Bankers' Acceptances

Over the last decade, the dollar volume of bankers' acceptances has increased some tenfold, reflecting in large part the growth of dollar-denominated international trade flows during that period. The expansion has brought in its wake major changes in the practices of the accepting banks, the organization and functioning of the secondary market, and the Federal Reserve's participation in that market.

The acceptance market has evolved despite the constraints of highly complex and, in some cases, anachronistic regulations. Because banking practices and monetary policy implementation have changed dramatically since the regulations governing acceptances were established, proposals to change the regulations are under discussion. Legislation currently before the Congress would raise the legal limits on the amount of certain types of acceptances a bank could create and, if enacted, might have a major impact on the acceptance market.

Notwithstanding the market's prominence, acceptances continue to be the least understood of the actively traded money market instruments. Before the impact of prospective changes in the acceptance market can be assessed, it is necessary to understand procedures for creating acceptances and the current regulations which influence them.

The authors would like to acknowledge the helpful comments of Arthur Bardenhagen, L. Thomas Block, Peter J. Bourke, Joseph A. Colleran, H.J. Escobar, Peter Gall, Kenneth D. Garbade, Robert Giordano, Ralph T. Helfrich, Susan Merriman, Iwao Miyamoto, Virginia Molinelli, Joseph Oricoli, Edward J. Ozog, Gordon M. Schmidt, and Walker F. Todd. The views expressed do not necessarily reflect those of the Federal Reserve Bank of New York.

Creating acceptances

Creating an acceptance involves nothing more or less than substituting a bank's creditworthiness for that of a borrower. The instrument itself is but one species of a bill of exchange—*i.e.*, a draft or order to pay a certain amount of money at a specified time. It differs from other bills in that it bears the unconditional promise of a bank to pay the draft at maturity.

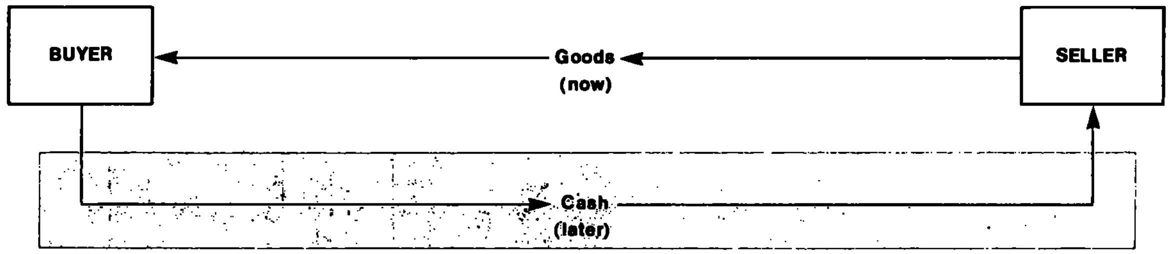
Typically, a buyer does not pay cash for a shipment of goods but requires credit until the goods are sold. This may present a problem for a seller who is poorly equipped to evaluate the creditworthiness of the buyer. Also, the seller may need immediate payment. As illustrated in Chart 1, a bank familiar with the buyer's business can act as an intermediary between the two trading partners by assuming the responsibility of making the payment for the goods on the buyer's behalf. Because of its superior ability to evaluate the buyer's creditworthiness, the bank may be more willing than other parties to assume the risk that the buyer may not be able to reimburse it.

In a typical acceptance transaction, the bank guarantees payment by "accepting" a time draft drawn on it by the seller.[1] The illustration shows a time draft ordering a bank to pay $100,000 to an export firm ninety days from presentation of the draft at the bank. By accepting such a time draft, the bank assumes an unconditional liability to pay the seller (or the ultimate

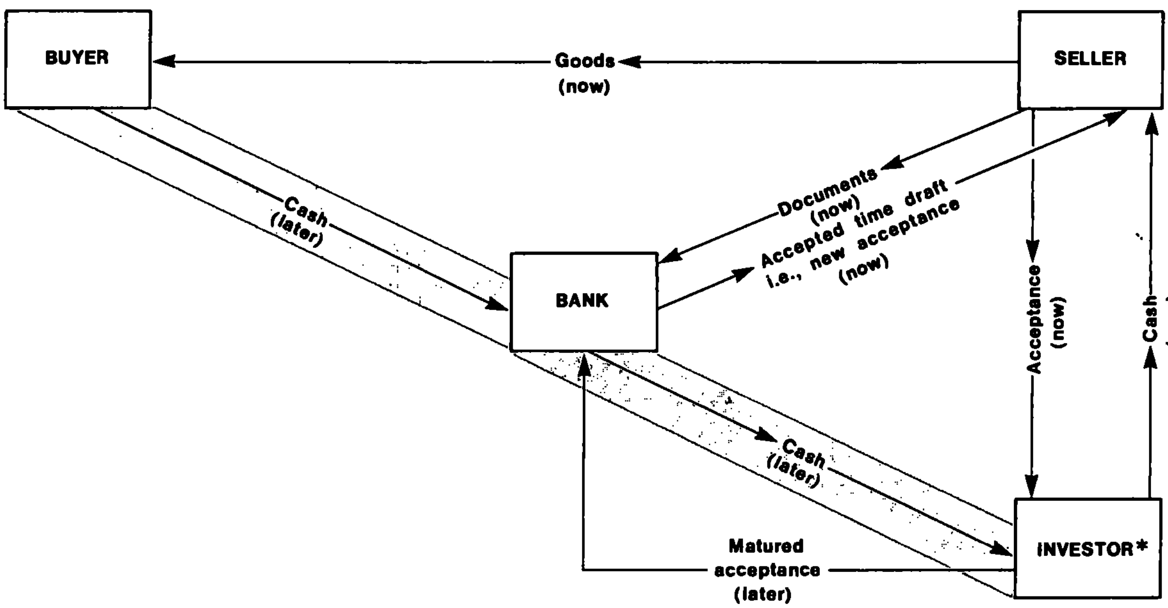
[1] Another alternative would be for the seller to draw a sight draft (an order to pay immediately upon presentation) which would be paid with the proceeds of a time draft drawn by the buyer, accepted by the bank, and sold to an investor. In this case, the seller does not assume ownership of the acceptance at any point.

Chart 1

If a buyer and a seller arrange a delayed-payment transaction, the seller must assume the risk that the buyer may be unable to pay . . .



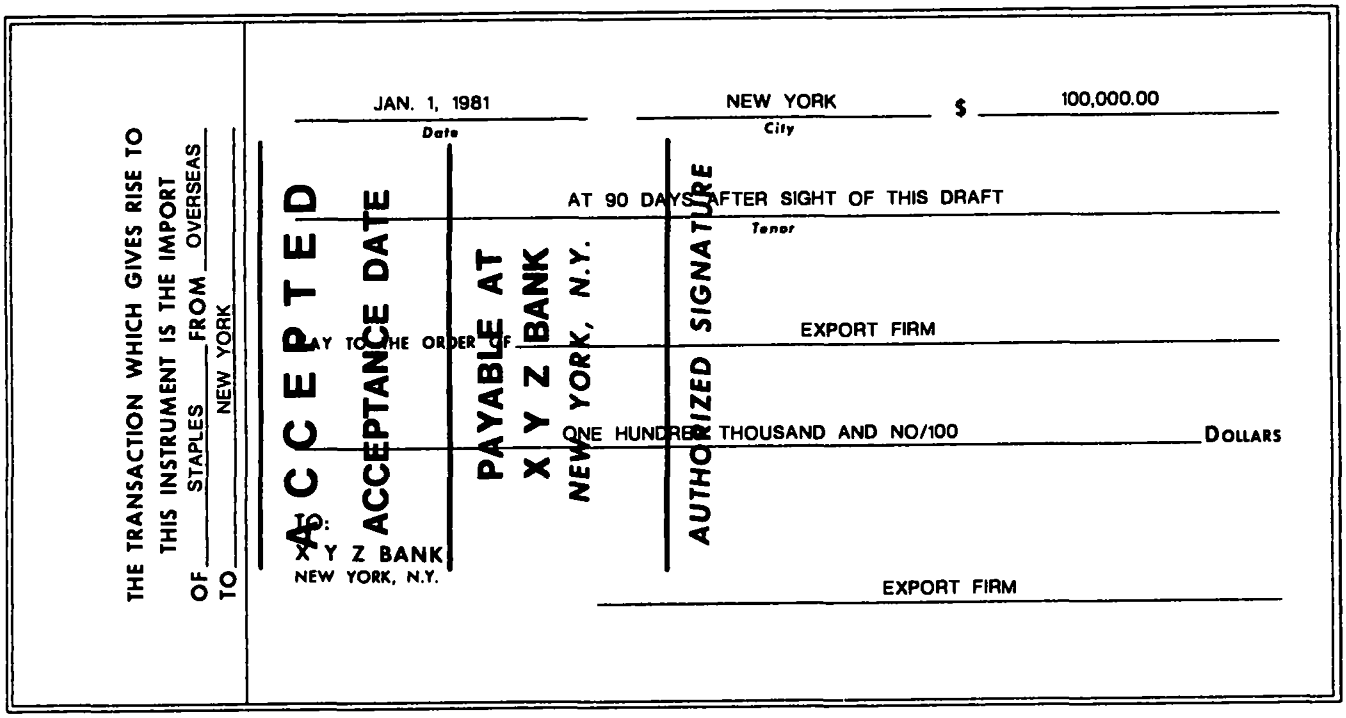
. . . but, if the same basic transaction is arranged with a bank guaranteeing payment, the risk is transferred from the seller to the bank.



