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

March 9, 1977

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Attached is the report from the Subcommittee on Bankers' Acceptances (Messrs. Balles, Eastburn, Gardner [Chairman] and Partee), dated March 8, 1977 and entitled "Recommendations Regarding Operations in Bankers' Acceptances."

It is contemplated that this report will be considered by the Committee at its forthcoming meeting.

Attachment

CONFIDENTIAL (FR)
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DATE: March 8, 1977

TO: Federal Open Market Committee

FROM: Subcommittee on Bankers' Acceptances (Messrs. Balles, Eastburn, Gardner [Chairman] and Partee)

SUBJECT: Recommendations Regarding Operations in Bankers' Acceptances

At the March 16, 1976 FOMC meeting, following a discussion of the role of open market operations in bankers' acceptances, the Committee accepted the Account Management's recommendation that the authorization for acceptance operations be continued, but with the understanding that the outright portfolio be gradually reduced from the level then of over $600 million to about $200 million. The Committee also felt that the desirability of continuing to conduct open market operations in acceptances should be reviewed further and for this purpose the present subcommittee was established. Further consideration of the question has led to the following conclusions by a majority of the subcommittee:[1]

a. Federal Reserve purchases of acceptances under repurchase agreements should be continued. They can be executed in reasonably large size to help meet short-term reserve needs and hence are a useful supplement to repurchase agreements in Treasury and Federal agency securities. Moreover, they expose the System to only minimal risk.

b. Outright Federal Reserve operations in acceptances should be discontinued and present holdings should be allowed to mature without replacement. It is not feasible to engage in outright purchase and sale activity on a scale that is useful in meeting System reserve objectives and there are potential disadvantages to such operations in terms of credit risk and risk of damaging bank reputations.

1. One member of the subcommittee, Governor Gardner, favored continuation of outright System operations, within recent limits, as well as repurchase agreements, in acceptances, but he sees no reason to present detailed dissenting views as he believes that reasonably full consideration was given to the pro and con arguments by the subcommittee.

The review of acceptance operations that the Account Management presented to the FOMC a year ago[2] stressed the changes in market practices which added a new dimension to Desk operations in acceptances. Specifically, the heightened sensitivity of the financial community to particular bank names made it more difficult, in some cases, for the Desk to adhere to a clear-cut definition of the word "prime" as used to describe acceptances the Committee had authorized the Desk to buy. A major consideration noted by the Account Management was that refusal or reluctance of the Desk to purchase the acceptances of a bank known or suspected to have problems could do further damage to that bank's reputation.

After weighing the benefits of acceptance operations against the risks, the Committee agreed with the view of the Account Manager that repurchase agreements against acceptances were a valuable method of supplying reserves and should be continued. The Committee also concurred in his view that there was reason by early 1976 to undertake a gradual reduction in the System's outright holdings of acceptances from the high level reached in late 1975, as the market had by early 1976 adjusted to the special factors that had caused the System to expand its portfolio. Those factors included the unsettled acceptance market conditions of 1974-75 (partly reflecting widespread concern over the stability of the banking system), the withdrawal of a major acceptance dealer from the market, the termination of the Federal Reserve System's guarantee of acceptances bought for foreign accounts, and some occasional shortages

2. In a memorandum dated March 5, 1976, and entitled "Acceptance Operations".

of Treasury securities in dealers' positions. While agreeing, as an interim matter, with the Manager's recommendation that the System maintain a reduced portfolio of outright acceptance holdings, the Committee also called for a further review of the desirability of continuing System operations in acceptances, to which this report responds.

The portfolio of acceptances held outright has declined from the all-time high of $758 million reached on January 22, 1976, to a level below $200 million reached last September. After holding steady for several months there has been a further slight decrease in recent weeks to about $175 million. The reduction in the past year was accomplished without any significant market effect, simply by keeping the rate of new purchases below the pace of maturities; no outright sales were necessary. In addition to modest purchases for the Federal Reserve Bank, the Desk also made purchases on most trading days for foreign accounts. Market conditions over the past year were conducive to accomplishing the reduction, as investor and dealer demand was generally good, short-term interest rate movements were relatively smooth, and total acceptances outstanding increased at a pace easily absorbed by the market. (Total acceptances outstanding increased by $3.8 billion in 1976 to a record $22.5 billion at year-end.) Also, market confidence in the banking system tended to improve over the period, as the economy strengthened, banks added to capital, and concern about lists of "problem banks" tended to abate with the passage of time. Indeed, the market paid remarkably little attention to the reduction of the System's acceptance portfolio--no doubt because the decline was accomplished gradually, without outright sales and without a complete cessation of buying.

