



## Bankers' Acceptances: Yesterday's Instrument to Restart Today's Credit Markets?

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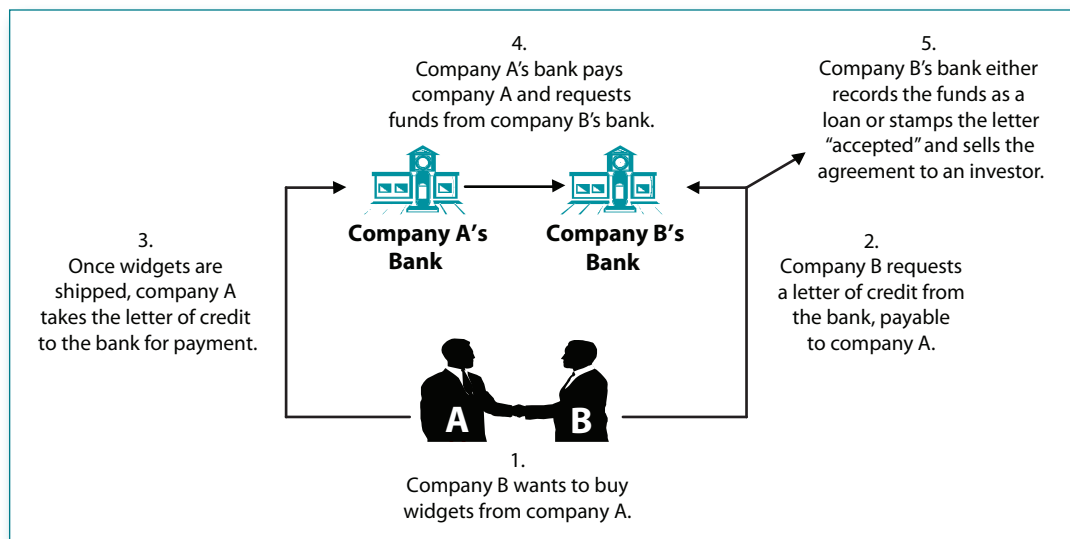
It is generally agreed that the U.S. economy's current financial problems began with heightened uncertainty regarding the quality of certain mortgage-backed securities. It is also generally agreed that these concerns were amplified by, and led to, a virtual collapse of the credit insurance market when investors discovered that credit-default insurers likely would be unable to perform on their guarantees. As a result, financial market participants, fearful of exposure to now-uninsurable counterparty risk, sharply reduced lending to others. By this path, a crisis of confidence regarding the solvency of counterparties became a liquidity crisis (Mizen, 2008). Timelines for these events are available from several sources, including this Bank ([www.stlouisfed.org](http://www.stlouisfed.org)).

Responses to these problems—at the Treasury, FDIC, and the Federal Reserve—include (i) injecting capital into banks to reduce the counterparty risk incurred when doing business with them and to stimulate bank lending; (ii) guaranteeing certain nonbank financial market transactions, including those involving shares held by investors in money market mutual funds, marketability of the assets held by money market mutual funds, and interbank borrowing for terms of 30 days or more; (iii) directly funding certain types of lending in financial markets by purchasing selected instruments, including commercial paper, debt issued by government-sponsored enterprises such as Fannie Mae and Freddie Mac, and long-term Treasury securities. Yet, one shortcoming of these programs is apparent: Rather than *increasing* credit flows through private financial markets, these programs tend to *replace* these flows with credit intermediated by the federal government. Could this be changed? And, if existing federal programs eventually are to be phased out, is there an alternative program that might both address counterparty-

risk concerns and provide an “exit strategy” as private market participants regain confidence in their ability to assess and price?

**“A bankers’ acceptance is created when a bank agrees to ‘accept,’ or guarantee, a future payment between two firms.”**

This note suggests considering an old—not new—financial market instrument: bankers’ acceptances. Bankers’ acceptances are one of the world’s older financial instruments, used as early as the twelfth century. Bankers’ acceptances have a long history in the Federal Reserve. The founders of the Federal Reserve, wishing to establish an active bankers’ acceptance market in New York City to compete with London, empowered the Federal Reserve Banks (which have charters similar to national banks) to participate in the bankers’ acceptance market. During their early years, Reserve Banks actively rediscounted and purchased eligible acceptances; during one period, some Reserve Banks conducted open market policy solely in acceptances (Meltzer, 2003, especially Chap. 4).



