Trading in Bankers' Acceptances: A View from the Acceptance Desk of the Federal Reserve Bank of New York

By RALPH T. HELFRICH*

The Acceptance Trading Desk at the Federal Reserve Bank of New York is a focal point, not only for System open market operations and foreign investment account activity in bankers' acceptances, but also for banks, dealers, students, and others seeking information about the acceptance area. As the volume of bankers' acceptances outstanding has increased substantially in recent years, the Acceptance Desk has been requested to provide information not readily available elsewhere. Although there is no lack of literature on the bankers' acceptance method of financing or its advantages as a money market instrument, there is a scarcity of printed information about the techniques and procedures followed by the Federal Reserve in its activities in the bankers' acceptance market. To answer some of the more frequent questions asked by the public, this article aims, in addition to providing general information on the acceptance market, to assemble and to put into an easily available form the standards and guidelines used in the daily operations of the Acceptance Desk.

DRAMATIC GROWTH IN OUTSTANDING ACCEPTANCES

Bankers' acceptances are primarily negotiable time drafts drawn to finance the export, import, shipment, or storage of goods, and they are termed "accepted" when a bank assumes the obligation to make payment at maturity. The first significant use of dollar-denominated bankers' acceptances in the United States occurred after the passage of the Federal Reserve Act of 1913. By the late 1920's the volume of acceptances outstanding was over \$1.7 billion. During the depression and World War II, acceptances financing international trade declined sharply. There has been, however, a considerable increase in the volume of acceptances outstanding in the United States since World War II. In May 1945 acceptances outstanding totaled \$104 million, and by the end of 1973 the total was \$8.9 billion (see Table I). During 1974 the amount of acceptances outstanding more than doubled, rising by \$9.6 billion to \$18.5 billion; a record level of \$18.7 billion was registered in March 1975. A substantial portion of the dramatic increase during 1974, and of the postwar growth as well, was related to the use of acceptance financing by Japan to sustain its international trade. As a result of this growth, the acceptance as a short-term credit instrument has gained significance in the money market. Purchases of acceptances by the Federal Reserve provide a supplementary method of conducting open market operations.

Finance bills, also known as working capital acceptances, are not included in the data showing total dollar acceptances outstanding (see Table I). Developed in the late 1960's, these bills are not related to specific trade transactions but are accepted by some banks as a vehicle for extending short-term credit, presumably to provide working capital to the drawer of the draft. In mid-1973, a record \$1.5 billion of outstanding finance bills was reported but the imposition of reserve requirements by the Federal Reserve at that point on funds raised through the use of such acceptances prompted a contraction of the market. Finance bills cannot presently be discounted or purchased by the Federal Reserve.

* Ralph T. Helfrich is chief of the Acceptance Division in Open Market Operations and Treasury Issues. The author wishes to acknowledge gratefully the contribution to this work made by his colleagues at the Federal Reserve Bank of New York: Lawrence B. Aiken, Robert L. Cooper, Edward J. Ozog, and Peter D. Sternlight.

Table I

DOLLAR ACCEPTANCES OUTSTANDING*

In millions of dollars

Year-end	Amount
1929	1,732
1939	233
1945	154
1950	394
1955	642
1960	2,027
1965	3,392
1967	4,317
1969	5,451
1970	7,058
1971	7,889
1972	6,898
1973	8,892
1974	18,484
1975	18,727

* Includes acceptances held by Federal Reserve Banks, commercial banks, and others and excludes finance bills, also known as working capital acceptances.

ACCEPTANCE DESK OPERATIONS

Operations at the Federal Reserve's Acceptance Desk consist of two major activities: first, operations undertaken for the System under the direction of the Federal Open Market Committee (FOMC) and, second, operations to invest funds for foreign accounts maintained at the Federal Reserve Bank of New York. Acceptance transactions related to the implementation of monetary policy are an integral part of Federal Reserve open market operations in the securities market. To supply bank reserves, the Federal Reserve purchases United States Treasury obligations, Federal agency securities, and bankers' acceptances either outright to provide a permanent base for monetary growth or under repurchase agreement when there is only a temporary need for reserves. Federal Reserve open market operations are conducted by the Federal Reserve Bank of New York on behalf of the entire Federal Reserve System. As will be discussed at some length, the Desk purchases in the market for System or foreign accounts only prime bankers' acceptances from established dealer firms.

