) (1928 Bulletin 64).
- Reg. A, 1937, §§ 1(h) and 3(b) (1937 Bulletin 985, 987); for similar provisions of 1955 regulation, see 1955 Bulletin 12, 13.
- 1963 Annual Report 198.
- By a court decision it was made plain that the Federal Reserve Act had no effect upon the character of a trade acceptance or the rights of the parties thereto. (Stafford v. Hill, 53 Calif. App. 337, 200 Pac. 33 (1921))
- 1917 Bulletin 116.
- Circular No. 16, Series of 1915 (1915 Bulletin
- Reg. P, Series of 1915 (1915 Bulletin 217).
- Reg. A, Series of 1916, § V(a) (1916 Bulletin 531).
- 1919 Bulletin 565.
- 1919 Bulletin 964. This ruling was incorporated in a footnote to Regulation A in 1920, which stated that "a consignment of goods or a conditional sale of goods can not be considered 'goods sold'."
- (1920 Bulletin 1180)
- 1918 Bulletin 33.
- 1917 Bulletin 114, 116.
- 1918 Bulletin 310.
- 1918 Bulletin 435.
- 1918 Bulletin 309.



- 1919 Bulletin 565. However, as previously indicated, it was permissible for the draft to include the cost of labor in installing goods sold. (Reg. A, Series of 1920, § VI(a), footnote 1; 1920 Bulletin 1180)
- 1918 Bulletin 30.
- 1918 Bulletin 636.
- Lane Company v. Crum, 291 S.W. 1084 (1927 Bulletin 510).
- 1927 Bulletin 510. Subsequently, in 1928, another Texas court held that a trade acceptance was negotiable even though it stated that the obligation of the acceptor arose out of the purchase of goods from the drawer (American Exchange National Bank v. Steeley, 10 S.W. (2d) 1038; 1929 Bulletin 157). The court distinguished this case from the Lane Company case on the ground that in the earlier case the statement on the acceptance required reference to the collateral transaction in order to determine maturity, while in the instant case this was not necessary, the instrument being an unqualified promise to pay
- at a certain time. Circular No. 17, Series of 1915 (1915 Bulletin
- Reg. Q, Series of 1915 (1915 Bulletin 310).
- Reg. A, Series of 1916, § VII (1916 Bulletin 532).
- Reg. A, Series of 1917, § VII (1917 Bulletin 540).
- Reg. No. 2, 1914 (1914 Annual Report 59).
- Reg. B, Series of 1915, § II(b)(1) (1915 Bulletin 37).
- Reg. A, Series of 1920, § II(b) (1920 Bulletin 1180).
- Reg. A, 1937, § 1(a)(2) (1937 Bulletin 984). Reg. A, 1955, § 3(a)(2) (1955 Bulletin 10).
- 1915 Bulletin 73; 1921 Bulletin 546.
- 1920 Bulletin 699; 1921 Bulletin 191.
- 1920 Bulletin 1301; 1921 Bulletin 191.
- 1918 Bulletin 309.
- 1916 Bulletin 67.
- 1918 Bulletin 971. 1921 Bulletin 191.
- 1926 Bulletin 585.
- 1920 Bulletin 699.
- 1938 Bulletin 86.
- Reg. A, 1973 (Appendix B).
- 1965 Bulletin 1409,
- Reg. B, Series of 1915, § II(b)(2) (1915 Bulletin 37).
- 91 Reg. A, Series of 1916, § II(c) (1916 Bulletin 531).
- Reg. A, 1955, § 3(a)(3) (1955 Bulletin 10).
- 1922 Bulletin 932.
- 1915 Bulletin 127.
- 1914 Annual Report 59.
- The present provision is contained in Reg. A, 1973, § 201.4(a) (Appendix B).

- Approved Apr. 5, 1918 (40 Stat. 506); subsequently amended by Acts of Nov. 21, 1918, Mar. 3, 1919, and Aug. 24, 1921.
- 1924 Bulletin 277.
- Reg. A, Series of 1924, §§ I(c), II(a) (1924 Bulletin 705).
- See 1916 Bulletin 587.
- 1917 Bulletin 158, 197.
- 1918 Bulletin 743; rescinded later, see 1924 Bulletjn 81.
- The Board previously had only discouraged the discount of paper of finance companies. (1915) Bulletin 72) Whether particular paper was finance or commercial paper was a matter, the Board held, for determination by the Reserve Bank. (1919 Bulletin 1054)
- 1919 Bulletin 1054; 1920 Bulletin 162, 1176; 1921 Bulletin 308.
- 1918 Bulletin 197.
- 1920 Bulletin 609.
- Reg. A, Series of 1920, § II(c) (1920 Bulletin 1180).
- Act of Mar. 4, 1923 (42 Stat. 1454).
- Reg. A, Series of 1923, § II(b) (1923 Bulletin 893). Under the first of these provisions, the Board held that notes of a factor the proceeds of which are loaned to producers of eggs, poultry, and butter were eligible for discount. (1926 Bulletin 251)
- 1926 Bulletin 665.
- 1930 Bulletin 746.
- 1937 Annual Report 31.
- 1937 Bulletin 1190.
- Ibid. See also 1938 Bulletin 86, regarding the eligibility for discount of notes of a finance company. Similarly, when the proceeds of a loan by a member bank to a credit union are used by the latter to make loans for "eligible" purposes, the note representing the loan to the credit union is eligible for discount. (1939 Bulletin 361)
- 1965 Bulletin 1409.
- 1972 Bulletin 279.
- 1937 Bulletin 1190.
- Act of June 27, 1934, § 505(b) (48 Stat. 1246). Sec. 24 of the Federal Reserve Act is to be found in 12 U.S.C. § 371.
- Act of Aug. 11, 1955 (69 Stat. 634).
- House Banking and Currency Committee Rep. No. 1349, 84th Cong., 1st Sess. (July 22, 1955), p. 2. See also Senate Banking and Currency Committee Rep. No. 399, 84th Cong., 1st Sess. (May 27, 1955), p. 2.
- Act of Sept. 9, 1959 (Pub. Law 86-251, 86th Cong.). The report of the House Banking and Currency Committee (House Rep. No. 693, 86th Cong., 1st Sess., July 21, 1959) pointed out that in such cases a national bank making such a loan relied upon the "take-out" commitment rather than the underlying real estate security and that



therefore such loans should be classed as commercial rather than real estate loans. The committee felt that the amendment would "permit national banks to make safe and desirable loans of this type which they may not now make, and will eliminate a competitive disadvantage which they now have vis-a-vis State banks in many States. The amendment had been recommended in 1956 by the Comptroller of the Currency for similar reasons (see Study of Banking Laws, committee print of Senate Banking and Currency Commit-

tee, 84th Cong., 2d Sess. (Oct. 12, 1956), pp. 49-51); and it had been included in the proposed Financial Institutions Act, which had passed the Senate in 1957 (S. 1451, 85th Cong., 1st Sess.) but had failed to pass the House.

Reg. A, 1937, § 1(c) (1937 Bulletin 985). Reg. A, 1955, § 3(d) (1955 Bulletin 12).

House Banking and Currency Committee Report on H.R. 9620, House Rep. No. 1922, 73d Cong., 2d Sess. (June 4, 1934), p. 4.



