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February 20, 1970

TO: Board of Governors
FROM: Division of Research and Statistics
(Mr. Axilrod and Mr. Keir)

SUBJECT: Economic issues in
the application of Regulation Q
and D to commercial paper of
bank-related affiliates.

This memorandum takes a further look at some of the economic issues the Board may wish to consider in deciding whether to apply Regulations Q and/or D to commercial paper issued by bank-related affiliates.^{1/}

The major conclusions reached by the memo can be stated briefly:

(1) If Regulation Q ceiling rates were applied to commercial paper issued by bank-related affiliates at this time, it would be difficult to keep this action from exerting a significant net tightening effect on the commercial banking system. Access of banks to commercial paper as a source of funds would be suddenly shut-off, and the large volume of paper scheduled to mature over the next few weeks would create an immediate adjustment problem for the banks affected. Although the sharp recent decline of Treasury bill yields has begun to make rate ceilings on longer maturity CD's at least marginally competitive, ceilings on shorter maturity CD's are not yet competitive. Thus, without a sizeable further decline of bill rates, banks would not be able to use new CD sales as a ready means of replacing the funds lost through commercial paper

^{1/} A similar memo dated January 12, 1970, was distributed to the Board prior to its mid-January deliberations on the commercial paper question. The present memo is a revision of that earlier paper, designed to take account of the developments in policy and short-term interest rates that have occurred in the interim.

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maturities and would tend to put renewed pressure on the Euro-dollar and Federal funds markets. Given the System's present policy posture, it would seem desirable to avoid the risk of any action that might exert such a tightening impact at this time.

(2) If the Board wishes, nevertheless, to alleviate some of the inequities in the present differential treatment of bank funds obtained from commercial paper and CD's, Regulation D could probably be applied to commercial paper without too worrisome a tightening effect on bank operations. If such action is taken, however, provision should be made to assure that the tightening effect of the higher reserve requirements is minimized. Along with liberal offsetting reserve supplying operations by the Desk, a number of procedures have been proposed for stretching out the reserve impact of a Regulation D action--including various grandfathering suggestions and a spreading of the requirement over more than one effective date. Of these two types of proposals, the latter would seem to be somewhat neater.

The Current Structure of Short-Term Rates

Since mid-January when the Board raised the levels of Regulation Q rate ceilings on large time CD's, the market yield on 3-month Treasury bills has dropped about 1-1/8 percentage points. While rate declines on other short-term market instruments have generally been less dramatic, spreads between the whole structure of short-term market rates and CD rate ceilings have been substantially narrowed.

As Table 1 shows, discount yields on Treasury bills with maturities of 90 days and beyond have all dropped below the ceiling rates on large time CD's. But on an investment yield basis only the 1-year bill is below its respective CD rate ceiling. In past years when CD rate ceilings were not a limiting factor, market analysts have usually assumed that rates on CD's had to be about 2 basis points above investment yields on Treasury bills of corresponding maturity in order for the CD's to be fully competitive, given the substantially greater marketability of bills.

Current levels of bill rates have been reached too recently to be significantly reflected in the CD data thus far available from weekly reporting banks. More current telephone checks with a small number of representative bankers show some evidence of scattered investor interest developing in CD's with maturities of one-year or more. But as yet this interest has not been very strong. Generally investors seem to prefer to hold instruments of shorter maturity where CD rates are not even marginally competitive.

On the other side of the market, some bankers reportedly prefer to continue borrowing at higher rates on relatively short maturities in the commercial paper and Euro-dollar markets rather than to commit themselves to long CD's at the 7-1/2 per cent rate. There has been some pick-up in sales of CD's to foreign official accounts

Table 1

CEILING RATES ON LARGE TIME CD'S COMPARED WITH
RECENTLY PREVAILING RATES ON SHORT-TERM MARKET INSTRUMENTS(Rates in per cent per annum^{1/})