SHADED AREAS DENOTE: credit risk; [ ] = substantial credit risk, [ ] = minor credit risk.

*Typically an acceptance is purchased (discounted) first by the accepting bank and then resold (rediscounted) to another investor.

Illustration of a Bankers' Acceptance



holder of the draft) regardless of whether the buyer reimburses the bank or not. The bank indicates its willingness to do so by stamping the draft "accepted" and affixing the signature of an officer empowered to sign for the bank.

If the bank is willing to provide its guarantee, it notifies the seller (most likely through the medium of the seller's bank) that a letter of credit has been issued on behalf of the buyer authorizing the seller to draw a draft on the bank for an indicated dollar amount. The letter of credit also indicates the terms that must be met by the seller before the bank will accept the draft. The letter of credit is a legally binding commitment by the bank to accept the draft if the specified terms are met. Letters of credit are usually irrevocable, subject to cancellation only with the consent of all parties to the agreement. The terms specified in the letter may include presentation of documentary proof from which the bank can ascertain that the goods in question actually have been shipped and that the underlying transaction conforms to Federal Reserve regulations (Appendix). Once the goods are shipped, the related documents are forwarded by the seller (or his bank) to the buyer's bank along with the time draft drawn on the buyer's bank. When these are received, the buyer's bank verifies that the specified terms have been met and accepts the time draft.

At this point, the acceptance is the property of the seller. Frequently, however, the seller prefers to obtain cash immediately so that the accepting bank generally offers to discount (purchase) the acceptance for its own account.[2] The bank, in turn, may rediscount (sell) the acceptance in the secondary market. Upon maturity, the ultimate investor will present the acceptance through his bank to the accepting bank for payment. The bank, of course, collects the funds owed it by the buyer.

The key element of an acceptance is obviously the bank's unconditional guarantee of payment on the draft, an obligation fully on par with the bank's obligation to redeem its uninsured deposits at maturity. While this feature is common to all acceptances, there are, of course, many possible variations on the simple sequence of events outlined above. For example, the

[2] Since acceptances carry no explicit interest payment, they trade at a discount from the face value similarly to most other money market instruments.

bank's customer may be a seller financing a series of shipments to a known buyer over a period of time at his own risk. This might make sense, for example, if the buyer is a subsidiary of the seller and the parent firm can obtain better financing terms than the subsidiary. Or a buyer might be planning to finance a number of purchases. In both of these cases, an acceptance facility permitting a series of drafts to be drawn might be used.[3]

Moreover, it is not necessary that the buyer's bank be the accepting bank as in the example above; the draft could be drawn on and accepted by the seller's bank or some other bank, provided it was willing to assume the risk. In addition, a bank may endorse an acceptance of some other bank. In this way, a less well-known bank may be able to lower the financing cost for its borrowing customers by arranging for a well-known bank to add its name to the acceptance and assume an obligation to pay at maturity if the accepting bank cannot do so. The acceptance is then made more marketable.[4]

Some acceptances are not trade related. For example, finance bills raise working capital for the firm drawing the draft. Such acceptances are close substitutes for commercial paper but differ from commercial paper backed by a bank credit line principally in that the bank's obligation to pay the acceptance is unconditional.[5]

Finally, an acceptance may or may not involve the actual extension of funds by the accepting bank. If the bank accepts the draft but does not discount it, then the bank has simply provided its guarantee to facilitate the raising of funds by the borrower from some other source. However, for reasons discussed in more detail below, the bank typically buys and then sells its acceptance, and the acceptance serves as a medium for the bank both to advance credit as well as to fund itself.

In contrast to the many possible procedures for creating acceptances, the instrument itself is fairly standardized. As the Appendix explains, the nature of the underlying transaction is important in determining a bank's maximum allowable exposure to any single customer, as is the original term to maturity (or tenor) of the acceptance. Moreover, both of these factors are important in determining whether funds raised by a bank through the sale of an acceptance are subject to reserve requirements and whether the acceptance is eligible as collateral for repurchase agreements (RPs) executed by the Federal Reserve.

Growth trends

Trade-related acceptances fall into three main categories depending on the nature of the underlying transaction. The first group—import and export acceptances—are used to finance United States imports and exports, respectively. Prior to the 1960s, these acceptances were by far the predominant form of acceptance financing.

Starting in the early 1960s, however, third-country acceptances—which finance trade between countries other than the United States—increased rapidly and on the whole have been the major source of expansion of total acceptances outstanding. Most third-country acceptances are created by the largest United States banks for foreign borrowers and foreign banks, mostly in Japan and to a less degree Korea and Latin America. These acceptances generally originate with drafts drawn on a foreign bank or its United States branch or agency. To obtain the requisite dollars to pay the draft, the foreign bank may draw a so-called "refinance bill" to be accepted and discounted by a United States bank. Since 1974, third-country acceptances have accounted for about half of total acceptances outstanding, with import and export acceptances each providing between 20 and 28 percent of the total.

Domestic acceptances—which finance the shipment and storage of goods within the United States—are the least utilized type of trade-related acceptance, representing only about 3 to 6 percent of total outstandings. The additional documentation burden required for the funds raised from the sale of domestic shipment acceptances to be exempt from reserve requirements, as well as the more popular use of open account financing for domestic United States trade, has inhibited their use (Appendix, Table 2).

Numerous interrelated factors have influenced the utilization of trade-related acceptances. These include the monetary and regulatory policies of different countries, the prevailing and expected future dollar exchange rates, and changes in the value and volume of trade. For example, the sudden price shocks to the agricultural and petroleum markets during the 1970s greatly affected the nominal value of acceptances used to finance the trade of these commodities. During 1974 alone, in the wake of sharply increased oil prices, total acceptances outstanding more than doubled. Rapid in-

[3] Recently, Petroleos Mexicanos (Pemex), the Mexican state petroleum producing and refining firm, arranged a $4 billion acceptance facility with a consortium of eighty-two banks, the largest such facility ever.

[4] Acceptances accepted by only one bank are referred to as "two-name paper", since they are the obligation of the drawer as well as the accepting bank. Paper accepted by one bank and endorsed by another is "three-name paper", and so forth.

[5] However, commercial paper is sometimes backed by a bank's "standby" letter of credit, in which case the bank's obligation to pay an investor is more binding than a credit line and only slightly more conditional than under an acceptance.

creases also occurred in 1979 and 1980, and by May of this year the total was $60.6 billion, more than double the level just three years ago (Chart 2).

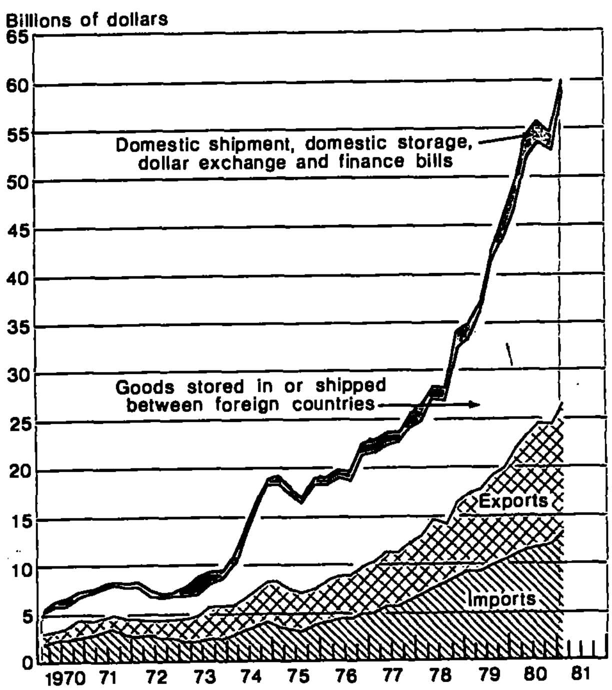
Currently, acceptances which are not specifically trade related constitute only a small portion of the market, though they have been important at various times in the past. For example, so-called dollar exchange bills may be accepted for agriculturally dependent countries, mostly in Latin America, to alleviate seasonal shortages of dollars. In recent years, however, these countries have stabilized their foreign trade earnings through crop diversification and industrial development. Accordingly, their need for this form of financing has become negligible.