OUTRIGHT PURCHASES. Acceptances are normally purchased each day for the Federal Reserve's own portfolio of outright holdings, which totaled about $725 million in December 1975. Since acceptances are short-term instruments, daily maturities of acceptances from the Federal Reserve's holdings are sizable and the portfolio must be continually replenished to provide its share of a steady base for bank reserves. If there is no reason to affect bank reserves, the Desk replaces the maturities which are scheduled to occur during a bank reserve-accounting week by purchasing approximately equal amounts each trading day during the same reserve period. In each reserve-accounting period, however, the Desk may elect to purchase more or less than its portfolio replacement needs either to supply or to absorb bank reserves in accord with monetary policy objectives. Dealers with which the Desk is authorized to transact business are usually contacted by telephone between 10 and 10:30 each morning and told the approximate amount of purchases the Desk will make. Dealers soon respond with offerings by rate, and under normal circumstances purchases are completed within an hour. Purchases are always awarded on a best rate basis, and most purchases are delivered and paid for on the day of the transaction.

The Desk does not usually ask dealers to specify in advance the names of the banks that created the acceptances the dealer is offering, since the Desk does not attempt to distinguish gradations of quality among the prime bank paper it finds acceptable for purchase. Nevertheless, the market has assigned slightly different values to the money market instruments of different classes of banks. Therefore, to avoid acquiring undue amounts of paper that the market considers to be less attractive to hold, the Desk instructs dealers to offer and to deliver to the Federal Reserve's own account a reasonable mixture of acceptances created by large money center banks, regional banks, and foreign banks.

The Federal Reserve avoids acquiring an unduly large percentage of any bank's total outstanding acceptances by setting limitations on the amount of any individual bank's acceptances which it will buy. If dealers' deliveries of any bank name cause the Federal Reserve's holdings of that name to exceed a reasonable percentage of that bank's outstanding acceptances, the Acceptance Desk will temporarily refuse to accept that name until the holdings are reduced below the acceptable percentage. When a bank learns that the Federal Reserve has stopped buying its acceptances from the dealers, it sometimes inquires as to the reason. Ordinarily, there is no significance to the Federal Reserve's action other than that its holdings of a certain bank's acceptances have grown out of proportion to that bank's activity in the market. There need be no implications regarding the credit standing of the accepting bank involved. It is a temporary situation that will end when the Federal Reserve's holdings are reduced through maturities, normally within a month or so.

REPURCHASE AGREEMENTS. Federal Reserve operations to purchase bankers' acceptances under repurchase agreements serve as an important method of supplying bank reserves for a short time, usually one to seven days. As a rule, dealers maintain fairly sizable inventories of acceptances. These inventories provide opportunities for the Federal Reserve to acquire acceptances under repurchase agreements designed to achieve the money market conditions desired by the monetary authorities. When the Federal Reserve observes a temporary shortage of bank reserves, dealers are contacted by the Desk and informed of the number of days for which the Desk will offer to provide funds under repurchase agreements. Dealers subsequently offer to sell to the Desk an amount of acceptances at specific rates. The Desk has an amount of bank reserves it wishes to supply and, in effect, auctions this amount to dealers at the highest rates. Dealers deliver to the Desk acceptances which have a market value somewhat greater than the dollar amount the Desk pays to dealers, thus providing a margin of excess "collateral". Dealers may terminate a repurchase agreement before maturity, in whole or in part. The repurchase operation at the Acceptance Desk is conducted as a joint operation with the Securities Trading Desk at the Federal Reserve and, consequently, both acceptance dealers and Government securities dealers compete for the amount of funds the Federal Reserve is providing on any given day.

PURCHASES FOR CUSTOMER ACCOUNTS. In recent years many foreign correspondents of the Federal Reserve Bank of New York, mainly other central banks, have found bankers' acceptances an attractive means of employing a portion of their dollar balances maintained in investment accounts at the Federal Reserve. When acting for its customers, the Acceptance Desk usually contacts each dealer at the time that it seeks offerings for the System Open Market Account. Purchases for customer accounts are confined to acceptances created by banks specified by the customer and to maturity ranges specified by the customer. Within these limits, purchases are decided on a best rate basis.