#### AGRICULTURAL CREDITS

- 50 Congressional Record 4647.
- See, for example, statements by Mr. Harrison (50 Congressional Record 4729), Mr. Moss (50 Congressional Record 4774), and Mr. Neeley (50 Congressional Record 4845).
- 50 Congressional Record 4846.
- 51 Congressional Record 613.
- Mr. Tribble stated that Mr. Glass had so construed the bill as originally reported. (50 Congressional Record 5045) There were some who asserted that the provision was approved only after a "hard struggle" in the Democratic caucus and in the face of Glass's opposition. (50 Congressional Record 5009, 5022, 5045)
- Act of July 17, 1916 (39 Stat. 360).
- The Reserve Banks were authorized to buy and sell such bonds to the same extent that they could purchase and sell municipal bonds under § 14(b) of the Federal Reserve Act. Sec. 14(b) permitted (and still permits) the purchase and sale of municipal bonds having maturities of not more than 6 months. Member banks were given blanket authority by the Farm Loan Act to buy and sell farm loan bonds. The provisions of the Farm Loan Act were superseded by the comprehensive Farm Credit Act of Dec. 10, 1971, but the authorities above mentioned were continued. (12 U.S.C. 2158)
- See discussion during the congressional debates on the Agricultural Credits Act of 1923; 64 Congressional Record 1742, 1746.
- 41 Stat. 1084.
- Mar. 4, 1923 (42 Stat. 1454).
- The Banking and Currency Committees agreed that it was desirable to encourage more country banks to join the System (Senate Rep. No. 998, 67th Cong., 4th Sess. (Jan. 8, 1923), p. 8; House Rep. No. 1712, 67th Cong., 4th Sess. (Feb. 24, 1923), p. 19). A proposal to increase dividends

- paid on Federal Reserve Bank stock was finally abandoned as not being a substantial inducement to membership (House Rep. No. 1712, p. 19). However, the Agricultural Credits Act sought to make membership more attractive by somewhat liberalizing capital requirements, and a joint congressional committee was assigned the task of considering what measures might be taken to increase membership.
- House hearings on S. 4280, 67th Cong., 4th Sess. (Jan. 31, Feb. 2-19, 1923), p. 1.
- 13 64 Congressional Record 1758.
- House hearings on S. 4280, Jan. 31, 1923, p. 1.
- Id., p. 62.
- 1923 Bulletin 913.
- Reg. C, Series of 1915 (1915 Bulletin 38). 17
- Reg. A, Series of 1923, § VI(a) (1923 Bulletin 893).
- Reg. A, 1955, § 3(e) (1955 Builetin 12). 19
- 1918 Bulletin 310.
- 1916 Bulletin 526. 22
- 1918 Bulletin 1118. 1918 Bulletin 310, 312.
- 1915 Bulletin 75.
- 1918 Bulletin 309.
- 1916 Bulletin 67.
- 1918 Bulletin 743. But the note of an irrigation company is commercial rather than agricultural paper, even though all of its customers are farmers. (1921 Bulletin 964)
- 1916 Bulletin 679; 1917 Bulletin 378.
- 1916 Bulletin 112; 1915 Bulletin 72.
- 1915 Bulletin 212.
- 1917 Bulletin 616.
- Statement by Senator Capper, 64 Congressional Record 1757.
- Senate Rep. No. 998, 67th Cong., 4th Sess. (Jan. 8, 1923), p. 7.
- 64 Congressional Record 4903.



- Eugene Meyer felt that this restriction was unimportant because of the large reserves available to the Reserve Banks. (Hearings on S. 4280, 67th Cong., 3d and 4th Sess. (Apr.-May 1922 and Jan.-Feb. 1923), p. 60)
- Senate Rep. No. 998, 67th Cong., 4th Sess. (Jan. 8, 1923), p. 7.
- 37 Reg. No. 5 (1914 Annual Report 61).
- <sup>38</sup> Circular No. 13, 1914 (1914 Annual Report 184).
- Act of Sept. 7, 1916 (39 Stat. 752). See statement by Senator Owen, 53 Congressional Record 11002.
- 40 Reg. A, Series of 1923, § VI(e) (1923 Bulletin 893).
- 41 1917 Bulletin 378.
- 42 1923 Bulletin 911. See statement by Senator Platt during hearings on S. 4280, 67th Cong., 3d and 4th Sess. (Apr.-May 1922 and Jan.-Feb. 1923), p. 104; also Senate Rep. No. 998, 67th Cong., 4th Sess. (Jan. 8, 1923), p. 6.
- 43 Act of Mar. 4, 1923 (42 Stat. 1454).
- 4 Act of May 29, 1928 (45 Stat. 975).
- <sup>45</sup> Reg. A, Series of 1923, § VII (1923 Bulletin 894).
- \* Reg. A, 1955, § 3(b) (1955 Bulletin 11).
- 17 1966 Bulletin 506.
- <sup>48</sup> 1924 Bulletin 276.
- 49 1925 Bulletin 737.
- 50 1926 Bulletin 854.
- <sup>51</sup> Reg. A, 1937, § 1(b) (1937 Bulletin 984).
- Hearings on S. 4280, 67th Cong., 3d and 4th Sess. (Apr.-May 1922 and Jan.-Feb. 1923), p. 60
- <sup>™</sup> *Id.*, p. 74.

- Reg. A, Series of 1923, § VIII (1923 Bulletin 894).
- E Reg. A, 1955, § 3(g) (1955 Bulletin 12).
- ™ 1926 Bulletin 251.
- 1923 Bulletin 911. For statement by Eugene Meyer regarding development of such associations, see hearings on S. 4280 before House Banking and Currency Committee, 67th Cong., 3d and 4th Sess. (Apr.-May 1922 and Jan.-Feb. 1923), p. 61.
- 1923 Bulletin 999.
- See summary of such rulings in 1922 Bulletin 1044.
- 1921 Bulletin 1312.
- Hearings on S. 4280 before House Banking and Currency Committee, 67th Cong., 3d and 4th Sess. (Apr.-May 1922 and Jan.-Feb. 1923), p. 61.
- <sup>42</sup> 1923 Bulletin 999,
- Reg. A, Series of 1923, § VI(b) (1923 Bulletin 893). See also Reg. A, 1955, § 3(f) (1955 Bulletin 12).
- Reg. A, Series of 1923, § VI(d) (1923 Bulletin 894).
- This limitation was not applicable, however, when paper of a Federal intermediate credit bank was rediscounted at a Federal Reserve Bank by a member bank. (1926 Bulletin 252)
- 4 1928 Bulletin 777,
- 97 1937 Bulletin 984.
- <sup>48</sup> Reg. A, 1955, § 6(a) (1955 Bulletin 14).
- 5 75 Congressional Record 8860.
- <sup>70</sup> 47 Stat. 159.



#### **BANKERS' ACCEPTANCES**

- Report of National Monetary Commission, Senate Doc. 243, 62d Cong., 2d Sess. (Jan. 9, 1912), p. 28.
- House Rep. No. 69, 63d Cong., 1st Sess. (Sept. 9, 1913), p. 49.
- 50 Congressional Record 4678.
- 51 Congressional Record 434.
- 51 Congressional Record 469.
- 50 Congressional Record 4647.
   51 Congressional Record 1470.
- 6 Circular No. 11, Series of 1915 (1915 Bulletin 44).
- D Ibid.
- Press statement, Sept. 10, 1915 (1915 Bulletin 312).

- <sup>1</sup> 1916 Bulletin 591.
- 1919 Annual Report 22.
- 1920 Annual Report 50.
- See article on "Bankers' Acceptance Financing in the United States," 1955 Bulletin 482.
- 15 Ibid. See also Wilbert Ward and Henry Harfield, Bank Credits and Acceptances (4th ed.; N.Y.: Ronald Press Co., 1958), p. 88.
- <sup>10</sup> Reg. J, Series of 1915, § I (1915 Bulletin 45).
- " Id., § IV(b).
- <sup>18</sup> Reg. A, Series of 1916 (1916 Bulletin 532).
- <sup>19</sup> Reg. A, Series of 1920 (1920 Bulletin 1180).
- <sup>20</sup> 1916 Bulletin 112.
- <sup>21</sup> 1915 Bulletin 362.
- <sup>22</sup> 1918 Bulletin 634.