What, exactly, are bankers' acceptances and how do they work? A "bankers' acceptance" is a *time draft*, that is, an order to pay a specified amount of money to the holder of the acceptance on a specified date (Stigum, 1990). A bankers' acceptance is created when a bank agrees to "accept," or guarantee, a future payment between two firms. For example, suppose company B wishes to buy a shipment of generic widgets, costing \$1 million, from company A. Company A wishes to be paid at the time the widgets are shipped, but company B does not have on hand the \$1 million required. The principal economic concept in this essay is that financing via bankers' acceptances reduces the counterparty risk that arises when these firms are unable to accurately measure and/or insure the risk of doing business with each other: If company B pays in advance, what is the risk that company A will not ship the widgets? And, if company A ships the widgets before receiving payment, what is the risk that company B will not pay?

In an acceptance transaction, company B would go to its bank, request a letter of credit payable to company A, and send the letter of credit to company A. When company A ships the widgets, it would take the letter to its bank; after company A's bank has assured itself that company A has in fact shipped the widgets, it would request \$1 million from company B's bank. To reduce its risk, company B's bank likely would require title to the widgets as collateral for the funds paid on company B's behalf. Company B's bank, next, must choose whether to record the \$1 million sent to company A's bank as a loan to company B or to "accept" and sell to a third-party investor the promise by company B to pay \$1 million at the specified future date; if the latter, a bankers' acceptance is created. The acceptance is a combination of two parts: company B's obligation to pay its bank \$1 million at a specific future date (a commitment that the bank sells to an investor), plus the promise by company B's bank to pay the investor if company B does not. If company B fails to pay, the bank is obliged to pay because it has "accepted" responsibility for timely payment (see chart). The bank's decision to record the \$1 million as a loan or to create an acceptance is often complex, involving projections of anticipated future lending opportunities, the cost and availability of lendable funds, the willingness of customers to pay fees, and the bank's level of capital.

Flexibility is an advantage of acceptance financing: The trading firms need not assess the integrity of each other, and the various parties to the transaction might be located in different countries. Although acceptance financing is not a risk-free endeavor, the risk is borne largely by the accepting bank. The accepting bank incurs risk when advancing funds to company B—but it is the *business* of banks to assess and monitor risk. (Traditionally, because of the distances involved, acceptances were popular for international trade, but the same prin-

ciples apply to domestic transactions.) Bankers' acceptance financing, however, may be costly. More than one bank may be involved, and specialists are required to create the acceptance documents, verify the shipment and receipt of goods, and prevent the diversion of the goods before repayment. In recent years, other financial market instruments have tended to offer business financing with lower transaction costs, at least when counterparty risk can be well measured and/or insured via third-parties.

Bankers' acceptances are an old idea whose time may have returned—but with central banks acting in the role of the accepting bank. Historically, commercial banks created bankers' acceptances and, in certain circumstances, the holders of these acceptances (including banks, security dealers, and nonfinancial firms) would rediscount the acceptances to the Federal Reserve. It seems a worthwhile idea to explore whether these roles might be reversed, with Federal Reserve Banks "accepting" and thereafter selling the acceptance to investors. For example, depository institutions currently hold more than \$640 billion in excess reserve deposits at the Federal Reserve Banks, while the Federal Reserve is lending funds to special-purpose vehicles that purchase a variety of assets, including commercial paper, risky assets formerly held by Bear Stearns, and debt issued by the government-sponsored housing enterprises Fannie Mae and Freddie Mac. In a bankers' acceptance-style program, the assets held by these vehicles perhaps would be "accepted" by the Federal Reserve and then sold to private-market investors. If successful, so doing would simultaneously reduce banks' excess balances at the Federal Reserve while "retraining" private investors to hold debt issued by private borrowers. Both results seem highly desirable. Eventually, as fears of counterparty risk diminish and financial market conditions return closer to normal, private sector borrowing and lending should be expected to return to normal channels. Consider, as an example, commercial paper. In the near term, commercial paper currently funded by the Federal Reserve's Commercial Paper Funding Facility (<http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm>) might be repackaged as bankers' acceptances for sale to the private sector, with the Federal Reserve Banks acting as "accepting" banks. In the longer term, when the Federal Reserve guarantee is no longer required, normal functioning of the commercial paper market could resume. ■

Meltzer, Allan H. *A History of the Federal Reserve*. Chicago: University of Chicago Press, 2003.

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Views expressed do not necessarily reflect official positions of the Federal Reserve System.