Prior to November 8, 1974, the Federal Reserve guaranteed the acceptances it purchased for its foreign correspondents. The policy of guaranteeing acceptances held by foreign correspondents was developed in the process of working out reciprocal correspondent relationships with other central banks during the early years of the Federal Reserve System. Such guarantees were at that time considered useful in encouraging the development of the bankers' acceptance market. In part, due to the favorable rate spread between acceptances and Treasury bills, foreign correspondent holdings of bankers' acceptances guaranteed by the Federal Reserve increased rapidly during 1974 to a level of about $2 billion. Against this background, officials of the Federal Reserve concluded that there was no longer justification for extending a guarantee favoring a particular private market instrument or a particular group of investors. Customer holdings receded to around $300 million in 1975.

AUTHORITY FOR OPERATIONS

Acceptance Desk operations for the Federal Reserve System are governed by directives from the FOMC. The Committee's authorization for domestic open market operations in acceptances stems ultimately from the Federal Reserve Act, Section 12A, Section 13, paragraphs 6, 7, and 12, and Section 14, paragraph 1.

At one time, System operations in acceptances were governed by Regulations B and C of the Board of Governors of the Federal Reserve System, but these were revoked effective April 1, 1974 in order to realign and modernize the rules relating to open market operations. This action recognized that responsibility for open market operations in acceptances rests with the FOMC rather than with the Board of Governors. The FOMC issued new rules which broadened the scope of acceptances eligible for purchase by the Federal Reserve, but Regulation A, as well as the sections of the Federal Reserve Act that define those acceptances eligible for discount at the Federal Reserve, was not changed. As a result, many questions arose concerning the frequently misunderstood term "eligibility". Prior to the revocation of Regulations B and C, Federal Reserve Banks were, subject to certain minor exceptions, permitted to purchase under Section 14 of the act only bankers' acceptances discountable under Section 13, and consequently reference to eligibility could be made with less ambiguity. At present, use of the word eligibility without further clarification is ambiguous since some acceptances eligible for purchase are not eligible for discount and some acceptances eligible for discount are not eligible for purchase (see Table II).

"The new rules issued by the FOMC authorize the Federal Reserve Bank of New York to buy (outright or under repurchase agreement) and sell 'prime' bankers' acceptances—with maturities of up to nine months at the

Table II

PRIME BANKERS' ACCEPTANCES
ELIGIBILITY AND RESERVABILITY

Type of bankers' acceptance	Eligible for		Reserves required‡
	Purchase*	Discount†	
Export-import, including shipments between foreign countries:			
Tenor—6 months or less	Yes	Yes§	No
6 months to 9 months	Yes	No	Yes
Domestic shipment, with documents conveying title attached at the time of acceptance:			
Tenor—6 months or less	Yes	Yes§	No
6 months to 9 months	Yes	No	Yes
Domestic shipment, without documents conveying title:			
Tenor—6 months or less	Yes	No	Yes
6 months to 9 months	Yes	No	Yes
Shipment within foreign countries:			
Tenor—any maturity	No	No	Yes
Foreign storage, readily marketable staples secured by warehouse receipt:			
Tenor—6 months or less	No	Yes§	No
6 months to 9 months	No	No	Yes
Domestic storage, readily marketable staples secured by warehouse receipt:			
Tenor—6 months or less	Yes	Yes§	No
6 months to 9 months	Yes	No	Yes
Domestic storage, any goods in the United States under contract of sale or going into channels of trade and secured throughout its life by warehouse receipt:			
Tenor—6 months or less	Yes	No	Yes
6 months to 9 months	Yes	No	Yes
Dollar exchange, required by usages of trade, only in approved countries:			
Tenor—3 months or less	No	Yes	No
3 months to 9 months	No	No	Yes
Finance or working capital, not related to any specific transaction:			
Tenor—any maturity	No	No	Yes

Note: Tenor refers to the full length of time of the acceptance from date of inception to maturity.