- House Rep. No. 69, Sept. 9, 1913, p. 49.
- 50 Congressional Record 4676.
- 51 Congressional Record 434.
- Sec, for example, 1921 Bulletin 547, 816.
- 12 C.F.R. 7.7420.
- 1923 Bulletin 319 1923 Bulletin 316-19.
- 1915 Bulletin 98.
- Rcg. A, 1937, § 6(b) (1937 Bulletin 988).
- 1916 Bulletin 532. In 1928 the Board published suggested forms of certificates evidencing eligibility of bankers' acceptances. (1928 Bulletin 517)
- 1920 Bulletin 386.
- Reg. No. 6, Nov. 10, 1914 (1914 Annual Report
- Reg. J. Series of 1915 (1915 Bulletin 45)
- Reg. A, Series of 1916 (1916 Bulletin 532).
- 1917 Bulletin 28.
- 1915 Bulletin 276.
- 1918 Bulletin 976.
- 1929 Bulletin 294.
- 41 1920 Bulletin 162.
- 1916 Bulletin 458.
- 1916 Bulletin 12.
- 1917 Bulletin 30.
- 1926 Bulletin 854.
- 1927 Bulletin 860.
- See "Bankers' Acceptance Financing in the United States," 1955 Bulletin 482.
- 1915 Bulletin 276; 1918 Bulletin 435.
- 1920 Bulletin 162; 1921 Bulletin 419. The Board also ruled that it was immaterial whether or not the goods had been actually sold at the time of acceptance, if the accepting bank was reasonably sure that the draft was drawn to finance the shipment and the proceeds would be used for that purpose. (1917 Bulletin 527)
- 1918 Bulletin 438.
- Reg. A, Series of 1920, § B(b)(1) (1920 Bulletin 1180).
- The Board had previously ruled that there was no need for identification of the goods at the time of acceptance (1915 Bulletin 405; 1917 Bulletin 527). Nor were there any limitations on the kinds of goods that might be involved. The Board ruled that gold bullion and gold coin were "goods" for this purpose. (1917 Bulletin 29)
- 1921 Bulletin 70.
- 1922 Bulletin 433.
- 1915 Bulletin 91.
- Reg. A, Series of 1916, § B(c) (1916 Bulletin
- Reg. A, Series of 1923, § X (1923 Bulletin 892,
- Reg. C, 1946, § 1(a) (Appendix C).
- Act of Sept. 7, 1916 (39 Stat. 752).
- 1915 Annual Report 22. Later, on Mar. 10, 1916,

- the Board recommended the amendment to the Senate Banking and Currency Committee. See Senate Banking and Currency Rep. No. 481, 64th Cong., 1st Sess. (May 18, 1916), p. 9.
- 53 Congressional Record 11001.
- Reg. A, Series of 1916, § B(c) (1916 Bulletin 532).
- 1917 Bulletin 380.
- 1920 Bulletin 1301; 1921 Bulletin 1312.
- 1929 Bulletin 811.
- 1921 Bulletin 191. Nor is an acceptance agreement, which purports to assign certain collateral security but does not specifically mention any security as assigned, sufficient to qualify as a shipping document. (1918 Bulletin 311)
- 1919 Bulletin 471.
- 1917 Bulletin 765; 1918 Bulletin 971, 972. Eventually, this principle was incorporated in the Board's Regulation C. See Reg. C, as revised Aug. 31, 1946, \$ 1(a)(2) (Appendix C).
- 1918 Bulletin 634,
- 1919 Bulletin 254.
- Reg. C, 1946, § 1(a)(2) (Appendix C). Some lawyers have questioned this interpretation, arguing that domestic shipments may properly cover shipments within a foreign country. (See Ward and Harfield, Bank Credits and Acceptances (1958), p. 100.)
- 1919 Bulletin 858.
- 1922 Bulletin 52.
- 1920 Bulletin 66.
- Reg. A, Series of 1920 (1920 Bulletin 1181).
- 1918 Bulletin 437, 871.
- 1918 Bulletin 636.
- 1918 Bulletin 31; 1918 Bulletin 634; 1921 Bulletin 963.
- 1926 Bulletin 666.
- 1923 Bulletin 1194; 1926 Bulletin 666.
- 1933 Bulletin 188.
- 1918 Bulletin 31; also 1918 Bulletin 862.
- Reg. A, Series of 1928, as amended, § XI(3) (1928 Bulletin 777).
- 1923 Bulletin 316.
- Reg. A, Series of 1920, § B(b)(3) (1920 Bulletin 1181). The requirement was repeated in Reg. A, as revised effective Feb. 15, 1955, footnote 8 (1955 Bulletin 11); but it was eliminated in the 1973 revision.
- 1919 Bulletin 740; 1924 Bulletin 638.
- Reg. A, Series of 1928, § XI(3) (1928 Bulletin 66).
  - 1916 Bulletin 523.
- 1919 Bulletin 652.
- 1918 Bulletin 309.
- 91 1923 Bulletin 1194.
  - 1917 Bulletin 30; 1916 Bulletin 523.
- 1925 Bulletin 737.



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1915 Bulletin 126.
    1916 Bulletin 523.
                                                           1.19
                                                               39 Stat. 752; 12 U.S.C. § 372.
    1917 Bulletin 614.
    1918 Bulletin 520.
                                                               1919 Bulletin 143.
    1918 Bulletin 636.
                                                           141
                                                               1919 Bulletin 364.
    1920 Bulletin 65; 1921 Bulletin 699.
                                                               1917 Bulletin 286.
    1920 Bulletin 494; 1921 Bulletin 419.
                                                           143
                                                               1920 Bulletin 1065.
    Senate committee report on H.R. 13391, Senate
                                                               1922 Bulletin 52.
                                                           145
                                                               1919 Bulletin 254, 468.
    Rep. No. 481, 64th Cong., 1st Sess. (May 18,
                                                               1917 Bulletin 286, 881; 1919 Bulletin 254; 1921
    1916), p. 10.
    53 Congressional Record 11002.
                                                               Bulletin 1313.
    1916 Bulletin 666.
                                                               Reg. C, Series of 1920 (1920 Bulletin 1182). The
    1920 Bulletin 835.
                                                               condition as to control of the goods was strictly
    Reg. C, 1946, § 2(c)(1) (Appendix C).
                                                               applied. Even when the customer held a trust
    Id., § 2(c)(2).
                                                               receipt as agent for the bank for the sole purpose
    See "Bankers' Acceptance Financing in the United
                                                               of diverting the cars carrying the goods to a ware-
    States," 1955 Bulletin 482.
                                                               house, it was concluded that the customer would
                                                               have some control of the goods. (1921 Bulletin
    1916 Bulletin 534.
    1916 Bulletin 532.
                                                               1313)
                                                               Reg. C, 1946, § 1(c) (Appendix C).
    Reg. C, 1946, § 2(a) (Appendix C).
    1916 Bulletin 666.
                                                               In 1934 the Board held that, for the purpose of
                                                               this limitation, capital stock included capital notes
    1918 Bulletin 938.
    1920 Bulletin 1175. Obviously, "San Salvador"
                                                               and debentures legally issued by a State member
                                                               bank and purchased by the Reconstruction Fi-
    referred to the country of Salvador rather than
                                                               nance Corporation. (1934 Bulletin 749)
    the city of San Salvador.
    1921 Bulletin 188.
                                                               38 Stat. 958. In its report on this amendment, the
    1922 Bulletin 50, 680.
                                                               House Banking and Currency Committee, headed
                                                               by Carter Glass, stated that the Reserve Bank
    1918 Bulletin 938; 1922 Bulletin 680.
    1946 Bulletin 997.
                                                               Organization Committee, on its tour of the
                                                               country, had found that there were a number of
    See hearings on S. 1451 and H.R. 7026 before the
    House Committee on Banking and Currency, Part
                                                               State banks that desired to become members of
    2, 85th Cong., 2d Sess. (Jan. 14-Feb. 7, 1958),
                                                               the System but were deterred by the restrictions
    p. 1036.
                                                               of § 13 of the Federal Reserve Act and that
    Id., p. 989.
                                                               they might become members if this amendment
119
    Id., pp. 1010, 1065.
                                                               were approved. (House Rep. No. 1165, 63d
                                                               Cong., 2d Sess. (Sept. 24, 1914))
    Id., p. 1036.
121
                                                           1.51
    Id., p. 1063.
                                                               Reg. K, Series of 1915 (1915 Bulletin 46).
122
    See present Reg. C, § 1(b) (Appendix C).
                                                               1916 Annual Report 28.
    1917 Bulletin 690; 1923 Bulletin 158.
                                                           153
                                                               40 Stat. 232.
    1917 Bulletin 690; 1921 Bulletin 815.
                                                               See 1918 Bulletin 1119.
    1929 Bulletin 811.
                                                               Reg. C, Series of 1917 (1917 Bulletin 542).
    Reg. A, Series of 1920, § B(c)(2) (1920 Bulletin
                                                               Reg. C, 1946, § 1(e) (Appendix C).
    1181).
                                                               1916 Bulletin 397.
                                                           158
    1921 Bulletin 815; 1922 Bulletin 52.
                                                               Reg. C, 1946, § 1(d) (Appendix C).
    Reg. A, 1955, § 3(c), footnote 10 (1955 Bulletin
                                                               1917 Bulletin 528.
                                                               Federal Reserve Act, § 13, ¶ 12; 12 U.S.C. § 373.
    11)
    1917 Bulletin 30; 1921 Bulletin 699; 1926 Bul-
                                                           161
                                                               Reg. C, 1946, § 2(e) (Appendix C).
    letin 854.
                                                               Id., § 2(c)(2).
    1920 Bulletin 66.
                                                           163
                                                               Id., § 2(f)
    Reg. J, Series of 1915 (1915 Bulletin 45).
                                                               Reg. A, 1955, § 2(c) (1955 Bulletin 11).
   Reg. R, Series of 1915 (1915 Bulletin 311).
Sept. 10, 1915 (1915 Bulletin 312).
                                                           163
                                                               38 Stat. 958.
                                                               Reg. J, Series of 1915 (1915 Bulletin 45).
    1919 Bulletin 858.
                                                               Reg. R, Series of 1915 (1915 Bulletin 310).
    Reg. A, Series of 1920 (1920 Bulletin 1181).
                                                               1915 Bulletin 269.
136
    1927 Bulletin 860.
                                                               For a discussion of the nature and form of letters
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of credit, see 1921 Bulletin 158, 410, 681, 926.

