BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

January 30, 1974

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Enclosed is a copy of the report of the staff committee on bankers' acceptances, dated January 29, 1974, and entitled "Recommendations on Desk Operations in Bankers' Acceptances."

It is contemplated that this report will be considered at the February meeting of the Committee.

Arthur L. Broida
Secretary
Federal Open Market Committee

CONFIDENTIAL (FR)

TO: Federal Open Market Committee January 29, 1974

FROM: Staff Committee on Bankers' Acceptances

SUBJECT: Recommendations on Desk Operations in Bankers' Acceptances.

FOMC Charge to Staff Committee

At its meeting on September 18, 1973, the FOMC concurred in two proposals that had been made in a memorandum from the Secretariat dated August 14, 1973.[1/] These proposals recommended essentially:

1. That the Committee agree in principle to amend Section 270.4 of its Regulation on the conduct of open market operations as it applies to transactions in bankers' acceptances, but that the effective date of this change be deferred until the Committee is also prepared to make related amendments in the language of paragraph 1 of its authorization for domestic open market operations regarding the kinds of bankers' acceptances in which the Federal Reserve Bank of New York may operate.

2. That a staff committee be appointed to develop recommendations regarding the substance of these needed amendments and whether they should be made a part of paragraph 1 or incorporated as separate guidelines.

On September 19 Chairman Burns designated the undersigned as members of the staff committee to develop the indicated recommendations.

Why Further FOMC Action is Needed

Until the above noted FOMC agreement to amend its Regulation actually becomes effective, Section 270.4 continues to rely on the Board's Regulation B ("Open Market Purchases of Bills of

1/ A copy of the Secretariat's memorandum, entitled "Proposed actions with respect to bankers' acceptances," is appended as Attachment B.

Exchange, Trade Acceptances, Bankers' Acceptances") for a description of the kinds of bankers' acceptances in which open market operations are authorized. Once finalized, however, the amendment will delete the Regulation B reference entirely as shown below:

> Section 270.4 Conduct of Open Market Operations.
>
> **********
>
> (c) In accordance with such limitations, terms and conditions as are prescribed by law and in authorizations and directives issued by the Committee, the Reserve Bank selected by the Committee is authorized and directed--
>
> **********
>
> (2) To buy and sell bankers' acceptances ~~of the kinds made eligible for purchase under Part 202 of this Chapter--[Regulation B]~~ in the open market for its own account.

The FOMC approved this deletion in principle because, on July 3, 1973, the Board of Governors had decided to revoke the now obsolete Regulation B, contingent upon necessary action by the Committee to amend its own Regulation.[1/] Further action by the Committee is now needed to amend its authorization for Domestic Open Market Operations, because paragraph 1 of the latter authorizes

---

1/ At the same time the Board agreed to revoke Regulation C, "Acceptance by member Banks of Drafts or Bills of Exchange," but this action has no direct bearing on the regulations of the Open Market Committee.

operations in acceptances--"of the kinds designated in the Regulation of the Federal Open Market Committee"--and the amended Regulation (reproduced above) no longer designates any particular kinds of acceptances. Moreover, as the charge to the staff committee indicates, the need to introduce requisite technical changes in the authorization offers a useful opportunity for the FOMC to consider substantive changes as well, directed at liberalizing and modernizing its rules governing the kinds of acceptances in which the Desk is allowed to operate.

In discharging its assignment, the staff committee began by reviewing the history and background of System participation in the bankers' acceptance market, including earlier recommendations for action by various System-wide committees. We then considered recent changes in acceptance practices with a view to determining what, if any, additions or modifications should be made in these earlier recommendations, and arrived at the following conclusions and recommendations. The considerations shaping our conclusions are provided in greater detail in the appendix.

Conclusions and Recommendations

1. Although it was not specifically a part of our charge, the staff committee considered the question whether the System should continue to engage in open market operations in bankers' acceptances. It seemed appropriate to explore this question because one of the major justifications for the System's reentry into the acceptance market in 1955--to encourage the postwar development of that market--no longer exists; the acceptance market has long been sufficiently well-established to obviate the need for special support or encouragement from the System.