* Authorizations announced by the Federal Open Market Committee on April 1, 1974.

† In accordance with Regulation A of the Federal Reserve Act.

‡ In accordance with Regulation D of the Federal Reserve Act.

§ Providing that the maturity of nonagricultural bills at the time of discount is not more than ninety days.

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 are secured throughout their life by a warehouse receipt or similar document conveying title to the underlying goods."[1]

[1] Quoted from Federal Reserve Bank of New York Circular 7366 dated March 27, 1974.

ELIGIBILITY

As mentioned, prior to April 1, 1974, the Federal Reserve's eligibility requirements for the discount or outright purchase of bankers' acceptances were almost synonymous, but since that date it has become very important for those who work with acceptances to know for what an acceptance is eligible. Bankers' acceptances acquired by the Federal Reserve through the discount of such paper or through open market operations are methods of supplying bank reserves. However, as a matter of practice, the Federal Reserve Banks for many years have not discounted paper for member banks. Rather, Federal Reserve Banks will advance funds to member banks if secured by obligations or other paper eligible under the Federal Reserve Act for discount or purchase by Reserve Banks. The principal remaining significance of eligibility for discount, from the Federal Reserve's standpoint, is that bankers' acceptances described in Section 13 of the Federal Reserve Act and eligible for discount are not subject to reserve requirements; i.e., a bank which is a member of the Federal Reserve System and which creates a bankers' acceptance that is sold in the market and that is not described in Section 13 or not eligible for discount must maintain reserves against such an acceptance. While an acceptance may not be eligible for discount, it may be eligible for purchase by the Federal Reserve Bank of New York for its open market operations and, if so, it would also be eligible to secure an advance from the Federal Reserve to a member bank, i.e., secure "borrowing from the discount window".

The FOMC's authorizations, announced on April 1, 1974, changed the type of acceptance the Federal Reserve could purchase, as follows:

(1) Maturities at time of acceptance of more than six months and up to nine months, providing they meet other requirements, are eligible for purchase *but not eligible for discount.*

(2) Domestic shipment acceptances without attached documents conveying title at the time of acceptance are eligible for purchase *but not eligible for discount.* To be discountable, the shipping documents securing title must be in the possession of the bank or its agent at the time of acceptance.

(3) Foreign storage acceptances are not eligible for purchase *but are eligible for discount,* provided the goods are readily marketable staples, are stored in an independent warehouse, and are secured at the time of acceptance by a receipt or other documents conveying title.

(4) Acceptances financing the domestic storage of goods (any goods, not necessarily readily marketable staples) that are 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 documents conveying title to the underlying goods are eligible for purchase *but are not eligible for discount.* To be discountable, the goods must be readily marketable staples and stored in an independent warehouse or subject to governmental control and must be secured at the time of acceptance by a receipt or other document conveying title.

(5) Dollar exchange acceptances are not eligible for purchase *but continue to be eligible for discount.*

As can be seen, therefore, the new rules have separated acceptances, in some instances, into those eligible for purchase and those eligible for discount. Table II defines "eligibility" and "reservability" for various classifications of acceptances.

When dealers make deliveries of the acceptances sold to the Federal Reserve, the Acceptance Division's clerical staff verifies each acceptance for eligibility, acceptability, and negotiability. The following lists some of the most common faults that *disqualify* an acceptance for purchase by the Federal Reserve even though the acceptance may meet the broad tests of eligibilty described in Table II.

(1) The face of the draft does not specify the details of the underlying transaction; this information is usually presented in a standard "eligibility" stamp.

(2) Incomplete description of underlying transaction. *Example:* "Merchandise—various; from —various countries to Japan." If a broad category must be used, it should be supported on the back of the draft or on an attachment giving the details of the commodities, the countries of origin and destination, and the amount of each such transaction.

(3) Draft drawn to finance only freight charges or service charges such as interest, customs, insurance.

(4) Changes in the terms of the draft or the tenor is incomplete or questionable.