Meanwhile, repurchase agreements against acceptances were used actively. As shown in the attached table, a total of $22 billion of repurchase agreements was arranged against bankers' acceptances during 1976. This was 8.3 per cent of all System repurchase agreements. On some individual days the proportion was as high as 25 per cent. Moreover, since repurchase agreements in acceptances are less likely to be withdrawn early than are those in Treasury and agency issues, the volume of acceptance repurchase agreements outstanding, as a proportion of total repurchase agreements outstanding, was 10.7 per cent on average during 1976. As shown in the table, this proportion ranged as high as 16 per cent on average in June.

The basic arguments for and against retaining a modest outright portfolio of acceptances that were reviewed by our subcommittee are those presented in a memorandum from Mr. Ozog to Mr. Sternlight dated October 5, 1976. A copy is attached to this report. The points made in that memorandum may be summarized briefly as follows:

<u>Pro</u>:

1. While outright activity in acceptances is not making a significant contribution at present to open market operations, continued outright activity on a modest scale would preserve a technique that may be more useful in the future.

2. Continued Federal Reserve participation, even though modest, demonstrates confidence in the banking system.

3. Acceptances play a useful role in financing international trade, and the System has traditionally recognized and encouraged this role.

4. Federal Reserve participation has enhanced the reputation of acceptances and encouraged high standards in their use. Withdrawal could produce sharper "tiering" or differentiation among names by the market.

5. System withdrawal could lead to diminished participation by official foreign accounts.

Con:

1. Outright operations in bankers' acceptances do not make a significant contribution to the achievement of System reserve objectives, as it is not feasible to operate on a scale that would be meaningful in meeting reserve needs or absorbing excesses.

2. Even if discontinued now, outright operations could be reinstated readily--particularly if the System continues to do repurchase agreements in acceptances--should that become desirable in the future.

3. Outright operations require difficult credit judgments and expose the System to possible loss.

4. A decision by the Trading Desk to avoid buying the acceptances of a particular bank whose reputation had come under some question would risk causing further damage to that bank's name. In practice, the Desk finds it impossible to downgrade a bank's acceptances from "prime" status until the bank is declared insolvent.

In the judgment of a majority of the subcommittee, the arguments against continuation of outright operations in acceptances--especially the first and fourth in the list above--are more persuasive than those in favor. In the subcommittee's view, the market would adjust satisfactorily to the withdrawal of the System from outright operations particularly since the Federal Reserve will remain a participant in the repurchase market. Such transactions, as indicated, have proved useful to the Desk and can be especially valuable for managing reserves when sufficient amounts of Government securities are not available for repurchase agreements. The risks to the System involved in these transactions are at an acceptable level because of the temporary nature of repurchase agreements and the obligation of the dealer to repurchase the acceptances sold to the System.

If the Committee agrees with the subcommittee's recommendation that outright operations in acceptances be discontinued, there are two alternative methods of implementing the recommendation.

Outright operations in acceptances are covered by paragraph 1(b) of the Authorization for Domestic Open Market Operations, which reads as follows:

> 1(b) To buy or sell 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, prime bankers' acceptances with maturities of up to 9 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 billion.

Under the first alternative, this language would be left unchanged, except that the words "when appropriate", would be added at the beginning of the paragraph and the dollar limit in holdings at the end of the paragraph would be reduced from $1 billion to $100 million--somewhat less than present actual holdings. It would be understood, however, that the Account Management would allow present holdings to mature without replacement, and would make no future outright purchases unless required by exceptional developments, to achieve Committee objectives.[3] A majority of the subcommittee prefers this alternative because it would reduce the possibility that the Committee's decision to eliminate outright purchases of bankers' acceptances would be misinterpreted in a way that would reflect discredit on bank obligations.[4]

The second alternative would involve striking paragraph 1(b) from the authorization and renumbering 1(c), which relates to repurchase agreements, as 1(b). This paragraph would have to be expanded to include the description of bankers' acceptances now incorporated by cross reference to the description in the present paragraph 1(b). The revised paragraph could read as follows:

"To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers' acceptances of the types DESCRIBED BELOW ~~authorized for purchase under 1(b) above~~ from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall

3. While current holdings of about $175 million exceed the proposed ceiling of $100 million, it is anticipated that, with no new purchases, total holdings would decline to below $100 million within two months. If the Committee adopts a ceiling of $100 million the public record will make clear that the Committee was aware that outright holdings would exceed the $100 million level for that transition period.