CD Ceilings	Maturities	Market Yields			
		Treasury Bills		Commercial Paper 2/	
		Discount Basis	Investment Basis	Sales Finance	Industrial
(Close Feb. 19)					
30-60 days	6.25	1-month	6.10	6.22	
60-90 days	6.50	2-month	6.60	6.77	
90-179 days	6.75	3-month	6.73	6.94	8.54
180 days to 1-yr.	7.00	6-month	6.94	7.29	8.45
1-yr. and over	7.50	1-year	6.81	7.28	9.01

1/ Rates are on the offered side of the market.2/ Investment yields for week ending February 20.

recently, with major banks paying 9-1/8 to 9-1/2 per cent for these funds. This may reflect an effort by these relatively sharp penciled foreign investors to lock up a high yielding investment option, as bill yields have receded and the odds that banks may soon be able to rely on domestic CD's as a source of funds have increased.

Sizeable further growth of bank-related commercial paper has also occurred during January and early February. In January outstanding paper at affiliates of the 65 major banks in the Board's reporting series rose by \$1.2 billion to \$5.6 billion. This was largely concentrated among a few key institutions that had not previously been active in the commercial paper market. While bank sales of commercial paper during the first three statement weeks ending in February slackened somewhat from the very active January pace, growth during the latest week for which data are available still amounted to a large \$225 million. As Table 2 on the maturity structure of bank-related commercial paper shows, roughly half of the \$5.8 billion outstanding at the 65 reporting banks in February 15 is dated to mature by the end of March.

The Question of Regulation Q

The key question in deciding whether to apply Regulations Q and/or D to bank-related commercial paper at this time is, of course, whether such actions will help to promote the System's current monetary policy stance. Other questions to be considered relate to equity among banks, and the integrity of regulations.

One reason for the initial proposal to put commercial paper under Regulation Q was to prevent banks from subverting further the intent behind the Board's use of Regulation Q in its monetary strategy of 1969. Under that strategy, maintenance of Regulation Q ceilings at noncompetitive levels was an important aspect of policy in that this provided the quickest available means of reducing bank liquidity and loanable funds, and thereby of inducing banks to ration, or limit, credit to business or other borrowers.

The availability of the commercial paper market to banks may have provided a safety-valve enabling individual banks to make orderly adjustments to net outflows of time deposits, particularly of large CD's. But it was a relatively costly safety-valve--with the yields that had to be paid on such paper rising from around 7.25 per cent (on a discount basis) for 90-day paper at mid-year to about 8.63 per cent most recently. Moreover, the banks may have pre-empted funds from the commercial paper market which would otherwise have flowed directly to business borrowers.

Thus, one cannot say with certainty whether banks' entrance into the market did or did not reduce the effectiveness of monetary

restraint. The answer would depend on whether the borrowers whom the banks accommodated could otherwise have found financing outside the banking system--in the commercial paper market or elsewhere. Whatever the answer, it remains true that even including sales of commercial paper by bank-related affiliates there was a very marked slowing in growth of bank credit in the second half of 1969.

If the new CD rate ceilings were to be applied to bank-related commercial paper, at this time, bank access to the commercial paper market would be shut-off completely under the short-term rate relationships now prevailing. Although as noted, rate ceilings on some CD maturities are on the verge of becoming competitive with market rates, this would not be the case for bank-related commercial paper. Rates paid on bank paper typically fall somewhere between those required for sales finance and dealer-placed commercial paper, and, as Table 1 has indicated, CD ceilings are still far below current market rates, even on finance company paper.

This means that application of Regulation Q to commercial paper would create an immediate adjustment problem for banks under current market conditions. As Table 2 has shown, about half of outstanding bank paper is dated to mature by the end of March, and could not be rolled-over. Consequently, unless further declines of Treasury bill yields improved the competitiveness of CD's rapidly enough to refinance the maturing commercial paper there would be some net increase in monetary restraint.

In the absence of market rate adjustments large enough to permit a fairly close substitution of CD's for maturing paper, the commercial paper action thus would tend to eliminate what has been an important safety-valve for the banking system and force banks to seek greater accommodation in the Federal funds or Euro-dollar markets.