We were advised by the System Account Manager that authority to operate in bankers' acceptances improves his operating flexibility, particularly in the area of repurchase agreements, and is needed to help carry out the policy directives of the Committee with maximum effectiveness. On the basis of that opinion, we concluded that a continuation of operations in acceptances was desirable.

2. Under present rules and regulations, System operations in bankers' acceptances are limited to trade-related instruments and dollar exchange bills--essentially to the kinds of acceptances that are eligible for discount by the Reserve Banks under the Board's Regulation A and paragraphs 7 and 12 of Section 13 of the Federal Reserve Act. The staff committee considered the question whether, as would be permissible under the law, it would be desirable to authorize operations in all "prime" bankers' acceptances, including ineligible acceptances commonly referred to as "finance bills" or "working capital acceptances". As noted in section B of the appendix, there is considerable sympathy within the committee for authorizing operations in all "prime" acceptances, particularly since the recent application of reserve requirements to finance bills has eliminated much of the basis for earlier concern about the risk of uncontrolled expansion in these instruments.

While the staff committee believed that such a broadening would potentially increase the flexibility of open market operations, it also felt that in view of the newness and still limited use of finance bills--and in fact their reduced use since reserve requirements were imposed in mid-1973--further study would be desirable to determine how Desk operations in this type of

instrument might affect the general performance of the acceptance market and bank asset and liability management. Accordingly, we recommend that we be authorized to undertake the suggested study, conducting interviews with a small group of representative firms and perhaps also sending a written questionnaire to a broader group of industry participants.

3. The staff committee discussed several more limited types of changes in the rules governing System operations in bankers' acceptances that might be considered appropriate and desirable at this time. We concluded that until a final decision can be made on the broader question of finance bills, the most appropriate interim action would be to adopt essentially the modest reforms recommended by the preceding staff committee on bankers' acceptances. These changes are spelled out in Section D of the appendix.

4. On the question whether the needed rules relating to operations in acceptances would be better included in the Committee's authorization itself or in separate guidelines, we concluded that the rules could be formulated with sufficient brevity to warrant inclusion directly in the authorization. The specific language changes we recommend affect paragraphs 1(b), dealing with outright purchases and sales, and 1(c), dealing with repurchase agreements. These recommended changes are shown in Attachment A, following the appendix.

5. It should be noted that a change in the System's approach to operations in bankers' acceptances would call for a thorough review of the Board's rulings on acceptances contained in "Interpretations of the Board of Governors of the Federal Reserve System". About 75 of these rulings (#1050-1710) apply to bankers' acceptances and reflect the Board's approach, mainly in the 1920's,

to the trade-related acceptance described in Section 13 of the Federal Reserve Act. The rulings are still used extensively by accepting banks and by Federal Reserve Examiners as a guide to determining the eligibility of acceptances created by the banks for discount or purchase by the Federal Reserve. A change in the System's approach could make some of these rulings obsolete or incorrect. However, FOMC action on our recommendations, spelled out in Section D of the appendix, need not await review of these rulings and any resultant revisions therein.

Peter D. Sternlight, Chairman
(New York)
Frederick R. Dahl
(Board of Governors staff)
Peter M. Keir
(Board of Governors staff)
Roy A. Remedios
(San Francisco)
Hilbert G. Swanson
(Chicago)

(The staff committee acknowledges the valuable assistance of Mr. Robert L. Cooper, Federal Reserve Bank of New York, in the preparation of this report.)

APPENDIX

CONSIDERATIONS SHAPING STAFF COMMITTEE CONCLUSIONS

A. Historical Background

The Federal Reserve Bank of New York buys and sells bankers' acceptances outright and under repurchase agreement as part of the open market operations authorized by and conducted for the FOMC. Rules governing these operations are set forth in a chain of references involving the Committee's Authorization for Domestic Open Market Operations, the Committee's Regulation, the Board's Regulation B and ultimately, the Board's Regulation A and Section 13, paragraphs 7 and 12 of the Federal Reserve Act. Both of the last two sources, it might be noted, are directly concerned with acceptances eligible for discount and became involved in determining those eligible for purchase through cross reference.