4. One member of the subcommittee, President Eastburn, preferred the second alternative, which would formally remove the authorization for outright holdings, as he believes this is more consistent with the subcommittee recommendation to discontinue outright purchases. He finds unpersuasive the argument that elimination of the outright authorization might be misinterpreted by the market, as the System would still be arranging repurchase agreements in acceptances.

be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further 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. THE PRIME BANKERS' ACCEPTANCES THAT MAY BE PURCHASED UNDER THE PROVISIONS OF THIS PARAGRAPH ARE THOSE WITH MATURITIES OF 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."

The FOMC also may want to consider the term "prime", as applied to acceptances described in the Authorization for Domestic Open Market Operations. In the view of the Account Management, with which we would concur, the Desk should be guided by prudent investment principles and credit standards but should not feel obliged to automatically refuse to execute a repurchase agreement against a bank's acceptance because it receives some information which may raise a question about the financial stature of the accepting bank.

The word "prime" should be used to describe acceptances of banks which are known to have competence in the field of acceptance financing and acceptances which have established a reputation for freely trading in the market.

An additional attachment to this report is a draft of a possible press release reporting a Committee decision to discontinue outright operations in acceptances. The purpose of this attachment is not to seek the approval of the Committee of the specific language of the draft, but simply to suggest the general nature of the statement that might be released.

Attachments

TOTAL REPURCHASE AGREEMENTS MADE DURING 1976
(in millions of dollars)

1976	Treasury and Agency Securities	Bankers' Acceptances	Total	Bankers' Acceptances as a % of Total
Jan.	19,267	1,754	21,021	8.3 %
Feb.	18,438	1,716	20,154	8.5
March	16,946	1,568	18,514	8.5
April	18,251	1,543	19,794	7.8
May	21,300	2,069	23,369	8.9
June	15,109	1,850	16,959	10.9
July	13,443	1,461	14,904	9.8
Aug.	27,410	2,464	29,874	8.2
Sept.	25,180	1,978	27,158	7.3
Oct.	17,308	738	18,046	4.1
Nov.	18,509	1,845	20,354	9.1
Dec.	32,252	3,102	35,354	8.8
Total	243,411	22,088	265,499	8.3

Note: Figures may not add to totals due to rounding.

AVERAGE AMOUNT OF RP AGREEMENTS OUTSTANDING DURING 1976*
(in millions of dollars)

1976	Treasury and Agency Securities	Bankers' Acceptances	Total	Bankers' Acceptances as a % of Total
Jan.	2,284	254	2,538	10.0 %
Feb.	2,483	294	2,777	10.6
March	2,135	294	2,429	12.1
April	1,980	260	2,240	11.6
May	2,585	370	2,955	12.5
June	2,605	499	3,104	16.1
July	2,523	366	2,889	12.7
Aug.	3,720	444	4,164	10.7
Sept.	3,722	367	4,089	9.0
Oct.	3,354	234	3,588	6.5
Nov.	2,520	274	2,794	9.8
Dec.	4,291	452	4,743	9.5
Year	2,855	342	3,197	10.7

*Based on actual number of days in month that there were balances outstanding.

DRAFT PRESS RELEASE

RULES ON OPEN MARKET OPERATIONS IN BANKERS' ACCEPTANCES
Changes in FOMC authorization

The Federal Open Market Committee announced today a modification of its rules relating to open market operations in bankers' acceptances. Under the modification, the System will no longer maintain a permanent portfolio of bankers' acceptances, and will permit its present holdings to mature without replacement. The Federal Reserve will remain an active participant in the acceptance market, however; specifically, it will continue to purchase bankers' acceptances under repurchase agreements with dealers and will continue to purchase and sell bankers' acceptances on instruction for the account of correspondent central banks.