Parenthetically, it should be noted that one special reason advanced for applying Regulation Q rate ceilings to bank paper has been the desire to provide parallel treatment to the two types of instruments. As the preceding analysis suggests, however, when market rates are close to official ceilings the potential leeway for expansion provided by any given rate ceiling is greater for CD's than for commercial paper. Thus, if Regulation Q ceilings were applied to bank paper, the logic of the case for parallel treatment might seem to suggest the need for some spread between ceilings on the two types of instruments.

If for reasons such as those mentioned above, or for other reasons, the Board were not to apply Regulation Q ceilings to bank-related commercial paper, it might raise a question of equity as between large and small banks--though from another point of view it is less a matter of equity than of the effects of the greater capital investment and marketing skill of larger institutions. Access to the commercial paper market is no doubt easier for large banks than for smaller banks. This appears to be true also with respect to access to the CD market, but the relative advantage of large banks is probably greater in the commercial paper market--which, insofar as banks are concerned, is a market in process of formation and in which the instrument issued does not have even the minimum protection afforded by FDIC insurance.

While the relative advantage of large banks would exist whether there was or was not a Regulation Q ceiling, if both commercial paper and large CD's were placed under unrealistic ceilings there would be less basis for complaint about discrimination on the part of smaller banks. But if commercial paper were completely free of ceilings, large banks would have access to a marginal source of funds not available to many small banks and one that is free of reserve requirements. The sense of discrimination would, of course, tend to disappear if ceiling rates on CD's become increasingly competitive. In that case, commercial paper is likely to be less intensively used by banks, although its use is not likely to dry up completely because--as with the Euro-dollar market--banks would probably want to maintain the customer and dealer contacts built up during the past year at least for a while. In addition, banks may wish to move toward independently operated mortgage, consumer, and business finance affiliates--an option which would require continued development of the commercial paper market for bank-related affiliates. In that sense, it becomes virtually impossible to separate the question of placing Regulation Q on commercial paper from the Board's view of how it may wish to see the banking and financial system generally evolve over the longer-term.

Application of Regulation D

Regulation D can be applied to bank commercial paper either with or without Regulation Q. If the Board does not wish to take a

position on the longer-run role of Regulation Q in relation to bank affiliates at this time, or if it feels that under present conditions application of Regulation Q would lead to undesirable bank and market adjustment problems, some of the inequities in treatment might be alleviated by placing reserve requirements on bank-related paper.

Use of the reserve requirement approach would, of course, add to the required reserves of banks at the time it took effect. If Regulation D were applied to all commercial paper now outstanding in the same way as it applies to bank deposits, the added reserve requirement would total around \$700 million. On its face this might seem to represent a net tightening action at a time when further restraint would be inconsistent with current policy goals. The restrictive impact of the action could be minimized, however, both by stretching out the resultant reserve requirement increases over more than one effective date and by directing the System Account Manager to supply all of the resultant increase in bank reserve needs through liberal open market operations. If still further easing of the transition were desired, the Board could, of course, adopt some type of grandfather arrangement.

While this approach would cover banks' immediate needs for required reserves, the marginal cost of obtaining bank funds through sales of commercial paper would, of course, also be permanently larger. Commercial paper issued for maturity of less than 30-days would be subject to a 17-1/2 per cent reserve requirement at reserve city banks. Assuming the yield on alternative use of the proceeds at around 8 per cent,

the cost of such a reserve requirement to individual banks would be about 140 basis points. On commercial paper issued with maturities of 30 days or more, the 6 per cent reserve requirement on time deposits would apply, and the additional cost would be on the order of 50 basis points. The effect, therefore, would certainly be to discourage short-term paper, and to a lesser degree longer-term paper. On the average, bank-related paper issued with initial maturities of less than 30 days appears to have been running close to one-fifth of total new paper being issued.