1921 Bulletin 963.



- 170 1921 Bulletin 547.
- Reg. C, 1946, § 1(d) (Appendix C); also 1915 Bulletin 311.
- 172 1921 Bulletin 816.
- 173 1918 Bulletin 257.

- 12 U.S.C. § 353.
- 173 1923 Bulletin 317.
- <sup>170</sup> Act of June 16, 1933 (48 Stat. 162).
- <sup>177</sup> 12 C.F.R. § 270.7(b).
- <sup>178</sup> 12 C.F.R. § 202.2.



#### REDISCOUNT OF WORLD WAR I VETERANS' NOTES

- 3 43 Stat. 125.
- Set forth in 1927 Bulletin 33.
- <sup>2</sup> Reg. M, Series of 1926 (1927 Bulletin 30).
- The Board held that such a note was not eligible for discount if the requisite notice to the veteran had been waived. (1931 Bulletin 538)
- 5 1928 Bulletin 74.
- <sup>6</sup> Act of Feb. 27, 1931 (46 Stat. 1429).
- 1931 Bulletin 161.
- <sup>6</sup> Act of July 21, 1932 (47 Stat. 724).
- 1932 Bulletin 598.
- 10 1939 Bulletin 361.



#### ADVANCES TO MEMBER BANKS

- <sup>1</sup> 1915 Annual Report 22. Subsequently, the Board recommended specific language (1916 Bulletin 324), which was adopted by Congress without change.
- 39 Stat. 752.
- Senate Banking and Currency Committee Rep. No. 481, 64th Cong., 1st Sess., (May 18, 1916), n. 9.
- 53 Congressional Record 11001, 11002.
- Letter to Senate Banking and Currency Committee, Mar. 29, 1932 (1932 Bulletin 213).
- 1916 Bulletin 513.
- <sup>1</sup> 1927 Bulletin 29.
- 1932 Annual Report 25–31, 216.
- 1960 Bulletin 151.
- <sup>10</sup> Act of Sept. 21, 1968 (82 Stat. 856).
- <sup>11</sup> 1968 Bulletin 1012.
- 12 1916 Bulletin 685.
- <sup>14</sup> 53 Congressional Record 11001.
- <sup>14</sup> 1917 Bulletin 765, 879.
- Letter to Senate Banking and Currency Committee, Mar. 29, 1932 (1932 Bulletin 206).
- <sup>16</sup> Reg. A, 1955, § 2(b) (1955 Bulletin 9).
- 37 1968 Bulletin 1012.
- 75 Congressional Record 4324.
- S. 4115.

- Letter to Senate Banking and Currency Committee, Mar. 29, 1932. (1932 Bulletin 213) The Federal Advisory Council also opposed the proposed penalty rate on 15-day advances. (1932 Bulletin 224)
- <sup>n</sup> 1933 Bulletin 499.
- <sup>2</sup> 1970 Bulletin 940.
- 39 Stat. 752.
- <sup>24</sup> 48 Stat. 7.
- 1942 Bulletin 302.
- 1955 Bulletin 9.
- <sup>27</sup> 1968 Bulletin 1012.
- This change was technically unnecessary because a 1929 amendment to the Second Liberty Bond Act of 1917 had provided that, for purposes of the Federal Reserve Act, bonds and notes of the United States should be deemed to include certificates of indebtedness and Treasury bills (Act of June 17, 1929; 46 Stat. 19).
- 1960 Bulletin 858.
- 1937 Bulletin 987.
- 1939 Annual Report 6.
- 1941 Annual Report 1.
- War Finance Corporation Act of Apr. 5, 1918 (40 Stat. 506). Reference to the use of such bonds as collateral for Federal Reserve advances



was contained in the Board's 1920 revision of Regulation A (1920 Bulletin 1179), but it was omitted in the 1928 revision of the regulation.

47 Stat. 159.

- Previously, in December 1931, a bill to permit such debentures to be used as collateral for \$ 13 advances had been introduced by Senator Vandenberg but had failed to pass.
- House Rep. No. 1125, 72d Cong., 1st Sess. (Apr. 25, 1932), pp. 4, 5.
- 75 Congressional Record 10368.
- 75 Congressional Record 10369.
- This was made clear by a provision of the Act of Aug. 19, 1937 (50 Stat. 718; 12 U.S.C. § 1040).
- Act of July 17, 1916 (39 Stat. 380). The Farm Loan Act provision was superseded by a provision of the Farm Credit Act of 1971 that specifies that "any Federal Reserve Bank may buy and sell" bonds, debentures, or other obligations issued under the authority of that act to the same extent and subject to the same limitations placed upon the purchase and sale by such Banks of State, county, district, and municipal bonds under § 14(b) of the Federal Reserve Act (12 U.S.C. \$ 2158).
- 1918 Bulletin 33.
- House Committee on Agriculture Rep. No. 6. 73d Cong., 1st Sess. (Mar. 20, 1933), p. 2.
- 48 Stat. 31.
- 48 Stat. 344.
- House Committee on Agriculture Rep. No. 279, 73d Cong., 2d Sess. (Jan. 12, 1934), p. 1.
- Less than \$200,000 as of June 30, 1960.
- Reg. A, 1955, § 2(a), footnote 2 (1955 Bulletin 10).
- 75 Stat. 773.
- 1968 Bulletin 1012.
- 48 Stat. 643.
- House Rep. No. 1075, 73d Cong., 2d Sess. (Mar. 26, 1934), p. 4.
- 78 Congressional Record 4807.
- Pursuant to Act of June 30, 1953 (67 Stat. 121).
- 1917 Bulletin 949.
- 1949 Bulletin 247. Gd
- 1969 Bulletin 354. 57
- 1960 Bulletin 151. 1968 Bulletin 1012.
- 1962 Bulletin 690.
- 42 Opinions of Attorney General, No. 1, Apr. 14, 1961.
- 61 1966 Bulletin 188.
- 1966 Bulletin 340.
- Act of Sept. 21, 1966 (80 Stat. 825).
- Acts of Sept. 21, 1967 (81 Stat. 226) and Sept. 21, 1968 (82 Stat. 856).
- 1968 Bulletin 1012.
- 1969 Bulletin 355.