In addition, finance bills were once a significant factor in the acceptance market. As discussed in detail below, the volume of these acceptances has declined in recent years to negligible levels, but conceivably banks may again use them to meet customers' credit demands.

Chart 2

Types of United States Bankers' Acceptances Outstanding, 1970-81

End of quarter



Source: Federal Reserve Bulletin.

Advantages to banks

As mentioned above, a bank has several options in an acceptance transaction. First, the bank may opt to complete only the first stage of the transaction—*i.e.*, to accept the draft. In this case the bank itself advances no funds; it merely guarantees payment on the acceptance at maturity in return for a commission. Moreover, this guarantee is not a reservable liability. The owner of the draft can obtain funds before maturity by selling it to an investor who is willing to buy this unconditional obligation of the bank. Should a nonbank dealer firm discount the acceptance and place it with an investor, the dealer would be performing a function similar to that of dealers underwriting commercial paper issues.

Alternatively, the bank may discount the acceptance and then hold it in portfolio as an investment. In this case it is making a loan which must be funded like any other loan. Holding acceptances may be attractive if the bank has reached its limit on sales of certain types of acceptances.[6]

Finally, a bank may accept, discount, and subsequently rediscount the acceptance. The funds raised through rediscounting an acceptance are exempt from reserve requirements, providing the acceptance is of the type described in Section 13(7) of the Federal Reserve Act and the applicable aggregate limits are not violated (Appendix). The principal difference between this option and the first above is that, in addition to the acceptance commission, the bank would hope to earn the spread between the bid and asking rates on acceptances in the secondary market. For example, if the acceptance commission were 0.50 percentage point and the bid-ask spread 0.10 percentage point, then the bank would increase its profit by one fifth, provided that the market rate did not change during the interval of time between discounting and rediscounting the acceptance.

From the accepting bank's perspective, creating, buying, and selling an acceptance perform a function equivalent to issuing a negotiable certificate of deposit (CD) to fund a loan to a customer. However, because the funds raised from the sale of an acceptance which meets specific regulatory standards are exempt from reserve requirements, they will be less costly to a bank than those raised through issuing CDs.

In addition, a rediscounted acceptance may have significantly less interest rate risk than a fixed-rate loan funded with a fixed-rate CD. Should interest rates

[6] As discussed further in the Appendix, acceptances held in portfolio are not included in the amount subject to a member bank's aggregate limit. Therefore, to avoid violating regulations, a member bank at its aggregate limit may hold acceptances temporarily until other outstanding acceptances mature.

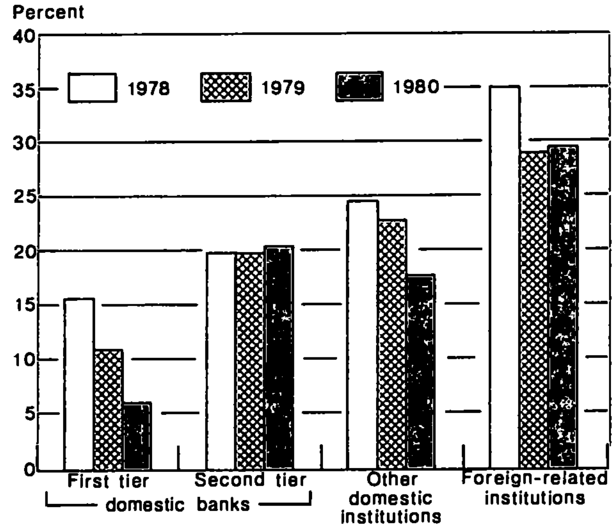
decline sharply, the bank loan would probably be prepaid while the bank would be unable to prepay its CD. In contrast, the commission fee for an acceptance is paid in advance and is in principle nonrefundable, so that prepayment can increase the borrower's effective financing cost substantially. Moreover, in the relatively infrequent cases when prepayment does occur, a penalty is generally added to the current acceptance discount rate, raising the effective cost still further. Finally, an acceptance, particularly if it is secured, may well pose less default risk than an unsecured loan, since the accepting bank may have recourse to the goods of the underlying transaction if the borrower defaults.[7]

At times, banks have had especially strong inducements to attempt to raise reserve-free funds through the sale of acceptances. For example, in 1969-70, when below-market Regulation Q ceilings capped interest rates payable on CDs, massive amounts of CDs matured without being renewed.[8] In response, large banks turned to acceptances—among other things—as one way to accommodate their borrowers' financing needs. By creating, buying, and then selling acceptances, banks could meet their customers' loan demands and avoid the constraints of Regulation Q as well as the costs imposed by reserve requirements.[9]

In early 1980, record-high interest rates and an increase in the marginal reserve requirement on "managed liabilities", imposed under the credit restraint program in March 1980, combined to increase the effective cost of funds raised through issuing CDs. Consequently, banks sold acceptances and held a

Chart 3

Own Acceptances Held in Portfolio as a Percentage of Total Outstanding of Each Group *

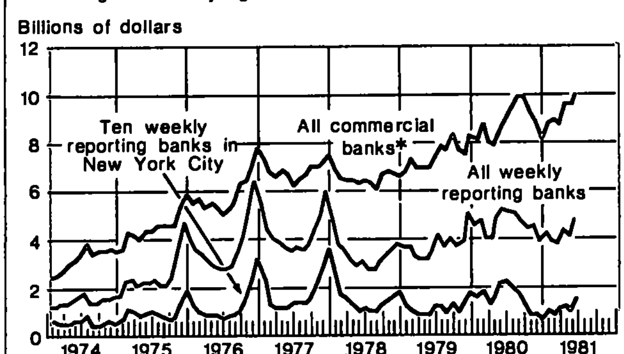


* As measured by total acceptances outstanding in December 1980, the first tier of domestic banks is the top ten United States accepting banks. The second tier is the next twenty largest United States accepting banks. Other domestic institutions are the approximately 250 remaining domestic accepting institutions. Foreign-related institutions include about 70 foreign-owned banks and agencies and branches of foreign banks in the Second, Seventh, and Twelfth Federal Reserve Districts.

Chart 4

Acceptances Held by Commercial Banks

Average of weekly figures



*Includes domestic banks, United States branches and agencies of foreign banks, New York investment company subsidiaries, and Edge Act corporations.

Source: Federal Reserve Bulletin.

[7] Most acceptances are unsecured, though import bills typically provide for the accepting bank to hold title documents. Nevertheless, the value of the collateral in such a case can be exaggerated. The story is told of a major New York City bank which financed the import of an elephant for a circus via an acceptance. Unfortunately, by the time the elephant arrived in this country, the circus had gone bankrupt. The bank thus owned the elephant, and a bank representative took possession of the animal and found it a place to stay in a warehouse while a purchaser was being sought. The elephant was provided with water, food, etc., and was chained securely to an I-beam in the warehouse wall. As fate would have it, the elephant panicked during the night, pulled the I-beam out of the wall, destroyed the warehouse and with it, alas, the collateral for the acceptance.

[8] For a description of the CD market during this period, see William C. Melton, "The Market for Large Negotiable CDs", this *Quarterly Review* (Winter 1977-78), pages 22-34.

[9] In addition, in 1969 some innovative banks also began creating and selling working capital acceptances (finance bills) since the funds received from the sale of these bills were not reservable at the time. The volume of such bills increased rapidly, from average levels of $300-400 million in the early 1970s to almost $1.5 billion in June 1973, equal at that point to about one fifth of all other acceptances. In mid-1973, however, reserve requirements were imposed on funds raised through the sale of finance bills, and only negligible amounts have been created since then.

historically low 16.2 percent of outstandings in 1980.[10] In general, the largest accepting banks were more aggressive in this regard than other institutions (Chart 3).