The net effect of this chain of references has been to limit System purchases of bankers' acceptances to trade-related and dollar exchange instruments; specifically:

1. Acceptances having not more than six months to run, which grow out of: (a) transactions involving the importation or exportation of goods; or (b) transactions involving the domestic shipment of goods, provided shipping documents are attached at the time of acceptance;

2. Acceptances (with same maturity as in (1)) which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples.

3. Acceptances having not more than three months to run, drawn by banks or bankers in foreign countries or dependencies for the purpose of furnishing dollar exchange.

The System is not legally required to limit its acceptance purchases to the bills described above. The Federal Reserve Act, as interpreted by the Board in the past, provides broad authority for the Federal Reserve Banks to purchase and sell bankers' acceptances under the direction of the Federal Open Market Committee.

Some banks have recently issued "ineligible" acceptances--also known as finance bills, marketable time drafts, or working capital acceptances. Under Section 13 of the Federal Reserve Act, these acceptances are not eligible for discount by the Federal Reserve Banks--hence the term "ineligible". Under present rules--but not law--they also are not eligible for purchase by the Desk.

Because of the rather rapid growth in bank finance bills during 1972 and early 1973, and the potential for still greater expansion in future periods of monetary restraint, the Board of Governors acted in July 1973 to apply time deposit reserve requirements to these instruments. Specifically, the regulation applies to bank liabilities in the form of bankers' acceptances

> "issued or undertaken by a member bank as a means of obtaining funds to be used in its bank business, except any such obligation that .... arises from the creation of a bank acceptance of the type described in Section 13 of the Federal Reserve Act and eligible for discount by the Federal Reserve Banks".

This amendment to Regulation D has had the effect of putting finance bills on a similar basis to CD's, as far as reserve requirements are concerned.

B. Desirability of Continuing System Operations in Bankers' Acceptances

One of the major objectives of the FOMC when it authorized a reentry of the System into the acceptance market in 1955 was to encourage the postwar redevelopment of this market. Since that time

the acceptance market has become self-sustaining, and no longer requires support or encouragement from the System.

The Account Manager has stated, however, that System operations in acceptances do provide an important marginal assist to the day-to-day implementation of monetary policy. These operations have centered largely in repurchase agreements, although small variations are also undertaken in outright holdings. When the Desk seeks to provide reserves to meet temporary needs, it frequently offers RP's against acceptances as well as Treasury and Agency securities. The acceptance portion, while relatively small, generally provides a significant share of the total--either permitting the Desk to meet its objectives more completely or to meet them in a way that encourages keener competition in the market for the System's repurchase money. The acceptance RP's are particularly helpful at times when market scarcities of Government securities tend to impede the Desk's ability to extend temporary RP assistance.

During 1973 repurchase agreements against acceptances totaled $5.6 billion, or about 6.1 percent of the System's total repurchase agreements against all collateral. This ratio probably understates the contribution of acceptance RP's to total RP's, since agreements secured by acceptances are less susceptible to early termination by dealers than those secured by Treasury and Agency securities.

In view of this positive contribution of acceptance RP's to open market policy, the staff committee concluded that it would be counter productive for the FOMC simply to abandon such operations. Such a move would seem to be particularly inconsistent with the

successful initiative of recent years in extending System transactions to Federal Agency securities as a means of broadening Desk operating flexibility.

C. Should Operations be Extended to All "Prime" Acceptances?

Once it is agreed that Desk operations in bankers' acceptances are beneficial to open market policy, logic suggests that this benefit would be maximized if such operations were permitted to encompass the widest possible range of "prime" acceptances. The staff committee spent considerable time evaluating the arguments for and against this approach.

Arguments advanced in favor of the expansion of Desk operations to encompass all types of "prime" acceptances were essentially as follows:

(1) Existing System regulations that restrict Desk operations to trade-related acceptances of the types eligible for discount are a carryover from the discredited "real bills" doctrine in vogue during the early 1920's when most of the relevant regulations were adopted. The underlying quality of a bankers' acceptance depends essentially on the credit standing of the business borrower and of the accepting bank or banks whose names it carries, rather than on the documentation related to the trade items it is financing. Consequently, the System would seem to be amply justified in broadening Desk operations in acceptances to encompass any acceptance of "prime" quality, whether a trade-related instrument or a more generalized finance bill. Such an approach would not only enhance the flexibility of open market operations; in the longer run it could provide some additional assurance that as economic growth generates the need for an expanded reserve base, there will be an ample supply of instruments in which the Desk can operate.