- 1971 Bulletin 399.
- 65 1972 Bulletin 983.
- 1971 Bulletin 399.
- 1916 Bulletin 609. It was pointed out that while bonds of the United States were mentioned both in § 13 and § 14(b), municipal tax obligations were mentioned in the latter but not in the former section.
- Thus, during the hearings on the Glass-Steagall bill, Governor Meyer stated that if § 10(b) were adopted, "banks would be freer to use their resources to buy warrants, knowing that in case of need they could borrow on them under exceptional circumstances" (Hearings on H.R. 9203, 72d Cong., 1st Sess. (Feb. 12, 1932), p. 19). During the debates, Senator Kean similarly indicated that the bill would permit the use of municipal bonds as collateral for advances in exceptional circumstances, (75 Congressional Record 4310) Previously, in December 1931, Senator Vandenberg had introduced a bill (S. 546) that would have made revenue bonds specifically eligible as collateral for advances to member banks under § 13 of the Federal Reserve Act, but that bill was never enacted.
- 1968 Bulletin 1013.
- 1969 Bulletin 150.
- Act of June 25, 1959 (73 Stat. 142).
- 73 47 Stat. 56.
  - 75 Congressional Record 3963.
- For example, Mr. Shannon (75 Congressional Record 3983); Mr. McFadden (75 Congressional Recond 3986); Senator Couzens (75 Congressional Record 4053).
- House Committee on Banking and Currency Rep. No. 475, 72d Cong., 1st Sess. (Feb. 13, 1932),
- Mr. McFadden, 75 Congressional Record 3986.
- Senator Robinson, 75 Congressional Record 4223. In the House, Mr. Stafford said: "This bill could not be justified in normal times, because some of the security that is offered for Federal reserve notes, though perfectly sound, is not of liquid character, such as bonds and mortgages. But hard cases require exceptional treatment. I justify this only as a temporary expedient \*\*\*." (75 Congressional Record 3981)
- 75 Congressional Record 3966.
- Senate Banking and Currency Committee Rep. No. 237, 72d Cong., 1st Sess. (Feb. 12, 1932), p. 2.
- Hearings on H.R. 9203, Feb. 12, 1932, p. 15. Later, the Board reported that, as of Dec. 31, 1931, member banks held \$4,694 million of Government bonds and \$2,573 million of eligible commercial paper. (1932 Bulletin 142)
- Mr. Steagall, 75 Congressional Record 3964.
- 75 Congressional Record 4136.



75 Congressional Record 4137. Senator Wolcott likewise thought the measure would cause banks to stop "hoarding" eligible paper and make more loans. (75 Congressional Record 4143)

75 Congressional Record 4242.

Mr. LaGuardia, 75 Congressional Record 3970.

Senate Rep. No. 237, 72d Cong., 1st Sess. (Feb. 12, 1932).

House Rep. No. 475, 72d Cong., 1st Sess. (Feb. 13, 1932).

<sup>91</sup> Mr. Beedy, 75 Congressional Record 3980.

- See statement by Secretary of the Treasury Ogden Mills during hearings on H.R. 9203, Feb. 12, 1932, p. 23.
- 75 Congressional Record 4228. Similarly, Mr. Williamson felt that a liberalization of the eligibility rules should be made permanent legislation. (75 Congressional Record 3972)

Hearings on H.R. 9203, Feb. 12, 1932, p. 18.

<sup>ω</sup> *Id.*, p. 3.

Senate Rep. No. 584 on S. 4412, 72d Cong., 1st Sess. (Apr. 22, 1932), p. 12.

12 U.S.C. § 347a,

Mr. Steagall, 75 Congressional Record 3964.

Scnate Rep. No. 237, 72d Cong., 1st Sess. (Feb. 12, 1932), p. 2.

- House Rep. No. 475, 72d Cong., 1st Sess. (Feb. 13, 1932).
- 101 Hearings on H.R. 9203, Feb. 12, 1932, p. 3.

75 Congressional Record 4135.

Said Mr. Strong: "It will permit the banks that have no eligible paper to get together and guarantee each other's paper." (75 Congressional Record 3965)

See 75 Congressional Record 4315.

- Senator Glass stated: "No limitation is put upon the amount of credit that may thus be obtained at a Federal reserve bank. That is left altogether within the discretion of the directors of the reserve bank \*\*\*." (75 Congressional Record 4135)
- The House bill (H.R. 9203) had limited § 10(a) to a period of 1 year, like § 10(b), although some Congressmen felt that neither section should be so limited. (75 Congressional Record 3966) On the other hand, the Senate bill, while limiting the duration of § 10(b), placed no time limit on § 10(a), and some Senators were unable to see why both sections should not be enacted for only a temporary period. (75 Congressional Record 4318)
- As passed by the House on Feb. 16, 1932, the bill would have required the consent of a majority of the Board; the Senate bill, passed on Feb. 19, required the consent of six members; the conference committee in effect followed the House version since the Board had eight members then.

75 Congressional Record 4134.

House Rep. No. 607, 72d Cong., 1st Sess. (Feb. 25, 1932), p. 4.

75 Congressional Record 4321.

See 75 Congressional Record 4315. Senator Reed was not satisfied that this change made the matter clear; he suggested that since all the banks in the group initially would receive the proceeds, the provision should refer to the "recipient" bank or banks as later mentioned in the section. (75 Congressional Record 4322)

See hearings on H.R. 9203, Feb. 12, 1932, p. 9; also comments by Senator Norris during the debates, 75 Congressional Record 4317.

- 75 Congressional Record 4317, 4318.
- 114 75 Congressional Record 4785.

5 1932 Bulletin 180.

S. 1451, 85th Cong. In its recommendation to the Senate Banking and Currency Committee regarding this matter, the Board stated:

ever made by the Reserve banks under this authority. One reason presumably was that the same time Congress enacted section 10(b) of the Federal Reserve Act authorizing advances to any individual member bank on any 'satisfactory security.' In the circumstances it seems reasonably clear that the authority contained in section 10(a) serves no useful purpose and should be repealed." (Study of the Banking Laws, committee print of Senate Banking and Currency Committee, 84th Cong., 2d Sess. (Oct. 12, 1956), p. 90)

75 Congressional Record 4135.

- Hearings on H.R. 9203, Feb. 12, 1932, p. 3.
- For example, Gov. Meyer, hearings on H.R. 9203, p. 9; Mr. Burtness, 75 Congressional Record 3966.
- 75 Congressional Record 4333. Senator Glass opposed this amendment because he felt that psychologically it was unwise to suggest that the emergency would last for 2 years.

<sup>121</sup> 75 Congressional Record 4786.

- 75 Congressional Record 4262. At an earlier point, a capital limitation of \$2 million had been contemplated.
- 75 Congressional Record 4315.
- 75 Congressional Record 4786.
- Mr. Strong, 75 Congressional Record 3966.
- House Rep. No. 1928, 72d Cong., 2d Sess. (Jan. 27, 1933), p. 3.
- 127 47 Stat. 794.
- 28 48 Stat. 1.
- 77 Congressional Record 56.
- <sup>∞</sup> 77 Congressional Record 57.
- 151 77 Congressional Record 79.
- 1933 Bulletin 122.