Tax considerations and so-called "window dressing" made acceptance holdings at the year-end attractive to a few large money-center banks during the latter part of the 1970s. A bank's allocation to its loan loss reserve of up to a specified percentage of total loans outstanding at the end of the year was deductible for Federal and some state income tax purposes.[11] Since acceptances held in portfolio are classified as loans, purchases of acceptances expand the dollar volume of tax-deductible loan-loss allocations. Therefore, in an environment in which loan losses were rising and loan demand was weak, some large banks increased their holdings of acceptances at the year-end and let them decline again shortly afterward. In addition, this maneuver reduced the ratio of loan write-offs to loans outstanding, a measure used by some bank stock analysts in evaluating bank management. Such window dressing had tapered off by 1978 as loan volume rose and alternative means to reduce taxes developed (Chart 4).

Advantages to borrowers

Compared with the costs of other borrowing alternatives, acceptances can be an attractive means of financing. In addition, an individual customer may be able to borrow more from a single bank by using acceptances to supplement other types of financing.[12]

The total interest costs of some other financing alternatives in June of this year are illustrated in Table 1. Generally, a bank will quote a potential acceptance customer an "all-in" rate, which includes several charges in addition to the acceptance discount rate in the secondary market. The commission charge listed in the table can vary depending on the availability of bank funds and the quality of the borrower's credit. In addition, the borrower may incur costs to secure required documentation. For example, if the acceptance is financing a domestic storage or shipment transaction, Federal Reserve regulations require a title document to certify that the collateral is under the control of an acceptable third party.

Clearly, in June 1981, acceptance financing potentially was less costly than conventional prime-based or LIBOR (London interbank offering rate)-based borrowing. The acceptance cost was comparable to that of prime commercial paper. But, for small- and intermediate-sized firms, the total costs of acceptance financing may well have been competitive with issuing commercial paper, if these firms have access to the commercial paper market at all. Investors will demand higher rates on the commercial paper of these firms than on an acceptance of a well-known bank.[13]

To reap the full cost advantage of acceptance financing, however, a borrower needs to be able to specify fairly precisely the duration of his financing need and thus the tenor of the acceptance. As noted earlier, prepayment of the acceptance—which generally would be required if the goods underlying the transaction were sold before the tenor date—may raise the borrower's effective financing cost substantially. Moreover, a bank cannot give a prior unconditional assurance of being able to accept a renewal draft, so that, if funds were not available by the tenor date, the borrower might have to arrange other means of finance. Hence, the relative inflexibility of its maturity somewhat limits the usefulness of the instrument.

Investors

An impressive record of safety and liquidity makes acceptances attractive short-term investments. Yields on ninety-day acceptances are closely in line with rates on ninety-day CDs. Since late 1977, the yields on both acceptances and CDs have averaged almost 100 basis points above Treasury bills of comparable maturity (Chart 5).

Acceptance investors include state and local governments, governmental agencies, savings institutions, foreigners, foreign central banks, industrial corporations, insurance companies, investment funds, accepting banks, and individuals. Data on dealer sales to these groups suggests that most investors have main-

[10] Under the program, banks were asked to limit the growth of their credit extensions. To offset the growth of other forms of credit, banks reduced their holdings of their own acceptances as well as those of other institutions.

[11] This percentage is being phased down in accordance with the Tax Reform Act of 1969. Between 1969 and 1975, it was 1.8 percent, while currently it is 1.2 percent and scheduled to be 0.6 percent in 1982.

[12] A bank's credit extension to a borrower via an acceptance eligible for discount is subject to a separate and distinct limit from the general lending limit of 10 percent of a national bank's paid-in and unimpaired capital stock and surplus—Sec. 5200 of the revised Statutes (12 U.S.C. 84). This provides the borrower with an avenue for additional borrowing capacity. Since acceptances made for a borrower are subject to a separate "10 percent limit", the effective per customer lending limit is 20 percent. Similar provisions generally apply to state-chartered banks.

[13] Of course, if borrowing under an acceptance, these firms would pay higher commission fees. However, in contrast to acceptances, the backing which a bank gives a commercial paper offering by extending a line of credit to the issuer is generally revocable and thus does not remove all the credit risk to the investor. Accordingly, firms perceived to be riskier must pay higher rates on their paper. As noted earlier, commercial paper can also be backed by an irrevocable letter of credit, in which case the bank's commitment to advance funds is more binding and the risk to the investor correspondingly reduced. However, the fee for such a service would be greater than for a revocable credit line.

Table 1

Comparison of Acceptance and Alternate Financing in June 1981

In percent

Method of borrowing	Charges
Bankers' acceptance:	
Ninety-day discount rate*	16.42
Prime acceptance commission†	0.50
"All-in" rate	16.92
Adjustment to convert discount basis to simple interest basis	0.75
Total interest charge	17.67
Bank loan:	
Bank prime rate‡	20.03
Total interest charge	20.03
LIBOR:	
Ninety-day London interbank offer rate	18.00
Spread over LIBOR§	0.25
Total interest charge	18.25
Commercial paper:	
Ninety-day prime paper rate	16.32
Dealer placement fee	0.125
Adjustment to convert discount basis to simple interest basis.	0.71
Commitment fee for bank backup lines	0.50
Total interest charge	17.66

All interest rates are monthly averages.

* The discount rate used in the example is for acceptances of the type described in Section 13(7); if the underlying transaction were not of this type, funds raised through its sale would be subject to reserve requirements, and the discount rate would have been about 70 basis points higher.

† Plus spread over prime acceptance commission, if any.

‡ Plus spread over prime and interest equivalent of compensating balances, if any.

§ Plus interest equivalent of compensating balances, if any.

tained their relative market share over the years.[14] However, as mentioned previously, accepting banks have decreased their acceptance holdings, and the investment portfolios of foreign central banks maintained by the New York Federal Reserve Bank contain fewer acceptances (Box 1). In contrast, money market mutual funds have greatly expanded their market share in the past few years, increasing their holdings in just four years from less than 0.5 percent to 15.4 percent of total acceptances outstanding in 1980. The growth might have been even greater, but funds registered in New York limited their holdings in order to minimize their state and city tax liabilities.[15] A fund can do so by restricting acceptance holdings to less than 15 percent of its total investment and business capital.[16] While amendments to the New York State tax laws for regulated investment companies recently eliminated this constraint, growth of acceptance holdings is still inhibited by the New York City tax structure.[17]

Secondary market

The ability to trade acceptances efficiently depends on the existence of a relatively standardized instrument. One dimension of standardization is the dollar amount of the bill. The typical trading size in the secondary acceptance market has changed over the years because of the development of "round lot" trading. Currently, a round lot consists of one or more acceptances of similar maturities issued by banks in the same credit class totaling $5 million. For example, a round lot might comprise five $1 million acceptances or ten $500,000 acceptances. Banks can create acceptances of relatively uniform size which can conveniently be aggregated with other acceptances into a round lot by instructing customers to draw one draft to finance several smaller underlying transactions. Alternatively, a very large transaction might be handled by instructing the customer to draw several drafts of conveniently aggregatable sizes which together can finance the underlying transaction. Acceptances of smaller or uneven dollar denominations are considered "odd lots". Dealers generally are reluctant to bid for odd lots and do so only at a below-market price. As a result, banks generally hold these acceptances in their own portfolios or sell them directly to individuals.

Another dimension of standardization is the uniformity of credit quality of acceptances. By trading the acceptances of certain banks "on the run"—*i.e.*, as readily substitutable for the acceptances of other banks in their credit class—dealers and other market participants avoid the need for extensive individual negotiation and appraisal. Nevertheless, investors do perceive gradations in the creditworthiness of different

[14] During 1980, dealers reporting to the Federal Reserve Bank of New York made about 19.8 percent of their sales (exclusive of those to other dealers and through brokers) to commercial banks, 18.5 percent to Federal, state, and local government agencies, 18.5 percent to industrial corporations, and 8.7 percent to foreigners, including the foreign central banks for whom the Federal Reserve Bank of New York acts as agent.

[15] About seventy-five money market mutual funds are registered in New York State, representing approximately 73 percent of the assets of all money market funds, and are subject to the state's tax laws.

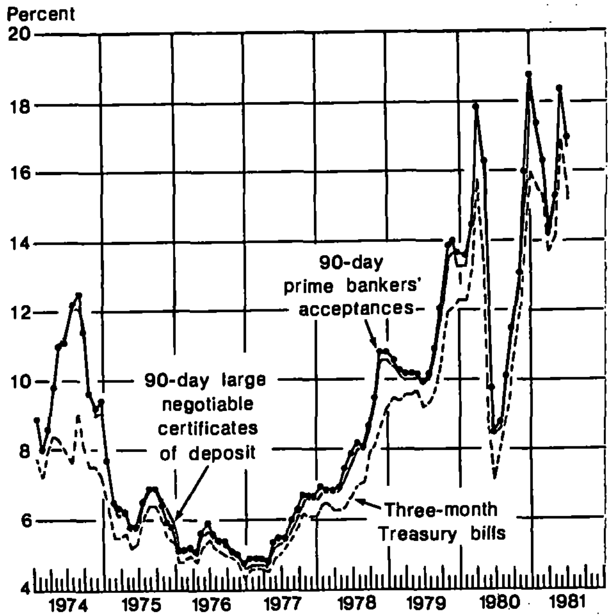
[16] Unlike CDs, which are classified as investment capital under the New York State and City General Corporation Franchise Tax Laws, holdings of bankers' acceptances are classified as business capital. Because of the tax implications of this distinction, funds limit their acceptance holdings.