(2) Earlier staff concern that System buying might encourage an uncontrollable growth in finance bills has been substantially eliminated by last summer's Board action making them subject to reserve requirements. Much of the earlier concern about undue expansion was fed by the evidence that large banks were focusing on finance bills as a means of avoiding reserve requirements on large CD's. Now that finance bills are reservable, there is no reason to continue stigmatizing them by refraining from System purchases and sales. (If the System decides, at some future date, to purchase finance bills, it may be advisable to purchase only the acceptances of member banks, thus ensuring that a reserve requirement is applicable to such bills, and providing a modest additional benefit to membership.)

(3) While the System might find it somewhat more difficult to identify finance bills appropriate for purchase than is now the case with trade-related acceptances, any resulting increase in administrative burdens could be reasonably handled. Examination reports and indications of marketability would continue to be the primary basis for making such judgments. As an additional protection, the FOMC could, if it wished, set quantitative limits on System acquisitions of the outstanding finance bills of any particular bank.

(4) The extension of System operations to any prime quality bankers' acceptance would encourage the development of a broader acceptance market and, to that extent, add liquidity to a part of bank loan portfolios. This could be particularly helpful to small- and medium-sized banks that do not have ready access to the CD market. In effect, the finance acceptances would be similar

to a more liquid form of CD. Realization of this full potential for finance bills might take a while to evolve, even with the System as a regular market participant. In time, however, regional markets could very well develop in which acceptances of medium-sized banks, located in that area, were readily traded. For the finance bills of small- and medium-sized banks to trade effectively in the national market they might, of course, have to be bought, endorsed, and resold by large bank correspondents, at some additional cost to the accepting bank. But this process would be encouraged if the System were a regular market participant.

(5) Expansion of Desk operations in finance bills could also lead to the development of a flexible means--alternative to the discount window--for the System to provide emergency assistance to individual banks in periods of severe general credit stringency. At such times, System acquisitions of acceptances could provide banks under particular pressure with added liquidity, without aggravating pressures on the secondary market. (Operations of this type would, of course, be different from the usual Desk practice of purchasing through the dealer market; the operations contemplated here would presumably be closely coordinated with discount window operations to assist banks under particular pressure.)

(6) By encouraging a broader and more flexible range of instruments in the acceptance market, System support of the finance bill would help to avoid some of the problems with United States letters of credit of the type that developed in the case of the United States National Bank of San Diego. Foreign banks apparently assumed that letters of credit issued by United States National Bank had the same binding effect as an acceptance--an assumption that

is now in question. Since there is no question about the liability status of a finance bill, System encouragement of this instrument might offer a more viable alternative than certain types of letters of credit, hence avoiding future difficulties of this type.

(7) There is no good reason to continue fostering what appears to be a specially protected area for trade-related acceptances, which in practice are primarily linked to international trade. One may ask why credit for this type of transaction should enjoy what might be construed as a priority over other types of credit transactions. The activity of financing international trade is now well able to stand on its own feet; if public policy calls for special support for some types of international trade financing that support might best be provided through such vehicles as the Eximbank.

Arguments advanced against the extension of Desk operations to all types of "prime" acceptances were essentially as follows:

(1) While analysts may scoff at the allegation that investors have good reason to rate trade-related acceptances more favorably than finance bills--independent of the credit standing of the accepting bank--in practice investors do seem to view the trade-related instruments more highly. To some extent this may simply reflect the fact that the volume of trade transactions suitable for financing with acceptance credit has not grown on a scale comparable with, say, bank CD's or various types of commercial paper. This limited dollar growth has helped the acceptance market to avoid some of the pitfalls of overly rapid expansion that have sometimes affected other types of instruments adversely. The excellent credit record in the acceptance market has inspired a high degree of confidence among investors, including some major foreign central

bank investors that have placed part of their dollar reserves in acceptances. In this way, the acceptance market has been able to serve to maximum advantage the specialized borrower needs on which it has concentrated.