- 1934 Bulletin 182.
- <sup>134</sup> 49 Stat. 684.
- 135 H.R. 5357; S. 1715.
- <sup>136</sup> Hearings on H.R. 5357, Mar. 4, 1935, p. 184.
- <sup>137</sup> 79 Congressional Record 6739.
- <sup>138</sup> 79 Congressional Record 13707.
- For example, Gov. Eccles, House committee hearings, Mar. 4, 1935, p. 184; House Banking and Currency Committee Rep. No. 742, 74th Cong., 1st Sess. (Apr. 19, 1935), p. 11; Mr. Hancock, 79 Congressional Record 6739.
- 140 1935 Bulletin 560.
- 111 1937 Annual Report 206.
- <sup>142</sup> 50 Congressional Record 5999.
- <sup>143</sup> 51 Congressional Record 523.
- Gov. Meyer, hearings on H.R. 9203, p. 9.
- Mr. Busby, 75 Congressional Record 3973.
- 75 Congressional Record 4135.
- Gov. Meyer, hearings on H.R. 9203, p. 19.
- <sup>148</sup> Mr. Strong, Feb. 15, 1932, 75 Congressional Record 3965.
- 110 Ibid.; also Mr. Stafford, 75 Congressional Record 3981.
- <sup>150</sup> Hearings on H.R. 9203, pp. 9, 10.
- <sup>151</sup> 75 Congressional Record 3972.
- <sup>152</sup> 75 Congressional Record 4228.
- <sup>183</sup> Hearings on H.R. 5357, Mar. 4, 1935, p. 183.
- 154 Id., p. 289.
- 155 Id., p. 405.
- 158 *Id.*, p. 387. 157 *Id.*, p. 453.
- <sup>158</sup> House Rep. No. 742, 74th Cong., 1st Sess. (Apr. 19, 1935), p. 11.
- <sup>150</sup> 79 Congressional Record 6718.
- <sup>180</sup> 79 Congressional Record 6736.
- Hearings on S. 1715, May 15, 1935, pp. 410, 701.
- 103 Id., p. 296; 79 Congressional Record 11825.
- Senate Rep. No. 1007, 74th Cong., 1st Sess. (July 2, 1935), p. 11.
- Senator Adams stated: "This provision constitutes a fundamental departure from the theory heretofore prevailing as to the character of securities acceptable by Federal Reserve Banks." (79 Congressional Record 4988)

- 103 79 Congressional Record 13706.
- 5 79 Congressional Record 13707.
- 167 1937 Annual Report 206.
- 168 1936 Bulletin 624.
  - <sup>9</sup> 1936 Bulletin 548.
- 170 Reg. A, 1937, § 2(d) (1937 Bulletin 986).
- <sup>71</sup> 1937 Annual Report 207.
- 12 Ibid.
  - 1937 Bulletin 989, 990. As to real estate loans, the minimum standards were: a first lien on improved real estate; compliance with the amount and maturity requirements of § 24 of the Federal Reserve Act; and maintenance by the member bank of an appraisal of the real estate, an adequate description of the property, evidence of title, evidence of no tax delinquency, and such other information as the circumstances might render advisable. As to instalment loans, the standards were: security by a first lien in the nature of a chattel mortgage, conditional sales contract, or similar instrument; goods of such a nature that in the event of resale the sum realized would be greater than the amount necessary to liquidate the obligation; and reasonable steps by member banks to satisfy themselves that payments and other requirements would be met.
- Hearings on H.R. 5357, Mar. 18, 1935, pp. 387, 406.
- <sup>72</sup> *Id.*, p. 387.
- <sup>176</sup> 1935 Bulletin 771.
- <sup>7</sup> Reg. A, 1955, § 2(c) (1955 Bulletin 10).
- Joint committee print of statements submitted to Subcommittee on Monetary, Credit, and Fiscal Policies, Senate Doc. 132, 81st Cong., 2d Sess. (Nov. 7, 1949), p. 58.
- Letters to the chairmen of the Banking and Currency Committees of the Congress, Aug. 21, 1963. (See also discussion in 1963 Bulletin 1235.)
- <sup>180</sup> For example, S. 1559, 89th Cong., 1st Sess. (1965); S. 966, 90th Cong., 1st Sess. (1967).
- 181 1971 Annual Report 211. A bill to implement the Board's new proposal was introduced in the Senate as S. 1951, 92d Cong., 1st Sess. (May 26, 1971).



#### CREDIT FOR NONMEMBER BANKS

1972 Annual Report 254.

75 Congressional Record 4786. During the House committee hearings on the bill, Gov. Meyer of the Board stated that the bill was not intended to

provide credit to nonmember banks but that they would benefit indirectly. (Hearings on H.R. 9203, Feb. 12, 1932, p. 7)

<sup>3</sup> 51 Congressional Record 958.



- Id., p. 1035.
- Id., p. 1119.
- Ibid.
- Id., p. 1145.
- Id., p. 1146. 1915 Bulletin 213.
- 1917 Annual Report 5.
  - 1918 Bulletin 743.
- 1918 Bulletin 520.
- 13 1918 Bulletin 745.
- 14 1921 Bulletin 963.
- 1923 Bulletin 891. The rescission was effective June 26, 1923.
- 1926 Bulletin 252.
- 17 1966 Annual Report 91.
- 1969 Annual Report 92.
- See Board press release of Oct. 24, 1972. The text of the amendment to Reg. J was published in 1972 Bulletin 650.
- Reg. A, Series of 1928, §§ III(2) and IX (1928) Bulletin 64, 65).
- 1937 Bulletin 987.
- 1955 Bulletin 13.
- Reg. A, 1973, § 201.5(c) (see Appendix B).
- 47 Stat. 709.
- A year later, both Senator Glass and Senator Barkley referred to this authority as including authority to discount paper for State banks on the ground that they were corporations. (77 Congressional Record 249, 333)
- 1932 Bulletin 519.
- 27 48 Stat. 1.
- 12 U.S.C. § 347c.
- 77 Congressional Record 56.

- 77 Congressional Record 79.
- 1942 Bulletin 302.
- 1942 Bulletin 207.
- 1955 Bulletin 9.
- 1968 Bulletin 1012.
- Reg. A, 1973, § 201.7 (see Appendix B).
- 48 Stat. 20.
- The act specifically covered banks and trust companies not only in the States but in any territory or possession of the United States or the Canal Zone. This clarification was added by the Senate Banking and Currency Committee. (Senate Rep. No. 4, 73d Cong., 1st Sess. (Mar. 13, 1933))
- Thus, Senator Glass observed that the pending proposal had already been covered "in a larger degree" by the Act of July 21, 1932, under which individuals, partnerships, and corporations, including nonmember banks, could in an emergency discount paper with the Reserve Banks, (77 Congressional Record 249) Senator Robinson pointed out that under the Act of Mar. 9, 1933, loans could be made to nonmember banks on Government bonds. (77 Congressional Record 332)
- 77 Congressional Record 631.
- 77 Congressional Record 601.
- 41 77 Congressional Record 332.
- 77 Congressional Record 333. Senator Kean offered an amendment to eliminate this requirement, but it was rejected. (77 Congressional Record 335)
- 77 Congressional Record 603.
- 77 Congressional Record 633.
  - 1972 Annual Report 197.

### LOANS TO INDIVIDUALS, PARTNERSHIPS, AND CORPORATIONS

- Senator Crawford, 51 Congressional Record 612.
- Thus, Mr. Phelan stated that the Reserve Banks would not compete with commercial banks and would "make no loans and receive no deposits from individuals." (50 Congressional Record 4673) The Glass bill as reported expressly provided that the Reserve Banks would deal only with the Government and depositing member banks. (50 Congressional Record 5063) Although this provision was not adopted, it was clearly understood that loans to individuals would be "contrary to the whole spirit and purpose of the law," (50 Congressional Record 5063)
- For text of the veto message, see 75 Congressional Record 15040.
- 47 Stat. 715.

- 12 U.S.C. § 343.
- 1965 Bulletin 1409; 1972 Bulletin 279. Under the 1973 revision of Reg. A, it appears that the note of a lending institution would be eligible as collateral for a Reserve Bank advance if the proceeds of the note were used to make home mortgage loans regardless of their maturities.
- 49 Stat. 684.
- 1932 Bulletin 518.
- See 1933 Bulletin 95; 1934 Bulletin 485; 1935 Bulletin 473; 1936 Bulletin 123.
- 1966 Annual Report 91; 1969 Annual Report 92.
- For example, in May 1933, the rate was 6 per cent as compared with the regular rate of 3½ or 3 per cent. (1933 Bulletin 428)
- 48 Stat. 1.



- 77 Congressional Record 57.
- 77 Congressional Record 79.

- Act of Sept. 21, 1968 (82 Stat. 856); 12 U.S.C.
- Reg. A, 1973, § 201.2(f) (Appendix B).