[17] Effective January 1, 1980, New York State adopted the Federal Government's tax scheme for a regulated investment company, with some modifications.

Chart 5

Money Market Rates

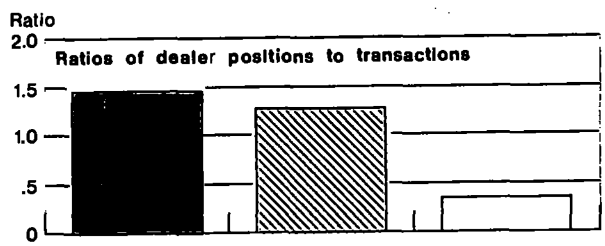
Bond equivalent yield basis



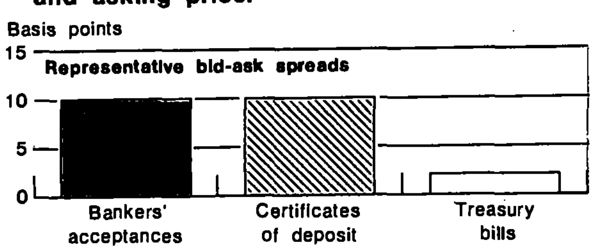
Source: Federal Reserve Bulletin.

Chart 6

Since acceptances and certificates of deposit require more inventory per transaction than Treasury bills . . .



. . . dealers compensate by maintaining higher spreads between their bid price and asking price.



bank names, and their preferences influence dealers' holdings of acceptances as well as the rates at which different acceptances trade (Box 2).

The heterogeneity introduced by the perceived differences in credit risk makes the secondary market for acceptances similar to that for CDs. In both markets, investor preferences dictate that dealers maintain a reasonable selection of names and maturities; dealers' interest in minimizing their own risk exposure also encourages this practice.[18] Moreover, an acceptance or CD of a specific bank and maturity date may be unique, so that it is practically impossible for dealers to establish short positions.[19] For these reasons, the amount of acceptances and CDs held in inventory by dealers relative to their purchases and sales is larger than for homogeneous securities such as Treasury bills. This, in turn, means that dealers incur greater inventory financing costs per dollar of transactions than for Treasury bills.[20] Dealers try to recoup these costs by maintaining a spread between their bid price and asking price which is larger than for bills. Then each "round trip"—*i.e.*, a matching purchase and sale—nets the dealer a commensurately greater return (Chart 6).

Dealers' acceptance positions, which generally average $1-2 billion, are also influenced by expectations of the near-term course of interest rates as well as the cost of financing inventories. For example, during mid-1980, when interest rates recently had declined substantially and expectations were widespread that further declines would occur, dealers' positions soared to $2-3 billion. For the most part, acceptance dealers finance their positions by using them as collateral for RPs with corporations, state and local governments, or money funds.[21] Rates charged for such RPs generally are about 20-30 basis points higher than RPs with Treasury or United States agency collateral.

[18] In some instances, dealers limit their total holding of an individual bank's CDs and acceptances. The logic to this arrangement is that both CDs and acceptances are principally obligations of the bank, though an acceptance is also the contingent liability of the drawer.

[19] A short position is created when a dealer sells a security which he does not own. The dealer borrows the security and delivers it to the buyer. Later, the security is bought by the dealer and returned to the lender. The dealer will profit if the security's price has declined between the time the short sale was made and the time it was covered.

[20] Moreover, as explained below, the financing cost per dollar of acceptances or CDs is generally higher than for Treasury or agency securities.

[21] The major exception to this generalization is bank dealers, who must maintain reserves against RPs with acceptance collateral if done with nonbank customers. To avoid the reserve requirement burden, bank dealers generally finance their acceptance positions either through RPs done with banks or through Federal funds purchases. In each case, the financing cost is generally higher than that which would be incurred by a nonbank dealer financing through RPs.

Box 1: Federal Reserve Participation in the Acceptance Market during the 1970s

During the 1970s, the Federal Reserve greatly altered the rules governing its participation in the market, in part because of recurring problems related to the perceived heterogeneity of acceptances.

The market's ever-changing perception of the credit quality of different banks necessitated periodic revisions in the Domestic Open Market Desk's eligibility list.[1] For instance, in 1970, the Bank of Japan removed its limitation on Japanese agencies' issuance of their own acceptances. Since the consequent increase in Japanese agency acceptances led to an oversupply of these acceptances in the market, they were temporarily dropped from the Desk's eligibility list. Later, these acceptances were restored to the list when agencies displayed restraint in selling their acceptances and their market standing improved.

A more serious and less tractable problem resulted when the market began differentiating between the relative standing of different banks on the Desk's eligibility list. Since the Desk executed all acceptance purchases at the same rate, dealers had an incentive to sell acceptances to the Federal Reserve which traded at a rate somewhat higher than the average for those on the eligibility list. As a result, the System portfolio tended to accumulate relatively low-grade paper. The Desk responded to this problem in 1971 by establishing internal guidelines on the volume of individual bank names which it would purchase for the System account.[2] While this procedure limited such purchases, it did not wholly eliminate the problem.

Since the Federal Open Market Committee (FOMC) decided to discontinue outright transactions in acceptances effective March 15, 1977, these percentage allocations for purchases of each bank name are now irrelevant. In announcing its decision, the FOMC noted that the market for bankers' acceptances had become mature and efficient, and thus no longer needed support through Federal Reserve outright purchases. In addition, it was noted that outright purchases and sales of acceptances had not been of sufficient size to contribute materially to the needed volume of System open market operations. Currently, repurchase agreements (RPs) are the only channel through which the System buys and sells acceptances for its own account. Approximately 250 bank names are eligible to serve as collateral for such RPs.[3]

During the 1970s the portion of RPs arranged by the System with acceptances as collateral increased considerably relative to total RPs. In part, this reflected the massive expansion of the amount of acceptances outstanding. However, another factor was the Desk's practice of applying the same minimum cutoff rate to all the competitive bids received, irrespective of whether the collateral was acceptances or Treasury and agency securities. Since market practice was to set a somewhat higher rate for RPs with acceptance collateral, the Desk's procedure often contributed to the attractiveness of System RPs for dealers needing to finance their acceptance inventory. In these circumstances, it was not surprising that the portion of RPs executed with acceptance collateral should have shown such growth. In fact, in 1974, dealer proposals for RPs with acceptance collateral occasionally taxed the ability of the Acceptance Division of the Federal Reserve Bank of New York to process them promptly. Accordingly, on some days the volume of such RPs was limited by setting the lowest rate accepted on them above the lowest rate accepted on RPs against Treasury and agency securities. In that year, RPs executed by the Desk with acceptance collateral exceeded 14 percent of all RPs, quite a jump from the 6.5 percent share during the previous year. More recently, such RPs constituted 11 percent of the total in 1977, rose to 15 percent in 1978 and 28 percent in 1979. Last year, to be more in line with market practices, the Desk began to set the minimum rate on RPs arranged with acceptance collateral somewhat above the minimum rate on those arranged with Treasury and agency collateral.[4] During 1980, the share of RPs executed with acceptance collateral dropped sharply to 17 percent.

[1] To qualify its paper as eligible for purchase by the Federal Reserve, an accepting institution must meet requirements (1), (2), and (5), as described in Ralph T. Helfrich, "Trading in Bankers' Acceptances: A View from the Acceptance Desk of the Federal Reserve Bank of New York", *Monthly Review* (Federal Reserve Bank of New York, February 1976), pages 51-57.

[2] Holdings of a particular bank's acceptances were limited to not more than 30 percent of the bank's total acceptances in existence as indicated by monthly survey reports to the Federal Reserve. The only exception was that holdings of Japanese agency acceptances were limited to 5 percent of each agency bank's outstandings in the market rather than the total amount in existence. Since large amounts of acceptances were normally held by the Japanese agency banks in their own portfolios, it was felt that a limitation defined in terms of their outstandings in the market would relate the Federal Reserve's participation more directly to the willingness of other investors to acquire the agencies' bills. The limit on holdings of a domestic bank's acceptances was increased to 50 percent of that bank's total outstanding in 1974, while the limit for a foreign agency bank was increased to 15 percent of its outstandings in the market.