Action to set parallel reserve costs on bank paper and CD's would, of course, tend to improve the relative attractiveness of CD's; as has been noted, offering rates on bank paper run substantially higher than those on CD's. Thus, to the extent CD rate ceilings permitted, banks would be encouraged to substitute CD's for commercial paper. If CD rates were to remain generally uncompetitive with market rates, however, the higher reserve costs on commercial paper might also make banks more willing to pay higher interest rates in the Federal funds and Euro-dollar markets. Thus, even assuming that open market operations fully supply the initial needs for bank reserve adjustment, the imposition of reserve requirements on commercial paper would appear to represent at least a marginal tightening move of a more permanent character unless accompanied by other actions that increased the availability of funds to banks.

A broader application of reserve requirements, as with Regulation Q, also involves questions of strategy regarding the type of longer-run financial structure the Board would like to see develop. If reserve requirements were applied only to funds channelled to the bank, which seems the intent of the enabling legislation, there is the administratively difficult problem of identifying the specific uses to which funds raised in this market are put. This might not seem too difficult at present, especially since the use of D rather than Q would be greeted by most banks with relief, but it would undoubtedly loom larger and larger as an issue if and when the structure of affiliated financial activities contemplated by the holding company development reaches toward fruition.

D R A F T

TITLE 12--BANKS AND BANKING

CHAPTER II--FEDERAL RESERVE SYSTEM

SUBCHAPTER A--BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. Y]

Commercial Paper

§ 222.123 Issuance of commercial paper by registered bank holding company or its subsidiaries.

The Board of Governors has considered several questions that have arisen in recent months concerning the issuance of commercial paper by a registered bank holding company or its nonbank subsidiaries. Its conclusions and the reasons therefor are as follows:

(1) A registered holding company is not barred from issuing promissory notes, although it is limited by section 4(a) of the Bank Holding Company Act in the use that it may make of the proceeds. One of the permissible uses is that of "managing or controlling banks" - which necessarily includes managing or controlling all the holding company's subsidiaries. Issuance by a holding company of promissory notes and channeling the proceeds to its subsidiaries assists its subsidiaries to engage in their business. Such assistance, which is neither inconsistent with the language of section 4(a) nor with the basic purposes of the Holding Company Act - to control the formation and expansion of holding companies by acquisition of additional banks and to divorce holding companies from nonbanking businesses - may appropriately be regarded as "managing or controlling banks". This conclusion applies both where the holding company lends the proceeds of the notes to a subsidiary and where it uses the funds to purchase assets from a

subsidiary. Although in both situations the holding company is indirectly engaging in the lending business, it is not directly engaged in such business outside the holding company system's inter-corporate framework, and, accordingly, the activity is not prohibited by section 4(a).

(2) The Holding Company Act imposes no restriction on the issuance of commercial paper by most nonbanking subsidiaries that may be acquired by a registered holding company pursuant to the exemptions in section 4(c) of the Act. For example, a subsidiary the Board has determined, under section 4(c)(8), to be so closely related to the business of bank or managing or controlling banks as to be a proper incident thereto is not prohibited by the Act from obtaining funds in the commercial paper market.^{1/}

(3) However, the authority for a registered holding company to acquire subsidiaries on the basis of section 4(c)(5) of the Act depends on whether a national bank may establish such a subsidiary. National banks are specifically permitted to establish certain subsidiaries, and the Board has favored an amendment to section 4(c)(5) that would limit the types of subsidiaries that a registered holding company may acquire on the basis of such section to those explicitly permissible for national banks under provisions of Federal statute law and regulations issued pursuant thereto. However, until section 4(c)(5) is so limited, the Board's ruling on "Member bank purchase of stock of 'operations subsidiaries'" (12 CFR 250.141; 1968 Federal Reserve Bulletin 681) has an automatic effect on the types of subsidiaries holding companies may acquire on the basis of section 4(c)(5).

^{1/} The Board considers that a holding company may establish a subsidiary to perform an activity - such as issuing commercial paper - that the holding company itself could perform. Such conclusion is based on reasons similar to those set forth in 12 CFR 250.141.