(5) A draft drawn subject to a bill of lading date is not acceptable, i.e., the Federal Reserve will not purchase an acceptance on which the due date is described as a stated number of days from the date of the bill of lading issued in connection with the shipment of goods underlying the draft. At this writing, our interpretation is that there may be a legal infirmity to the practice of specifying the tenor of an acceptance in this way. The Federal Reserve prefers to see specific language such as "accepted to mature on . . . ."

(6) Authorized signatures missing, e.g., drawer, acceptor, endorser.

(7) Restrictive foreign endorsement or drafts drawn without recourse. *Example:* The endorsement "Pay any Bank, Banker, or Trust Co." does not under the Uniform Commercial Code impair negotiability among banks and special endorsees of banks, but this result may not follow under foreign laws.

(8) Words and figures on drafts do not agree, or any change casting doubt on the amount, such as "with collection charges" or "with interest".

(9) Drafts payable in a nonreserve city are not acceptable as a matter of policy.

Also, it should be noted that since July 11, 1974, when the dealer endorsement requirement was discontinued, the Federal Reserve buys two-name paper—i.e., the drawer and a nonaffiliated acceptor—for its own and its customer accounts.

MARKET PARTICIPANTS

The market for bankers' acceptances is an over-the-counter market made by perhaps ten to fifteen dealer firms, some with nationwide branches. Most of these firms deal in a variety of marketable obligations, with the acceptance trading constituting one part—in some cases a relatively modest part—of their overall activities. The major dealers in bankers' acceptances are located in New York City, a natural outgrowth of the close relationship between acceptance financing and foreign trade as well as between acceptances and the international departments of larger banks. Participants in the market, in addition to dealers, are the accepting banks both domestic and foreign, Edge Act corporations, other investors of all types ranging from individuals to foreign central banks, and the Federal Reserve System.

The acceptance market, until the latter part of 1969, differed from some other short-term markets in that it featured posted rates by dealers. The major dealers in acceptances quoted bid and asked rates for specified maturities and stood ready to buy or sell prime acceptances at their posted rates. Inasmuch as these acceptance rates changed rather infrequently prior to 1969, the relative stability provided the investor a certain measure of protection against market risks. As the market for bankers' acceptances became more volatile, the practice of posting rates was altered and, although some dealers continued to post bid and asked rates for informational purposes, it has become generally understood that trading is done on a negotiated basis.

Movements in acceptance rates are closely aligned with other short-term money market instruments and are also influenced by the size of dealers' portfolios. The difference in rate between what the dealer pays for acceptances and what he sells them for, as well as the spread on the cost of financing his position, largely determines his profit. The normal dealer spread between buying and selling rates is ⅛ to ¼ percent, but it can be 1 percent or higher in a sharply fluctuating market. Despite the relatively costly paper work involved with each acceptance transaction, i.e., the verification of each bill to assure negotiability and eligibility, some large volume dealers manage on somewhat smaller spreads, providing the cost of financing their holdings is favorable. Accepting banks utilize dealer quotations in establishing a discount basis for customer acceptance financing, usually adding an acceptance fee to the dealer bid rate.

DEALER TRADING RELATIONSHIP WITH THE FEDERAL RESERVE

A dealer firm trading in bankers' acceptances and desiring to establish a trading relationship with the Federal Reserve must meet certain financial, managerial, and operational criteria. Before the Federal Reserve trades with a dealer firm, the officers responsible for open market operations ask the following types of questions:

(1) Is the firm actively engaged on a daily basis in trading bankers' acceptances?
(2) Is the firm's trading activity of sufficient volume and diversification to satisfy the Federal Reserve's requirements that the dealer be a significant market participant?
(3) Does the firm maintain a portfolio of satisfactory size, particularly relative to the other firms with which the Desk transacts business?
(4) Is the firm reputable and financially sound?
(5) Will the Federal Reserve's open market operations benefit from recognition of the dealer, i.e., from the firm's ability to make markets and its ability to contribute to the development of a broader market?
(6) Is the management and staff competent?

If these questions can be answered affirmatively, with appropriate documentation, then the dealer firm can expect the Federal Reserve to establish a trading relationship with it.