In taking this action, the Committee noted that the market for bankers' acceptances has for some time exhibited the characteristics of a well developed and efficient market, no longer in need of nurturing through official Federal Reserve participation. It also recognized that Federal Reserve outright purchases and sales of acceptances, as distinct from short-term repurchase agreements in acceptances, have not been a significant factor in Federal Reserve open market operations in recent years. Repurchase agreements in acceptances, on the other hand, have been a useful supplement to Federal Reserve repurchase agreements in Treasury and Federal agency issues, in countering the effects of short-term ebbs and flows of bank reserves.

At the end of 1976, total acceptances outstanding in the U.S. market were $22.5 billion, compared with $7.9 billion five years earlier and $642 million at the end of 1955, the year when the Federal Reserve resumed operations in bankers' acceptances on a modest scale after a period of minor intermittent activity since the early 1930's -- following active participation in the 1920's. The strong growth in the acceptance market in recent years has reflected the recognition by borrowers and investors of the efficiency and quality of this market.

Repurchase agreements are a technique frequently used by the Federal Reserve to meet short-term needs for bank reserves. In these transactions the Federal Reserve purchases Treasury or Federal agency securities or bankers' acceptances from dealers under an agreement requiring the dealer to repurchase the securities after a specified time, usually one to seven days. The interest rates employed in repurchase agreements are determined by competitive bidding.

Add, if first alternative is adopted:

The Committee's action allowed for the possibility that unusual circumstances might arise from time to time under which outright operations in bankers' acceptances might prove useful in meeting System objectives. Thus language permitting such operations, where appropriate, was retained in the Authorization for Domestic Open Market Operations issued to the Federal Reserve Bank of New York. At the same time, the limit on total System holdings of bankers' acceptances on an outright basis was reduced from $1 billion to $100 million; while System holdings are currently in excess of $100 million, it is anticipated that maturities within the next two months will reduce holdings to a level below the new limit.

MISC. 31 2-- 3/75

FEDERAL RESERVE BANK
OF NEW YORK

OFFICE CORRESPONDENCE

DATE October 5, 1976

TO Mr. Sternlight

SUBJECT: Bankers' Acceptances Held Outright by the System.

FROM E. J. Ozog

EJO

In order to assist in the process of reaching a decision regarding the System's portfolio of bankers' acceptances held outright, the following arguments are offered for and against maintaining a modest portfolio in the neighborhood of $200 million. The arguments presume that if outright activity by the System is ended, repurchase agreements against acceptances will be continued and the Federal Reserve will continue to offer the service of purchasing acceptances for foreign accounts on their instruction.

PRO

1. Holding a modest portfolio of bankers' acceptances exhibits the Federal Reserve System's confidence in the obligations of the nation's banking system. A decline in the portfolio to the zero level may be viewed as symbolic of the tarnished reputation of the banking system. Assuming the risks of maintaining a modest portfolio would seem to be a small price to pay for avoiding the possibility that the public will misunderstand the System's desire to cease holding a marketable obligation of the banking system which has a traditional place in the System's portfolio. Terminating operations may, therefore, introduce a greater risk than that intended to be avoided.

2. Continuing modest outright activity in acceptances preserves a technique of open market operations which can provide a flexible response to unusual circumstances and may have unforeseen future value. While this tool could conceivably be reactivated when needed, even if the portfolio is allowed to drop to zero, maintaining a small portfolio is not costly in terms of resources and

eliminates the possibility that a complete withdrawal could damage the reputation of the banking system or the character of the market.

3. Bankers' acceptances play an important and unique role in the financing of world trade, as a money market instrument, and in providing liquidity to bank loan portfolios. The Federal Reserve System, from its inception, encouraged the use of the instrument and the development of a market. While the market no longer needs the support of the Federal Reserve, the termination of outright activity would seem to be an abandonment of the System's policy of recognizing the importance of bankers' acceptances. The status of bankers' acceptances would be significantly reduced, possibly resulting in sharp criticism of the System's decision from the banking community.

4. Bankers' acceptances are considered secure investments in part because the Federal Reserve's participation in the market has encouraged strict standards. The respect investors have developed for the instrument would be diminished by the absence of the Federal Reserve's outright activity. The tendency of many investors to regard only the obligations of the "prominent" banks to be safe investments would be reinforced and probably secure the dominance of the very largest banks.

5. Several foreign accounts of the Federal Reserve continue to find that bankers' acceptances satisfy their investment objectives, and their holdings amounted to $417 million at the end of September. The System's portfolio of acceptances indicates to foreign central banks that the Federal Reserve has expertise in the market and so this activity places the System in a better position to attract foreign investments to this country.