There is some risk--difficult to evaluate but nonetheless a source of concern to some market participants--that an extension of System operations to finance bills would make it difficult for investors to distinguish between trade-related and other acceptances with the result that the needs now so well served by trade-related acceptances would be less well served than before. The concept of a fairly homogeneous "prime" bankers' acceptance--in which, say, export or import bills accepted by any of 200 or so large- and medium-sized accepting banks are regarded about the same by the market--might well disappear. Instead one would be likely to have the much greater distinctions now drawn by the market between CD's of the top handful of major money market banks and those of second and third echelons of less prestigious institutions. While the result might be some greater liquidity for the general loan portfolios of large- and medium-sized banks, there might also be a diluted and hence reduced ability of medium-sized institutions to finance the types of transactions now covered by trade-related acceptances.

(2) The current System approach to the trade-related acceptance should not be viewed as a special program designed to favor the financing of international trade. The trade-related acceptance is simply a credit instrument particularly well adapted to financing international trade. It goes beyond the mere extension of credit since the banks involved perform other functions on behalf of both the exporters and the importers of the goods. This helps

to explain why acceptance credit has never developed to any great extent in the financing of domestic shipments of goods, where the collateral services of the banks, beyond the extension of credit, are not really needed.

(3) By extending its participation in the acceptance market to include finance bills, the Federal Reserve would give encouragement to an area of credit formation that might prove difficult to control or limit in the future. Formation of traditional trade-related acceptances is limited both by the need to tie the credits to specific transactions and by the legal ceilings on individual banks' acceptance liabilities in relation to their capital. Other acceptances are not similarly constrained. To be sure, these other acceptances, if sold by the accepting bank, generate reserve requirements, and indeed the volume of finance bills has shrunk precipitately since such requirements were imposed. Still, it remains to be seen whether the reserve requirement would prove to be an effective constraint if the prestige of finance bills were enhanced by initiating Federal Reserve purchases.

(4) Under broadened criteria to buy acceptances, the Federal Reserve would have to give greater care to credit judgments on the accepting banks and in some cases on the drawers and endorsers of the paper as well. To some degree the System faces this responsibility even now, but it would be considerably expanded under the proposed extension of Desk authority to include transactions in finance bills. Other investors in the acceptance market would face similar complications. Some important investor groups, such as foreign investors in our acceptance market, might well respond by cutting back--and perhaps even abandoning--their participation in the market.

(5) The language of Regulation D imposes reserve requirements only on finance acceptances sold by the accepting bank. If the bank returned the accepted draft to the drawer to be sold by him, presumably there would be no reserve requirement imposed. There is no evidence that this is being done, since it has not been the usual practice in this country for the drawer of an acceptance to market the instrument himself, but it could provide a means of lessening the restrictive effects of System policy.

****

After reviewing these various pro and con arguments, the staff committee developed considerable sympathy for the view that System operations should be broadened to include finance bills. The recent application of reserve requirements to finance bills was a key consideration, because it eliminated much of the basis for earlier concern about the risks of uncontrolled expansion in these instruments.

However, no systematic review of market judgments regarding the possible effects of System operations in finance bills has been made since the application of reserve requirements. Previously, some of the largest issuers of finance bills had strongly opposed such an extension, on the grounds that it would be preferable not to blur the distinction between finance bills and trade-related acceptances. In view of the rather limited use now being made of finance bills and the still open question how System operations in these instruments might affect trade-related acceptances, the staff committee concluded that it would be prudent for the FOMC to proceed cautiously. We recommend, therefore, that the FOMC take no action with respect to System operations in finance bills until

participants in the acceptance market can be questioned to gain better insights on the likely ramifications of System operations in finance bills. This further study could be undertaken by the present staff committee, on the basis of interviews with selected representative firms and perhaps also a questionnaire sent to a wider cross-section of participants in the industry.

D. Recommended Changes in the Substance of Rules on Acceptances

Although our staff committee is not prepared to propose an immediate extension of Desk operations to finance bills, we do recommend some modernization in the technical language defining acceptances eligible for purchase. These language revisions, by increasing the usefulness of trade-related acceptances to merchants and other borrowers and to the banking system, are designed to improve the performance of the bankers' acceptance market and thus enhance the usefulness of this market to System open market operations.