[3] However, in December 1979, the Federal Reserve announced it would no longer purchase under RPs or accept as collateral for advances acceptances that indicate that the Iranian Government or any of its controlled entities is a party to the documents or to the underlying transactions.

[4] Although some market participants do RPs collateralized by less prime acceptances at a higher rate than those collateralized by prime acceptances, the Federal Reserve makes no such distinction.

Box 1: Federal Reserve Participation in the Acceptance Market during the 1970s *(continued)*

Finally, during 1974, two other important changes were made in the System's acceptance operations to make them conform more closely to market practices. In July, the requirement of dealer endorsement of acceptances sold to the System and customer accounts was terminated. In earlier years such endorsement had been a common practice, but by the 1970s the System was the only market participant requiring it.

The second change, effective in November 1974, was the termination of the Federal Reserve guarantee provided for acceptances purchased by the Desk on behalf of the accounts of foreign central banks. This procedure had probably performed a useful role in promoting the development of the acceptance market in earlier years, but by the 1970s it was creating difficulties. In April and May 1974, acceptance rates rose rapidly relative to rates on Treasury bills. During the May-September period, the gross spread exceeded 200 basis points and peaked at over 400 basis points in July, compared with a more normal spread of less than 100 basis points.[5] In these circumstances, foreign central banks regarded investments in Federal Reserve-guaranteed acceptances as especially attractive. As a result, acceptances held in foreign accounts mushroomed from $581 million at the beginning of the year to over $2 billion (11.8 percent of total acceptances outstanding) shortly before the termination of the guarantee in November. In the view of the Board of Governors, the guarantee of a particular money market instrument for the benefit of a particular group of investors was unwarranted. Following its termination, the number of active foreign accounts declined from twenty-five to six, and the dollar amount held in these accounts fell to $293 million by the end of 1975.

[5] The net spread was slightly less, since the Federal Reserve charged 1/8 percentage point for its guarantee and passed on a 1/16 percentage point charge for the dealer endorsement. However, with the termination of dealer endorsements in July, this latter charge was removed.

Box 2: Structure of Acceptance Rates

During the 1970s, the trend toward negotiated dealer rates and the emergence of a tiered rate structure greatly affected the workings of the secondary market. The more refined rate tiers reflected greater discrimination among different bank names by investors.[1]

Prior to 1969, acceptance dealers posted the rates at which they would sell prime acceptances. Rates on acceptances perceived as more risky were scaled off these posted rates. In late 1969, two firms announced that they would no longer follow this practice but would negotiate rates on a case-by-case basis. Their motive was to increase their share of the market. Although negotiation away from posted rates had occurred from time to time prior to 1969—largely as a *sub rosa* practice—negotiated rates were the exception rather than the rule. Other acceptance dealers continued to post rates after 1969 but reserved the right to negotiate. At the same time, though, these dealers began to display greater flexibility in changing their posted rates.

In 1974, following the emergence of problems at Franklin National Bank, prime acceptances were no longer considered to be a homogeneous group, and thus posted rates became less meaningful. Most dealers opted instead to quote a range of rates within which they expected to trade prime acceptances. This reflected a greater tiering of acceptance rates, similar to the tiering which developed simultaneously in the CD market.[2] The final abandonment of posted rates occurred in August 1974. Accordingly, the Federal Reserve then began collecting data on the range of rates quoted by dealers on prime acceptances.

Practices affecting secondary market acceptance rates have not changed materially since 1974. Dealer firms continue to quote ranges of rates (about 10 to 15 basis points) within which they expect to trade prime acceptances. The rates tend to be inversely related to the size of the accepting bank. As a rule, acceptances from the top ten or so money-center banks trade at rates at the lower end of the dealers' quoted ranges, and acceptances of well-known regional banks and United States agencies and branches of foreign banks trade at rates near the top of the ranges. Acceptances created by smaller and less well-known banks trade at considerably higher rates.

[1] Although an acceptance is also the contingent liability of the drawer of the draft, the market has long since come to rely on the credit quality of the accepting bank as the primary criterion of the credit quality of the acceptance.

[2] The emergence of rate tiers in the CD market is analyzed in Dwight B. Crane, "Lessons from the 1974 CD Market", *Harvard Business Review* (November-December 1975), pages 73-79.

Organizationally, the secondary market is, like the market for most money market instruments, an over-the-counter market.[22] It is comprised of about thirty dealers and a handful of brokers, principally located in New York City and linked by telephone lines. Of these dealers, about two thirds (including some bank dealers) have a direct relationship with the Federal Reserve Bank of New York, making them so-called "reporting dealers". (Some dealer firms are reporting dealers in acceptances but not in Treasury and agency securities, and vice versa.) Some of these dealers obtain direct access to purchase orders from the foreign customers for which the Federal Reserve Bank of New York acts as an agent. Other market participants can sell to customer accounts at the Federal Reserve through one of these dealers. In addition, when the Federal Reserve is arranging RPs as part of its open market operations, these dealers may be able to finance their acceptance inventory at competitive rates by using it as collateral for the RPs (Box 1).[23]

Traditionally, a key function performed by dealers has been to distribute acceptances for accepting banks. During the 1960s, about three fifths of reporting dealer sales were to commercial banks, reflecting the key role of dealers in the production of "three-name paper" desired by some foreign investors. An accepting bank would sell its own acceptances to a dealer in exchange (generally with a spread of ⅛ percent) for acceptances of other banks. The banks would then endorse the other banks' acceptances and sell them to foreign investors. Over the years, as foreign investors ceased to demand three-name paper, dealer sales to commercial banks declined to well under one fifth of total sales.

A large portion of reporting dealer sales are now to institutional investors. Lately, however, a number of money-center banks have stepped up their efforts to reach these investors directly instead of through dealers. The economic incentive is clear: a bank that sells its paper directly to investors can save the cost of the dealer's bid-ask spread. This strategy is more feasible now than in the past primarily because of the emergence of money market mutual funds as major acceptance investors, many of which have significant amounts to invest. As yet, these activities do not appear to have altered the share of dealers in the distribution of acceptances, since banks continue to sell a bit more than one half of their acceptances to dealers, with the rest going to institutional investors.

Brokers in the acceptance market, like brokers generally, provide a central source of information concerning the bid and offering rates of the many market participants. In addition, they preserve anonymity for dealers and thus allow trades to take place without an individual dealer having to make known the extent of his buying or selling interest.[24] For example, if it were widely known in the dealer community that a particular dealer was trying to liquidate a large position, the other dealers would have the opportunity—and the incentive—to bid at lower prices for the acceptances being offered. While the recent development of acceptance brokers has thus somewhat reduced this risk, daily trading volume in the broker market is modest, averaging a bit more than $100 million per day compared with average daily reporting dealer transactions of well over $1 billion. The reason for the small share of the brokers is that dealers naturally prefer to save the 1 basis point broker commission whenever possible by arranging trades directly with other dealers or investors.

Outlook

Future growth of the bankers' acceptance market will be influenced by the outcome of discussions on proposed regulatory changes. In the last several years, as Chart 7 shows, the market share of the largest accepting banks has dropped, while that of other accepting banks has either held stable or increased. Some major accepting banks, which are members of the Federal Reserve System, have reached the aggregate limitation on the amount of certain types of acceptances they can create and subsequently sell to raise reserve-free funds (Appendix). Regional member banks, while generally below their limits at present, may soon become constrained by this limitation as well. However, nonmember banks—including virtually all the United States agencies and branches of foreign banks—are exempt. Because of these competitive inequities, the Board of Governors of the Federal Reserve System recently indicated its support for legislation which would increase the aggregate limitation

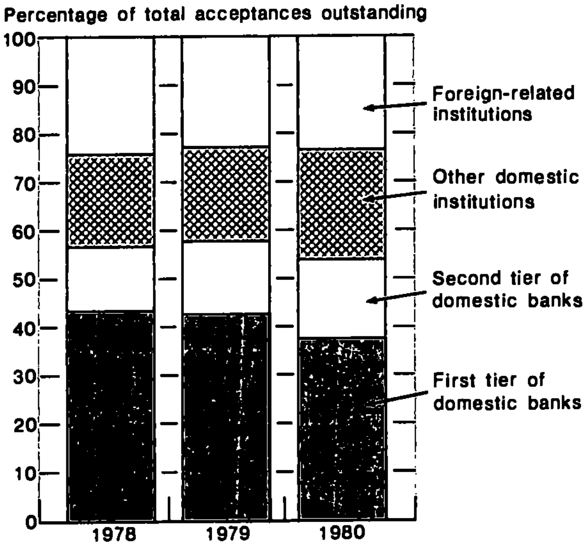
[22] For descriptions of the secondary market for Treasury securities, see Christopher J .McCurdy, "The Dealer Market for United States Government Securities", this *Quarterly Review* (Winter 1977-78), pages 35-47, and Kenneth D. Garbade, "Electronic Quotation Systems and the Market for Government Securities", this *Quarterly Review* (Summer 1978), pages 13-20.