ESTABLISHMENT OF BANK NAME AS PRIME

To qualify its acceptances for purchase by the Federal Reserve, a bank must establish its name in the market and its acceptances must be considered "prime". A bank may market its acceptances in any manner it chooses, but it is when sales are made to dealers reporting to the Acceptance Department on a daily basis that a bank's sales become known to the Federal Reserve. When a bank's acceptances move in the dealer market, the Federal Reserve can more easily reach a judgment regarding the marketability of the paper and whether it is considered prime by the dealers. The volume and frequency of market transactions is also a factor which the Federal Reserve considers before it decides to add a bank's name to the "acceptable" list that can be purchased in the open market. The financial condition and reputation of the bank is, of course, an important ingredient in whether a bank's acceptances are considered prime.

A bank seeking to have its acceptances qualify for purchase by the Federal Reserve Bank also has to meet certain other standard criteria in the form of documentation. The requirements are somewhat different for agencies or branches of foreign banks and for nonmember commercial banks than for Edge Act corporations and member banks of the Federal Reserve System.

Member banks of the Federal Reserve System and Edge Act corporations governed by Federal Reserve Regulation K have only to submit a list of authorized signatures, in addition to the requirement that the bank's acceptances trade as prime in the market. When a bank indicates to the Acceptance Department that it seeks to have its acceptances qualify for purchase by the Federal Reserve, a review of the bank's most recent examination by the Federal bank examiners is obtained from the Reserve District in which the bank is located.

The documents to be lodged by branches or agencies of foreign banks with the Federal Reserve Bank are:

(1) Certificate of resolution (in the form required by the Federal Reserve Bank of New York) of the board of directors of the foreign bank.

(2) Certification (in the form required by the Federal Reserve Bank of New York) by the principal officer or representatives of the agency or branch of the names, titles, and specimen signatures of persons authorized to sign acceptances.
(3) Certified copy of license to do business issued by the state in which the office is located.
(4) Copy of the letter to the State Banking Department requesting and authorizing the department to furnish the Federal Reserve Bank with copies of all reports of examinations of the foreign agency or branch.
(5) Opinion of the United States counsel to the foreign bank as to the authority of such bank to accept bills of exchange drawn upon it.
(6) Letter of transmittal from the foreign branch or agency addressed to the Federal Reserve Bank, accompanying the foregoing documents and containing a written undertaking by the agency or branch that it will inform the Federal Reserve Bank, at its request, of the details of any transactions underlying the acceptances.
(7) Whenever the principal officer or representative is to be succeeded, certification (in the form required by the Federal Reserve Bank of New York) by the principal officer or representative of the status and signature of his successor.
(8) Such financial statements as the Federal Reserve Bank may require.

It is recommended that the United States counsel to the foreign bank be consulted in connection with its preparation of the foregoing documents and that in the course of such preparation the counsel contact the Legal Department of the Federal Reserve Bank of New York.

A nonmember commercial bank seeking to qualify its acceptances for possible purchase by the Federal Reserve is required to supply similar information as follows:

(1) Opinion of counsel to the bank that (a) under its charter and the laws of the state in which it is located the bank is empowered to accept for payment at a future date bills of exchange drawn upon it and (b) the officers of the bank have been authorized by its directors to accept such bills.
(2) Certified copy of the most recent statement of condition of the bank.
(3) Most recent report of examination of the bank by the appropriate supervisory agency of the state.
(4) Copy of the letter from the bank to the State Banking Agency, authorizing and requesting the agency to furnish the Federal Reserve with copies of all examinations of the bank made by the agency.
(5) Letter of transmittal from the bank to the Federal Reserve Bank accompanying the foregoing and containing a written statement that the bank will inform the Federal Reserve, at its request, concerning the details of the transactions underlying its acceptances.

It should be emphasized that the policy of the Federal Reserve is to purchase in the open market only acceptances already established as prime acceptances; the lodging of the documents enumerated above with the Acceptance Department would not in and of itself mean that the acceptances of the Bank would be purchased immediately by the Federal Reserve. The documents merely put the Federal Reserve in a position to purchase the acceptances when such purchases are consistent with Federal Reserve policy objectives, or when Federal Reserve customer accounts request that such purchases be made.