#### WORKING CAPITAL LOANS TO BUSINESS

- Act of June 19, 1934 (48 Stat. 1105).
- 78 Congressional Record 9275.
- 78 Congressional Record 12234.
- Mr. O'Connor, 78 Congressional Record 9273.
- Mr. Martin, 78 Congressional Record 9274.
- 78 Congressional Record 9286.
- S. 2867, 73d Cong.; H.R. 8734, 73d Cong. S. 2946, 73d Cong.; S. 3101, 73d Cong.
- Letter from Board to Senator Fletcher, chairman of the Senate Banking and Currency Committee, dated Apr. 13, 1934.
- 78 Congressional Record 8718.
- 48 Stat. 1105.
- 78 Congressional Record 7908.
- 78 Congressional Record 9396.
- 78 Congressional Record 9396.
- 78 Congressional Record 12233.
- 78 Congressional Record 9274.
- Mr. Dirksen, who questioned the need for many of the limitations, asked rhetorically what was meant by an established business: "Is it one that makes money now under depressed conditions, or is it a business that has been actually in operation for a number of years, irrespective of whether it is established in the sense that successful men so often use the word 'established'?" (78 Congressional Record 9276)
- 1934 Bulletin 489.
- 78 Congressional Record 8718.
- 1934 Bulletin 430.
- Reg. S, § III(b) (1934 Bulletin 491).
- 1934 Bulletin 489. This statement regarding the blanket authority granted for direct loans was reiterated in a foreword to Reg. S when it was revised in 1942 (1942 Bulletin 428).
- See Reg. S, §§ 2(a) and 2(c) (1942 Bulletin
- 78 Congressional Record 9398.
- 1934 Bulletin 752.
- 1934 Bulletin 675.
- 27 1934 Bulletin 675.
- 1942 Bulletin 428.
- Reg. S, § 1(c) (1942 Bulletin 428).
- Reg. S, § 4 (1942 Bulletin 430).
- 78 Congressional Record 7908.
- Reg. S, § 3 (1942 Bulletin 430).

- 1934 Bulletin 510.
- As the bill passed the Senate, the Secretary would have been "directed" to make such payments to the Reserve Banks. The conference committee adopted the House bill provision, which merely authorized the making of such payments.
- P.L. 363, 80th Cong. (1947 Bulletin 980).
- 1934 Bulletin 489.
- The first \$ 13b rates were published in 1934 Bulletin 618. On direct loans the rates were fixed at from 4 to 6 per cent at the Federal Reserve Banks of Boston, New York, and Philadelphia; at from 5 to 6 per cent at Chicago, Dallas, and San Francisco; at 51/2 per cent at St. Louis; and at 6 per cent at the other Reserve Banks. For transactions with financing institutions, varying rates were established on the portion for which the financing institution was obligated and on the remaining portion. On commitments to make advances, the commitment charge varied from one-half of 1 per cent to between 1 and 2 per cent. These original rates on § 13b loans, participations, and commitments were changed on numerous occasions in subsequent years.
- 1942 Bulletin 427.
  - Act of Jan. 31, 1935 (49 Stat. 4).
  - Act of Apr. 13, 1938 (52 Stat. 212)
- S. 2759, introduced in July 1939, would have eliminated restrictions in § 13b. S. 2998 in October 1939 would have established an Industrial Loan Corporation with liberal lending authority. Both bills were sponsored by Senator Mead.
- S. 877, S. 939.
- S. 1918, 78th Cong., 2d Sess. (May 15, 1944). An identical bill in the House was H.R. 4804.
- S. 511, Senator Wagner, Feb. 12, 1945; H.R. 591, Mr. Spence, Jan. 3, 1945. Together, these bills were known as the Wagner-Spence bill.
- S. 408, Senator Tobey, Jan. 27, 1947.
- June 3, 1947, hearings, p. 297, et seq. The principal bills were S. 2975 (Senator Mahoney, Feb. 2, 1950); S. 3625 (Senator Lucas); H.R. 8565 (Mr. Spence); and H.R. 8566 (Mr. Patman). The last three were introduced on May 19, 1950.



- S. 1647.
- S. 381.
- 50 S. 1451, 85th Cong.
- 72 Stat. 689; 15 U.S.C. §§ 661, et seq.
- 1958 Bulletin 1059. The new law provided, how-

ever, that small business investment companies might make use, wherever practicable, of the advisory services of the Federal Reserve System, and the Reserve Banks were authorized to act as depositories or fiscal agents for such companies.



#### V LOANS

- See discussion of the origin of the V-loan program in "Financing War Production and Contract Terminations under Regulation V," 1946 Bulletin
- 1942 Bulletin 299.
- 1942 Bulletin 425.
- The text of this letter was quoted in hearings before the Senate Banking and Currency Committee in April 1947 when Chairman Eccles appeared in support of a bill to liberalize § 13 of the Federal Reserve Act.
- 55 Stat. 838.
- 1942 Bulletin 299.
- 1946 Bulletin 241.
- 56 Stat. 226 (1942 Bulletin 533).
- 56 Stat. 419 (1942 Bulletin 640).
- 56 Stat. 355 (1942 Bulletin 635).
- 11 58 Stat. 649 (1944 Bulletin 753).
- 12 1944 Bulletin 876.
- 1944 Bulletin 877.
- 64 Stat. 800 (1950 Bulletin 1158).
- 15 1950 Bulletin 1301.
- 50 U.S.C. Appendix, § 2166(a).
- 67 Stat. 129 (1953 Bulletin 948). 17
- Act of Aug. 15, 1970 (84 Stat. 799); 50 U.S.C. Appendix, § 2091(e).
- E.O. 10161 was superseded by E.O. 10480 (Aug. 14, 1953). That order, as amended and as presently in effect, is set forth in a note to 50 U.S.C. Appendix, § 2153.
- 1950 Bulletin 1307.
- 1942 Bulletin 425.
- 1944 Bulletin 877.
- 1950 Bulletin 1307.

- 1946 Bulletin 242.
- This revision of the form was published in 1943 Bulletin 379.
- One related to the meaning of the term "loss on the loan" (1951 Bulletin 20); the other defined "defense production contract" (1951 Bulletin 149).
- 1943 Bulletin 12.
- 28 1944 Bulletin 879.
- 1950 Bulletin 1283.
- 1966 Bulletin 1617.
- 1970 Bulletin 517.
- 1942 Bulletin 989.
- 1944 Builetin 879. 1949 Bulletin 247.
- 1951 Bulletin 391.
- 1942 Bulletin 1079.
- 37
- 1942 Bulletin 534.
- 56 Stat. 356 (1942 Bulletin 635).
  - 1942 Bulletin 640.
  - 1942 Bulletin 641.
- 1943 Bulletin 389.
- 1944 Bulletin 962.
- 1950 Bulletin 1308.
- Hearings on S. 2998 and S. 3839, June 12 and 14, 1940, p. 21.
- 54 Stat. 1029.
- 47
- B-84138, May 17, 1949 (unpublished decision). B-72929, May 18, 1950 (unpublished decision).
- 1951 Bulletin 20.
- Senate Banking and Currency Committee Rep. No. 217, 82d Cong., 1st Sess. (Apr. 11, 1951),
- 65 Stat. 41; 31 U.S.C. § 203 (1951 Bulletin 508).





#### INTERDISTRICT REDISCOUNTS

- 50 Congressional Record 4645.
- House Rep. No. 69, 63d Cong., 1st Sess. (Sept. 9, 1913), p. 45.
- 50 Congressional Record 4675. See also statement by Mr. Harrison, 50 Congressional Record 4729.
- 50 Congressional Record 4818.
- 51 Congressional Record 667.
- 51 Congressional Record 669.

- 51 Congressional Record 1192.
- 1915 Annual Report 8.
- 1915 Annual Report 29, note.
- 10 1918 Annual Report 3.
- 11 1919 Annual Report 5.
- 12 1921 Annual Report 42, 43.
- 1933 Bulletin 211.