[23] However, when RPs are arranged for the accounts of customers of the Federal Reserve, only Treasury and agency securities may be used as collateral.

[24] Because the two largest brokers clear their own transactions, they do not give up the names of parties to an acceptance trade. A broker without such a capability must do so.

Chart 7

The market share of the largest domestic accepting banks has declined while that of other institutions has increased or remained steady. *



* As measured by total acceptances outstanding in December 1980, the first tier of domestic banks is the top ten United States accepting banks. The second tier is the next twenty largest United States accepting banks. Other domestic institutions are the approximately 250 remaining domestic accepting institutions. Foreign-related institutions include about 70 foreign-owned banks and agencies and branches of foreign banks in the Second, Seventh, and Twelfth Federal Reserve Districts.

and provide for a more uniform limitation for all accepting institutions.[25]

Increasing the aggregate limitation would permit banks to structure more loans as acceptances, since the proceeds from the sale of certain types of acceptances are not reservable. To the extent that banks did increase such acceptance sales and reduced issues of CDs, growth of the M-3 monetary aggregate, which includes CDs but not acceptances, would be depressed. However, the magnitude of such an effect would be very small, and the narrower aggregates M-1B and M-2 would be unaffected.

Another consideration is the Treasury's prospective loss of revenue. If, for example, sales of reserve-free acceptances were to increase 50 percent, replacing about 18 percent of outstanding large CDs, this would produce a revenue loss to the Treasury from reduced reserve holdings of about $135 million per year.[26]

Irrespective of the ultimate outcome of proposed changes in the limitation on reserve-free funds raised through acceptance sales, a number of technical changes could be made to the regulations to simplify the creation process and thus to reduce considerably the legal and clerical costs to market participants. As discussed in the Appendix, overlapping sets of standards must be met for an acceptance to be eligible for discount, eligible for purchase, or exempt from reserve requirements. Currently, the only practical application of the rules for discount eligibility is in defining customer limits, *i.e.*, in limiting the volume of acceptance lending by a bank to an individual customer. A similar constraint could be placed on a bank's acceptance credit extension to one customer by replacing discount eligibility standards with those for purchase eligibility. Then legislative reference to discount eligibility could be eliminated without any undesirable consequences. Of course, since the rules for discount eligibility and purchase eligibility are not perfectly overlapping, some minor adjustments would be required.[27] While standards for purchase eligibility are currently important, they could also be eliminated if the Federal Open Market Committee (FOMC) permitted all types of acceptances to serve as collateral for System RPs. However, even if the FOMC preferred to maintain this distinction, substantial simplification could still be achieved. Consolidation of the standards for purchase eligibility with those necessary for a reserve requirement exemption if the acceptance is sold would mean that only two broad categories of acceptances would exist: those both eligible for purchase *and* exempt from reserve requirements and those which are not.

As noted earlier, to be exempt from reserve requirements if sold, domestic shipment acceptances must be accompanied by documentation considerably more

[25] Specifically, the Board recommended legislation to raise the aggregate limitation on the creation of Section 13(7)-type acceptances immediately to 150 percent of unimpaired capital and surplus, with a further increase to 200 percent allowed to institutions receiving prior approval from the Federal Reserve. The power of withholding approval would enable the Federal Reserve to prescribe certain standards, including minimum capital requirements, general condition, and level of risk exposure that an institution would be required to meet before assuming the greater exposure.

[26] In 1980, large time deposits at member banks averaged $170.3 billion. Using 18 percent of this average, the revenue loss was calculated assuming about a 4 percent reserve requirement and a 1980 average three-month Treasury bill interest rate of about 11 percent.

[27] In some cases, an acceptance is eligible for discount but not for purchase. For example, while foreign storage and dollar exchange acceptances with tenors of six months or less are eligible for discount, they are not eligible for purchase.

complex and expensive than that required for acceptances related to international transactions. Removal of this extra documentation requirement would make procedures for creating domestic acceptances uniform with those for international transactions. The insertion of this requirement in the original Federal Reserve Act apparently was related to the "real bills doctrine" prevalent at the time and reflected a view that special precautions were necessary to ensure that acceptances financing domestic transactions actually would be self-liquidating and trade related. The Board has been disposed to retain it in order to focus the benefits of the reserve requirement exemption on trade.

Finally, the regulations provide that the tenor of an acceptance—rather than its remaining maturity—must be less than six months in order that funds raised through its sale be exempt from reserve requirements. Hence, a bank cannot create an acceptance with a longer tenor, hold it in portfolio until six months before maturity, and then sell it. The regulation would be more precisely focused on the use of acceptance sales by banks as a funding device if the requirement referred to the remaining rather than the original maturity of the acceptance.

Whatever the outcome of proposed modifications in the acceptance regulations, major changes in the acceptance market may be in the offing. The role of dealers as distributors of acceptances seems likely to erode somewhat in the next several years. Banks are stepping up efforts to distribute their acceptances directly to investors, primarily money funds, and eventually this may reduce the portion of paper placed through dealers. Though the rapid growth of the money funds is likely to subside once banks are allowed to pay market interest rates on consumer-type deposits, the enlarged bank distribution networks are likely to be permanent.

In short, the acceptance market, having risen in a few years from relative obscurity to one of the most active money markets, should be transformed still further as banks and nonbank institutions innovate to meet credit demands more efficiently. However, the precise characteristics of this innovation will depend critically on action taken in regard to pending regulatory amendments.

William C. Melton and Jean M. Mahr

Appendix: Regulations Governing Bankers' Acceptances

Regulations concerning bankers' acceptances currently affect accepting banks in essentially three ways: (1) by defining the types of acceptances which are eligible for purchase by the Federal Reserve under repurchase agreements (RPs) and those which are eligible to secure Federal Reserve advances, (2) by setting conditions under which the funds obtained from the sale of an acceptance are reservable, and (3) for certain types of acceptances, by limiting the exposure which a bank can assume per individual customer and in aggregate (Table 2).

The conditions governing discount eligibility—contained in Section 13(6) of the Federal Reserve Act—were important in the early years of the Federal Reserve System. However, since then, Federal Reserve practice has been not to discount acceptances but rather to make advances to member banks secured by collateral which is eligible either for discount or for purchase.[1] As illustrated in Chart 8, the purchase eligibility standards are broader and encompass—except in two minor cases—those for discount eligibility. Hence, standards for eligibility for purchase rather than those for discount are relevant for the practical operation of the discount window.

The reserve treatment of a member bank's acceptance liability, however, is determined by a different set of regulations. The sole determinants of reservability are that the acceptance has been sold by the bank *and* does *not* conform to the type described in Section 13(7). Thus, reservability is logically distinct from discount eligibility.[2] The reserve requirement is

[1] This practice is explicitly sanctioned in Section 13(8) of the Federal Reserve Act.

[2] Until very recently, discount eligibility was important for determination of the required reserves of banks. Section 204.2(a)1(vii) (E) of Federal Reserve Regulation D, as revised effective November 13, 1980, specifically exempts from reservable deposits funds obtained through "the creation, discount, and subsequent sale by a depository institution of its bankers' acceptance of the type described in paragraph 7 of Section 13 of the Federal Reserve Act". The corresponding part of the earlier regulation required *in addition* that such acceptances be eligible for discount.