<u>CON</u>

1. Outright open market operations in bankers' acceptances are not useful for managing reserves and, ordinarily, have contributed little toward achieving

the FOMC's monetary policy goals. Although outright operations in theory have the potential for adding a sizable amount of reserves, the characteristics of the market make operations relatively inefficient and, since less than $20 billion of acceptances are outstanding, there are severe constraints on the feasible volume of operations.

2. Outright operations in bankers' acceptances involve the Acceptance Desk in credit judgments and expose the System to loss. Bankers' acceptances are considered to be low-risk investments because they are secured by both a bank and the credit of the drawer of the draft. Presumably the self-liquidating nature of the underlying transaction raises the probability that funds will be available to pay the acceptance at maturity and there is no known example of an investor having lost principle through the failure of an acceptance to be honored. Nevertheless, the Desk may not be in an ideal position to know or judge the value of a particular bank's obligation, nor is the Desk able to adequately analyze the underlying trade credit. Therefore, there exists a possibility that the Desk, through lack of adequate knowledge, may purchase an acceptance which will not be paid because both the bank and the drawer of the draft are unable to honor their obligation.

3. Dealing in obligations of banks presents the Acceptance Desk with potential conflicts of interest which are difficult to reconcile and which could result in serious repercussions. The Federal Open Market Committee authorizes the Desk to purchase "prime" bankers' acceptances but the term "prime" has become highly ambiguous because the market has in recent years assigned somewhat different values to different bank names in contrast to the earlier practice of trading all marketable names at a "prime" rate. In practice, the Desk has tended to equate "primeness" with "reasonable market tradeability", and has acquired a mixture of bank names that, individually, might move at somewhat different rates in the

market. These differentials do not necessarily denote the market's confidence in the "creditworthiness" of the bank name; to some extent it merely reflects "liquidity", which may in turn be a reflection of the breadth of investor interest in a particular bank's name. (For example, the market in acceptances drawn on foreign agency banks is more limited than that for major domestic money market banks, and this tends to be reflected in the somewhat higher yields on the agency banks' acceptances.)

At times, however, the differential in rates in the market may reflect some differences in the market's view of creditworthiness, and this can present the Desk with a serious dilemma. One may well ask at what point the Desk should consider the image of "primeness" to be sufficiently tarnished that those acceptances should be avoided. A strict interpretation could mean that banks whose names have come under the slightest cloud would find their reputations damaged further if it became known that the Desk was reluctant to buy their acceptances. Such an outcome could make it more difficult for those banks to overcome whatever problems they might be encountering. Nor would it necessarily help to adopt a more liberal interpretation of "primeness" as this would merely change the marginal point at which the difficult decision might have to be made to refrain from buying the acceptances of a "questioned" bank.

From the Desk's standpoint, questions about primeness could arise not only from the market's perception of a bank's standing but also from internal Federal Reserve information, such as from examination reports. In these cases, too, the Desk could face a serious dilemma in seeking to satisfy the FOMC's requirement to buy only "prime" acceptances and seeking also to avoid the damage that could occur to a bank's reputation if the Desk were seen to be reluctant to buy a name that had previously been regarded as satisfactory.

Thus far, the Desk has managed to avoid confrontations of the type indicated above--but this may be partly "good luck". When the Franklin National

Bank situation began to gain public attention, the System already held Franklin acceptances, but fortunately we were not requested by dealers to take on additional ones; if we had been so requested, and there was no graceful way to sidestep the issue, we would probably have felt obliged to buy them during that period of several months that Franklin was borrowing substantially at the discount window and was officially regarded as "solvent". American Bank and Trust is another name that could have presented us with a dilemma--we held none of their acceptances at the time the bank's name became newsworthy, but again we might have found it difficult to avoid taking the name if it had been pressed on us, as their name had been for some time on our list of prime eligible names.

Indeed, in the final analysis, it may be impractical to remove a bank's name from our prime list except when that bank has actually been declared insolvent, or has been taken over by another bank. For to remove it earlier, when the Federal Reserve or the market merely regards the bank as "facing some problems but capable of overcoming them" could be a factor contributing to the bank's difficulties.

EJO:PDS/rf

cc: Mr. Holmes, Mr. Meek, Mr. Sandberg, Ms. Tschinkel, Miss Clarkin and Mr. Hill.