### DISCOUNT RATES

- 12 U.S.C. § 357.
- See 12 U.S.C. § 347.
- 12 U.S.C. §§ 347a, 347b.
- 12 U.S.C. § 343.
- 12 U.S.C. § 347c. 31 U.S.C. § 821.
- Act of Mar. 18, 1968 (82 Stat. 50).
- Report of National Monetary Commission, Senate Doc. 243, 62d Cong., 2d Sess. (Jan. 9, 1912),
- House Rep. No. 69, 63d Cong., 1st Sess. (Sept. 9, 1913), p. 11.
- Senate Rep. No. 133, Part 2, 63d Cong., 1st Sess. (Nov. 22, 1913), p. 23.
- 1914 Annual Report 10.
- 1914 Annual Report 203.
- 1915 Annual Report 5.
- 1923 Annual Report 64.
- 1923 Annual Report 16.
- Act of June 16, 1933 (48 Stat. 168); 12 U.S.C. § 263
- See 1957 Annual Report 8, 9. See also discussion of the effect of the accord on pages 186 and 187
- (Chapter XV).
  "Report of a System Committee," Reappraisal
  of the Federal Reserve Discount Mechanism, 1971, Vol. 1, p. 21. (Initially prepared and published in July 1968; hereinafter referred to as 1968 Report of a System Committee)
- 1915 Bulletin 24,
- 34 Fed. (2d) 910.
- 34 Fed. (2d) 915.
- "Monetary Policy and the Management of the Public Debt" (committee print of the Joint Com-

- mittee on the Economic Report, Senate Doc. 123, Part 1, 82d Cong., 2d Sess. (Feb. 20, 1952), p. 279; hereinafter referred to as 1952 Patman Questionnaire).
- House Rep. No. 69, 63d Cong., 1st Sess. (Sept. 9,
- 1913), p. 53. 50 Congressional Record 4996.
- 50 Congressional Record 5995.
- 50 Congressional Record 6024.
- 50 Congressional Record 4673.
- 1914 Annual Report 10.
- 1952 Patman Questionnaire 276.
- 32 Opinions of Attorney General, No. 81.
- House Banking and Currency Committee Rep. No. 742, 74th Cong., 1st Sess. (Apr. 19, 1935), p. 9.
- 1952 Patman Questionnaire 279.
- See 1971 Annual Report 74, 82, 87; 1972 Annual Report 97.
- 1914 Annual Report 203.
- 25 1915 Annual Report 27-29.
- 1916 Bulletin 513. 37
- 1915 Annual Report 27-29.
- 1917 Annual Report 10.
- 1918 Annual Report 19.
- 1917 Annual Report 11.
- 1917 Bulletin 235, 241.
- 1919 Annual Report 71. 41 Stat. 550.
- Kansas City (April 19), Dallas (May 21), St. Louis (May 26), and Atlanta (May 31). (1920 Annual Report 58)
- 1920 Annual Report 59.
- 1920 Annual Report 66.



- 42 Stat. 1454.
- 48 1923 Annual Report 64. For a time after the enactment of the Agricultural Credits Act of 1923, some Reserve Banks fixed a slightly higher rate for long-term agricultural paper, but this differential did not long continue.
- 49 1942 Bulletin 1204.
- Board letter to Federal Reserve Banks, Sept. 18, 1972.
- 49 Stat. 684.

- Senate Rep. No. 1007, 74th Cong., 1st Sess. (July 2, 1935), p. 13.
- <sup>55</sup> Conference Rep. No. 1822, 74th Cong., 1st Sess. (Aug. 17, 1935), p. 51.
- <sup>54</sup> 1952 Patman Questionnaire 278.
- Board press release, Dec. 1, 1970.
- 1917 Bulletin 951; 1918 Bulletin 109, 744; 1924 Bulletin 639.
- <sup>57</sup> 1918 Bulletin 108.
- to 1916 Bulletin 461.
- 1915 Bulletin 308.



### RELATION TO CREDIT POLICY

- 1 1914 Annual Report 7.
- <sup>2</sup> 1919 Annual Report 68.
- 1921 Annual Report 95.
- 1921 Annual Report 96.
- 3 1923 Annual Report 3.
- 1928 Annual Report 9.
- See, for example, Milton Friedman and Anna Jacobson Schwartz, A Monetary History of the United States, 1867-1960 (Princeton University Press, 1963), pp. 254, 255.
- 12 U.S. § 248(m), as amended by Act of June 16, 1933 (48 Stat. 167).
- Act of Aug. 23, 1935 (49 Stat. 684). Sec, 5200 of the Revised Statutes subjects Government obligations to a 15 per cent limitation (except as permitted by the Comptroller of the Currency) in addition to the usual 10 per cent limitation on loans by national banks to one borrower. In 1958 the Comptroller by regulation raised the limit on loans on Government obligations to 100 per cent of a national bank's capital and surplus, and this limit carries over to loans by State member banks on Government obligations by reason of the provisions of § 11(m) of the Federal Reserve Act.
- Act of June 16, 1933, § 9 (48 Stat. 180).
- <sup>11</sup> See 1932 Bulletin 206.
- <sup>12</sup> *Id.,* p. 208.

- 12 U.S.C. § 301 (48 Stat. 163).
- Senate Rep. No. 584 on S. 4412, 72d Cong., 1st Sess. (Apr. 22, 1932), p. 13. A similar statement was contained in the Report of the Senate Banking and Currency Committee on S. 1631, May 15, 1933, p. 13, and also in the Report of the House Banking and Currency Committee, May 19, 1933.
- 75 Congressional Record 9885.
- 77 Congressional Record 3835, 3836. Also referring to these provisions, Mr. Kopplemann stated that "one of the chief purposes" was to prevent "undue diversion of bank funds into speculative operations." (77 Congressional Record 3907)
- 17 1914 Annual Report 10.
- 1914 Annual Report 17.
- 1952 Patman Questionnaire 393, 394.
- ≈ 1952 Patman Questionnaire 395.
- For a description of the accord, see 1951 Annual Report 3-8.
- 2 1951 Annual Report 5, 6. See also 1957 Annual Report 9.
- <sup>22</sup> 1952 Patman Questionnaire 395.
- 24 1955 Bulletin 8.
- ≈ 1957 Annual Report 7-16.
- ⇒ 1966 Annual Report 102.
- <sup>27</sup> 1968 Report of a System Committee 6.
- 28 Reg. A, 1973, § 201.2(b) (see Appendix B).



#### GENERAL PRINCIPLES: A SUMMARY

- 12 U.S.C. § 343.
- 12 U.S.C. § 357.
- 12 U.S.C. § 301.
- Reg. A, 1955 (1955 Bulletin 8).
- Reg. A, 1973, § 201.2(a) (see Appendix B).
- Circular No. 13 (1914 Annual Report 183).
- Clay J. Anderson, "Evolution of the Role and the Functioning of the Discount Mechanism," Reappraisal of the Federal Reserve Discount Mechanism, 1971, Vol. 1, p. 136.
- These provisions are still in effect. (12 U.S.C. § 301) The Banking Act of 1933 also contained provisions precluding Reserve Bank advances to any member bank that, after a warning by its Reserve Bank or by the Board, had increased its loans on securities.
- 1923 Annual Report 33.
- 12 U.S.C. § 343.
- 1928 Annual Report 8.
- 1968 Report of a System Committee 13.
- 1926 Annual Report 4.
- 1952 Patman Questionnaire 395.
- Foreword to Reg. A, as revised effective Feb. 15, 1955 (1955 Bulletin 9).
- 1926 Annual Report 4.
- 1968 Report of a System Committee 6, 8, and

- Id., p. 1.
- Id., p. 7.
- Id., p. 17.
- *Id.*, p. 18. 12 U.S.C. § 343.
- For text of his proposal, see Senate Rep. No. 133, 63d Cong., 1st Sess. (Nov. 22, 1913).
  - 51 Congressional Record 523.
- 51 Congressional Record 529. Senator Hitchcock emphasized the fact that the paper discounted would in all cases be "good" paper. (51 Congressional Record 1064)
- 51 Congressional Record 765. 50 Congressional Record 6026. See also 51 Congressional Record 667.
- 51 Congressional Record 1073.
- 51 Congressional Record 859.
- 51 Congressional Record 525, 843.
- 51 Congressional Record 859.
- 51 Congressional Record 1076.
- Farmers and Merchants Bank v. Federal Reserve Bank of Richmond, 262 U.S. 649, 663 (1923).
  - 1920 Bulletin 1303.
- 55 1920 Bulletin 386.
- 34 Fed. (2d) 910 (C.C.A. 2d., 1929).
- 1968 Report of a System Committee 10.
- 1914 Annual Report 17.



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