Appendix: Regulations Governing Bankers' Acceptances *(continued)*

Table 2

Bankers' Acceptances: Eligibility and Reservability

Type of bankers' acceptance	Eligible for purchase*	Eligible for discount†	Exempt from reserve requirements if sold‡
Export-import, including shipments between foreign countries:			
Tenor—6 months or less	Yes	Yes§	Yes
6 months to 9 months	Yes	No	No
Domestic shipment, with documents conveying title attached at the time of acceptance:			
Tenor—6 months or less	Yes	Yes§	Yes
6 months to 9 months	Yes	No	No
Domestic shipment, without documents conveying title:			
Tenor—6 months or less	Yes	No	No
6 months to 9 months	Yes	No	No
Shipment within foreign countries:			
Tenor—any maturity	No	No	No
Foreign storage, readily marketable staples secured by warehouse receipt:			
Tenor—6 months or less	No	Yes§	Yes
6 months to 9 months	No	No	No
Domestic storage, readily marketable staples secured by warehouse receipt:			
Tenor—6 months or less	Yes	Yes§	Yes
6 months to 9 months	Yes	No	No
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	No
6 months to 9 months	Yes	No	No
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	No
Finance or working capital, not related to any specific transaction:			
Tenor—any maturity	No	No	No

Tenor refers to the full length of time of the acceptance from date of inception to maturity. To be eligible for discount, a bankers' acceptance must be endorsed by at least one member bank, as provided in Section 13(6) of the Federal Reserve Act.

* 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.

‖ According to revised Regulation D, these acceptances are reservable, but the Federal Reserve Board's legal staff has expressed an opinion that the exemption from reserve requirements is also applicable to dollar exchange acceptances.

Source: Adapted from an unpublished paper by Arthur Bardenhagen, Vice President, Irving Trust Company, New York.

Appendix: Regulations Governing Bankers' Acceptances *(continued)*

calculated by treating the acceptance liability as a deposit with maturity equal to the acceptance tenor.[3]

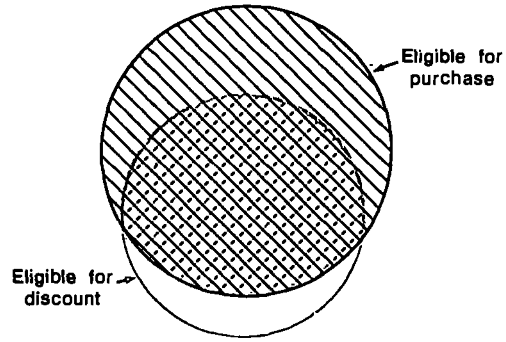
The funds obtained from the sale of an acceptance which *does* conform to the standards of Section 13(7) are exempt from reserve requirements, providing such acceptances outstanding are not greater than 50 percent of a member bank's paid-up and unimpaired capital stock and surplus. With the prior approval of the Board of Governors, this limit can be increased to 100 percent.[4] Since this so-called "100 percent rule" is defined exclusively in terms of the standards in Section 13(7), it has no relation to discount eligibility.

The reserve treatment of acceptances created by nonmember banks is similar in principle to that for member banks, with two important differences. First, the aggregate limitations on acceptances applying to nonmembers are generally substantially more liberal than member banks' 100 percent rule and provide a larger base of reserve-free-type acceptances (Table 3). Second, since the Monetary Control Act of 1980 provided that comparable reserve requirements for nonmember banks be phased in over time, the reserve requirement applying to the nonmember banks will be lower for several years before eventually becoming equal to that of members. Thus, the lower reserve requirement of nonmembers—and most foreign bank branches and agencies in particular—provides them a temporary advantage.

Customer limits are generally 10 percent of the member bank's unimpaired capital and surplus for acceptances eligible for discount unless the excess is secured. However, states may apply more liberal limits to institutions under their jurisdiction. Edge Act corporations are exempt from the 10 percent limit for eligible acceptances resulting from the international shipment of goods if the corporation's exposure is covered by guarantees of reimbursement by other banks. In addition, Edge Act corporations are allowed to reduce their aggregate exposure to one customer by entering into participation agreements with other banks, while member banks are not allowed to do so. Customer limits on acceptances ineligible for discount are generally identical to those applying to loans.

Chart 8

Standards for eligibility for discount and purchase overlap except in some minor cases.



However, not all these acceptances are the type which are exempt from reserve requirements if sold.*

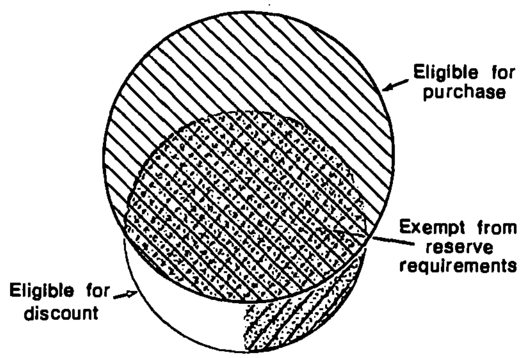


*Table 2 explains, in detail, the standards which must be met for an acceptance to be eligible for discount and/or eligible for purchase and/or exempt from reserve requirements if sold.

[3] Thus, a bank cannot make an acceptance with a seven-month tenor exempt from the reserve requirement by simply holding it for a month and then selling it when it has six months remaining to maturity. For this reason, domestic accepting banks almost always hold such acceptances.

[4] According to Section 13(7) of the Federal Reserve Act, a member bank cannot create acceptances in an amount greater than 100 percent of its capital. In practice, however, this limitation actually restricts the amount of acceptances which can be sold to raise reserve-free funds. According to the Published Interpretations of the Board of Governors (paragraph 1700), when a member bank purchases its own acceptances of the type described in Section 13(7), these acceptances are not included in the aggregate amount since the bank no longer has an outstanding obligation. Only if the acceptance is sold, thus renewing the obligation to pay at maturity, is it included in the aggregate amount. Therefore, a bank must limit the amount of Section 13(7)-type acceptances sold to 100 percent of capital and hold in portfolio any acceptances created beyond the aggregate amount allowed, or maintain reserves against the excess amount sold.

Appendix: Regulations Governing Bankers' Acceptances *(continued)*

Table 3

Synopsis of Major Rules and Regulations Governing Bankers' Acceptances

Category	Member banks	Nonmember banks	Edge Act corporations	State-chartered foreign branches and agencies
Customer limitations:				
Bankers' acceptances eligible for discount	10% of capital unless secured	Governed by state loan limitations*	10% of capital unless secured†	Governed by state loan limitations*
Bankers' acceptances ineligible for discount	For national banks, 10% of capital; state members governed by state loan limitations*	Governed by state loan limitations*	10% of capital	Governed by state loan limitations*
Reservability of bankers' acceptances sold into the market:				
Bankers' acceptances described in Section 13(7) of the Federal Reserve Act‡	Not reservable; the total outstanding must not exceed 50% of capital (100% with prior approval of the Board of Governors)§	Not reservable; aggregate limits set by state laws‖	Not reservable; but bankers' acceptances in excess of 200% of capital must be secured	Not reservable; aggregate limits set by state laws‖
Other bankers' acceptances	Reservable; no aggregate limit#	Reservable; aggregate limits set by state laws‖	Reservable; no aggregate limit	Reservable; aggregate limits set by state laws‖
Acceptability of bank name for purchase by Federal Reserve and as collateral for advances	Acceptable in principle**	Acceptable in principle**	Acceptable in principle**	Acceptable in principle**

* The customer limit on the sum of eligible and ineligible acceptances for New York State-chartered banks and branches and agencies of foreign banks is apparently 10 percent of the bank's overall capital. Those chartered in Illinois are subject to 15 percent of capital for ineligible acceptances (except dollar exchange) unless secured, in which case the limit is 50 percent. In California, eligible acceptances (except dollar exchange) are limited to 10 percent of shareholders equity and capital notes unless secured, in which case the limit is 50 percent. The total of secured and unsecured ineligible acceptances is limited to 20 percent of shareholders' equity and capital notes.

† Unless (i) the excess represents the international shipment of goods and the Edge corporation is fully covered by primary obligations to reimburse it for that portion which is guaranteed by banks or bankers, or (ii) the Edge corporation is covered by participating agreements from other banks.

‡ The revised Regulation D effective November 13, 1980 slightly expanded the category of acceptances which were exempt from reserve requirements (provided the aggregate limit was satisfied); previously, acceptances described in Section 13(7) and eligible for discount were exempt.

§ In addition, domestic acceptances are limited to 50 percent of such capital. According to the Published Interpretations of the Board of Governors (paragraph 1700), when a member bank purchases its own acceptance, the acceptance is not included in the aggregate limit. However, when the acceptance is sold, it is included in the limit.

‖ New York State- and Illinois State-chartered banks and United States branches and agencies of foreign banks have no aggregate acceptance limit. In California, eligible acceptances are subject to 50 percent of shareholders' equity, capital, and notes and with permission of the Superintendent of Banking to 100 percent. Ineligible acceptances have no aggregate limit.

One exception is that dollar exchange acceptances are limited to a separate and distinct 50 percent of capital and are not included in the limits imposed by Section 13(7) of the Federal Reserve Act.

** Individual banks must satisfy requirements set by the Federal Open Market Committee.