Specifically, the suggested language modifications would:

(a) Eliminate the present requirement that banks be in possession of shipping documents conveying or securing title at the time they accept drafts covering the shipment of goods within the United States. This would remove the distinction, for which there seems to be little, if any, rationale, between international and domestic shipments of goods in this respect.

(b) Broaden the use of acceptances to finance the storage of any goods rather than just "readily marketable staples". But the modification would confine such financing to goods stored in the United States and would continue to require that the accepting bank be secured by documents conveying title to the goods. The reason for not purchasing foreign storage bills is that verification on the documertation of these bills presents undue administrative difficulties. In any event, few such bills have appeared in the United States market.

(c) Remove dollar exchange bills from the list of acceptances suitable for System purchase, since these instruments are seldom used and have become essentially an anachronism.

(d) Increase the maximum maturity of "trade-related" acceptances from six months to nine months. This would permit the inclusion of transactions that require somewhat longer-term financing--thus covering a lengthier process of shipping and marketing. It was considered preferable not to go beyond nine months, however, since longer maturities might jeopardize the status of such acceptances as money market paper--not to mention the possibility of becoming subject to SEC registration requirements.

(e) Eliminate some unnecessary wording in the FOMC authorization to the Desk. Specifically, the proposed change would eliminate the reference to purchases or sales "on a cash, regular, or deferred delivery basis", and would eliminate the limitation of System holdings to 10 percent of total acceptances outstanding. The reference to delivery dates introduces technical jargon that serves merely to clutter up the authorization. The 10 percent limitation is not necessary, because with outstanding acceptances currently in excess of $8 billion, the binding limitation is the $125 million limit which it is proposed to leave intact. In the unlikely event of a sharp decline in the total outstanding volume of acceptances, the FOMC could re-impose a percentage limitation.

Items (a) through (c) were recommended initially by earlier System committees on bankers' acceptances. Item (d) is a new change that would provide further liberalization in the eligibility of trade-related acceptances for System operations.

We also considered authorizing System purchase of some nontrade-related acceptances, such as bills created to finance the processing of goods. The objective of such a move would be to broaden further the types of credits that might be financed through the acceptance market, while retaining some connection with physical goods and thus preserving the sense of a tangibly secured credit

that has long been associated with bankers' acceptances. We decided against this approach for the time being, however, because acceptance credit growing out of the financing of goods in process could be difficult, and perhaps impossible, to document in the same specific manner as goods in shipment or storage. Once goods are subject to processing, they begin to lose their identity. From the standpoint of a creditor seeking to attach "the security", there is little difference between an acceptance backed by goods in process, and one backed by the general credit of the borrower, which would be simply a working capital acceptance or finance bill.

ATTACHMENT A

Recommended Changes in the FOMC Authorization to the Federal Reserve Bank of New York Regarding Desk Operations in Bankers' Acceptances

(Deletions are shown by cancelled type and additions by capital letters.)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York...

(b) To buy or sell ~~prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee~~ in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, ~~on a cash, regular or deferred delivery basis~~, for the account of the Federal Reserve Bank of New York at market discount rates, OF PRIME BANKERS' ACCEPTANCES WITH MATURITIES UP TO NINE MONTHS AT THE TIME OF ACCEPTANCE THAT (1) ARISE OUT OF THE CURRENT SHIPMENT OF GOODS BETWEEN COUNTRIES OR WITHIN THE UNITED STATES, OR (2) ARISE OUT OF THE STORAGE WITHIN THE UNITED STATES OF GOODS UNDER CONTRACT OF SALE OR EXPECTED TO MOVE INTO THE CHANNELS OF TRADE WITHIN A REASONABLE TIME AND THAT ARE SECURED THROUGHOUT THEIR LIFE BY A WAREHOUSE RECEIPT OR SIMILAR DOCUMENT CONVEYING TITLE TO THE UNDERLYING GOODS; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed ~~(1)~~ $125 million ~~or (2) 10 percent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York, whichever is the lower.~~

(c) To buy .... prime bankers' acceptances ~~with maturities~~ of THE TYPES AUTHORIZED FOR PURCHASE UNDER 1(b) ABOVE, ~~six months or less at the time of purchase~~, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for

repurchase of such .... acceptances in 15 calendar days or less, at rates that .... shall be determined by competitive bidding .... provided .... that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

ATTACHMENT B

August 14, 1973

CONFIDENTIAL (FR)

To: Federal Open Market Committee
From: The Secretariat

Subject: Proposed actions with respect to bankers' acceptances

On July 3, 1973, the Board of Governors considered a memorandum from its Legal Division dated June 28, 1973 (copy attached), in which it was recommended that the Board revoke its Regulation B[1/] -- which relates to open market purchases of bills of exchange and bankers' acceptances--and that, on the same effective date, the Federal Open Market Committee amend Section 270.4(c)(2) of its Regulation to delete the reference therein to the Board's Regulation B.

The Board was favorably inclined toward the Legal Division's recommendations, but decided to defer action with respect to its own Regulations until the Open Market Committee had had an opportunity to consider the recommendation for an amendment in the FOMC Regulation. The latter recommendation, specifically, is to delete from Section 270.4(c)(2) the words stricken by dashes in the following:

> Section 270.4 Conduct of Open Market Operations.
>
> * * * * * * * * *
>
> (c) In accordance with such limitations, terms and conditions as are prescribed by law and in authorizations and directives issued by the Committee, the Reserve Bank selected by the Committee is authorized and directed--
>
> * * * * * * * * *

1/ The concurrent recommendation that the Board revoke Regulation C, "Acceptance by member banks of drafts or bills of exchange", is not relevant for present purposes.

(2) To buy and sell bankers' acceptances ~~of the kinds made eligible for purchase under Part 202 of this Chapter [Regulation B]~~ in the open market for its own account.

If the FOMC Regulation is amended in the manner proposed, paragraph 1(b) of the Committee's Authorization for Domestic Open Market Operations would also be in need of amendment. This is because that paragraph authorizes the New York Bank "To buy and sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee...." and the revised Regulation would no longer designate any particular kinds of acceptances. To meet this problem, a description of the kinds of bankers' acceptances in which the Committee wishes transactions to be undertaken could be incorporated in the authorization itself, or in separate guidelines analogous to those now in effect for operations in agency issues.

The Committee may wish to take advantage of the occasion on which these technical changes are made to introduce substantive changes appropriately liberalizing and modernizing its rules governing the kinds of acceptances in which the Desk is authorized to operate. The present rules are set forth in the Board's Regulation B--which, as noted in the Legal Division's memorandum, has not been amended since 1923--and in the opinion of Board members and staff they are badly in need of liberalization and modernization. Various proposals for this purpose have been debated within the System in recent years.

The Secretariat recommends:

1. That the Committee agree in principle at this time that it will amend Section 270.4 of its Regulation, in the manner described above, at such time as it is prepared to approve the necessary amendment to paragraph 1(b) of its Authorization, possibly

involving modified rules regarding the kinds of bankers' acceptances in which the Desk is authorized to operate.

2. That a staff committee be appointed to develop recommendations regarding the content of these rules and the manner in which they might be incorporated in the authorization and/or separate guidelines.

Messrs. Holmes, O'Connell, and Partee concur in these recommendations.

ATTACHMENT

ATTACHMENT B (Continued)

June 28, 1973

To: Board of Governors

From: Legal Division
(J. Ferrell)

Subject: Revocation of Regulations B and C regarding bank acceptances.

ACTION REQUESTED: Revocation of Board Regulations B and C, and an amendment by the FOMC of the FOMC Regulation Relating to Open Market Operations of Federal Reserve Banks.

Regulation B

Regulation B--which relates to open market purchases of bills of exchange and acceptances--has not been amended since 1923, thus antedating, in unamended form, the Federal Open Market Committee by ten years. When section 12A of the Federal Reserve Act was added in 1933 to establish a Federal Open Market Committee, it provided that "no Federal reserve bank shall engage in open-market operations under section 14 of this Act except in accordance with regulations adopted by the Federal Reserve Board." In 1935, this provision was amended to read:

> No Federal Reserve bank shall engage or decline to engage in open-market operations under section 14 of this Act except in accordance with the direction of and regulations adopted by the Committee [i.e., the FOMC].

Thus, only the FOMC has the authority to adopt regulations governing open-market operations. Therefore, the Board's Regulation B is invalid, and has been invalid since 1935.

The FOMC Regulation presently authorizes the Reserve Bank selected by the Committee "to buy and sell bankers' acceptances of the kinds made eligible for purchase under Part 202 of this Chapter [Regulation B] in the open market for its own account" (§ 270.4(c)(2)). Thus, it could be argued that, although Regulation B itself is invalid, portions of it are incorporated by reference into the FOMC Regulation, which is a valid regulation.

In 1923, the Board ruled that "bankers' acceptances may ... be eligible for purchase in the open market by Federal Reserve banks, even though not of the kinds and maturities made eligible for rediscount"; in this connection, it was noted that the "language of section 14 of the Federal reserve act is broader than that of section 13." 1923 F. R. Bulletin 317, 317. In effect, any bankers' acceptance is legally eligible for purchase in the open market (if authorized for purchase by the FOMC), although only certain types of such acceptances are eligible for discount by a Federal Reserve Bank.

The thrust of the recent revisions in the FOMC Regulation was "to incorporate in the Regulation general authorizations for transactions of the kinds subject to the regulatory jurisdiction of the FOMC and at the same time to make it clear that such general authorizations may be limited and restricted by specific authorizations and directives of the Committee." Final Report dated January 4, 1973 of the Ad Hoc Staff Committee on FOMC Rules and Regulations, page 25. Consistent with this effort, the Legal Division recommends (1) that § 270.4(c)(2) of the FOMC Regulation be amended to authorize the selected Reserve Bank "to buy and sell bankers' acceptances in the open market for its own account," subject to such authorizations

and directives as may be issued by the Committee from time to time,* and (2) that the Board revoke its Regulation B. The proposed changes would be technical and need not entail any change in the actual conduct of open market operations.

Regulation C

The Board's Regulation C ("Acceptance by Member Banks of Drafts or Bills of Exchange") is premised on the assumption that a member bank may make acceptances only of the type described in section 13 of the Federal Reserve Act. However, in 1923 the Board ruled that "the acceptance power of State member banks is not necessarily confined to the provisions of section 13, inasmuch as the laws of many States confer broader acceptance powers upon their State banks . . . ." 1923 F.R. Bulletin 316, 317. (Under F.R. Act § 19, paragraph 13, "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.") Therefore, under the 1923 ruling, a State member bank may make acceptances that are not of the type described in § 13 if they are so authorized under State law. In 1963, the Comptroller ruled that "[n]ational banks are not limited in the character of acceptances which they may make in financing credit transactions, and bankers' acceptances may be used for such purpose, since the making of acceptances is an essential part of banking authorized by 12 US.C. 24." Comptroller's Manual 7.7420. Thus, national banks are authorized by the Comptroller to make acceptances that are not of the type

*This would require action on the part of the FOMC, not on the part of the Board itself.

described in § 13. (See Legal Division dated January 12, 1973, entitled "Working-capital acceptances".) Therefore, the premise for Regulation C is no longer valid.

From 1963--the date of the Comptroller's acceptance ruling--until April 18, 1973, the only real significance of Regulation C was in determining the eligibility of bankers' acceptances for discount. The old Regulation A contained a cross-reference to Regulation C (12 CFR 203), viz., by referring to "such transactions . . . more fully described in § 203.1(a)(1), (2), and (3), respectively, of this subchapter" and referring to dollar exchange acceptances "as provided in § 203.2 of this subchapter." Effective April 19, 1973, this reference to Regulation C was deleted. In the bankers' acceptance provisions in the new Regulation A, the sole reference is to "applicable requirements of section 13 of the Federal Reserve Act."

Most of Regulation C merely repeats the statutory provisions of section 13. It adds very little of a substantive nature to the statutory provisions, and the few substantive provisions that are contained in the Regulation are of questionable legality. If Regulation C were revised so as to contain only those provisions that (1) do not merely restate the statute and (2) are clearly a permissible exercise of the Board's regulatory powers, there would be virtually nothing left to the regulation.

Accordingly, it is recommended that Regulation C be revoked.