

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N. Y. 10045

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July 10, 1970

S i r s :

Enclosed is a copy of a paper that was prepared at this Bank, dated July 10, 1970, on the subject, "Discount Window Accommodation of Issuers of Commercial Paper under the Third Paragraph of Section 13 of the Federal Reserve Act". No major changes have been made in the paper as compared with the copy of the paper in draft form that was furnished to Mr. Holland by Mr. Bilby on July 9.

Respectfully yours,

*William F. Treiber*

William F. Treiber  
First Vice President

Board of Governors of the  
Federal Reserve System  
Washington, D. C. 20551

Enclosure

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CONFIDENTIAL

July 10, 1970

Discount Window Accommodation  
of  
Issuers of Commercial Paper  
under the  
Third Paragraph of Section 13 of the Federal Reserve Act

At the joint meeting of the members of the Board of Governors and the Federal Reserve Bank Presidents on June 22, 1970, the day after the Penn Central Transportation Company filed a petition for reorganization under section 77 of the Bankruptcy Act, the discussion centered on the possible impact of the filing on the commercial paper market, the pressures that might, as a result, be experienced by commercial banks, and the posture or actions that might be taken by the Federal Reserve System.

At that meeting, the Federal Reserve Bank of New York reported on its conversations on the prior two days with the largest New York City banks to the effect that, as the banks experienced the need to make loans to pay off commercial paper and got into a tighter position needing more reserves, they should remember the availability of the Federal Reserve discount window. The banks were told that the first step to cushion the increased pressure on them would be the Federal Reserve discount window. It was indicated by the New York Reserve Bank that it would look sympathetically upon use of the discount window to take care of the initial pressure, but that the Reserve Bank would not expect the member banks to treat that use as a continuous indebtedness; the member bank would be expected to pay off the indebtedness in due course.

At the joint meeting, there was agreement with the position expressed by the New York Reserve Bank in its communications with its largest banks. It was agreed that the other Reserve Banks should have similar conversations with the major banks in their districts. Suggestions with respect to such conversations were transmitted to the discount officers of the Federal Reserve Banks during a conference call that afternoon.

At the joint meeting, there was also discussion of the desirability of removing or suspending indefinitely rate ceilings under Regulation Q with respect to large certificates of deposit. On June 23, the Board of Governors suspended the Regulation Q ceilings on large C/D's having maturities of 30-89 days. In its announcement with respect to this action, the Board stated:

"In taking the action, the Board recognized that there could be unusual demands upon commercial banks for short-term credit accommodation as a consequence of current uncertainties in financial markets. If this occurs, such increases in bank loans would not constitute an increase in total credit flows, to the extent that they simply represented a transfer of borrowings from other financing avenues, as for example the commercial paper market.

Under these circumstances, appropriate accommodations in bank lending, the Board said, would be a constructive element in the process of adjustment to changing financial conditions and would not interfere with the continuing objective of curbing inflation."

On Monday, June 22, the first business day after the Penn Central insolvency, there was only modest tension in the commercial paper market. There was little indication that the Penn Central developments were having a major adverse impact on the market although there was evidence of further investor

preference for prime names. As the week progressed, however, two or three major issuers of commercial paper began to experience serious difficulty in rolling over their maturing paper. Some maturing paper could be rolled over only on a one-to-three day basis. The tension continued to mount as Tuesday, June 30, an important statement day approached.

The principal bankers for these issuers of commercial paper recognized that the inability of the issuers to pay their paper at maturity would have dire consequences for the issuers, the commercial paper market, other financial markets and the banking system. They took the position that, since the issuers were basically credit-worthy companies and were encountering financial difficulties because of a market disturbance unrelated to their own activities, the banks should provide financial assistance to the extent they were able to do so. We encouraged the banks in their efforts to provide financial support to credit-worthy companies.

The additional financial assistance developed by the banks took the form of increasing the banks' credit lines for the commercial paper issuers, purchases without recourse of notes receivable of the issuers, commitments to make additional purchases in the future, and loans to affiliates of the issuers for the ultimate benefit of the issuers.

In discussions with bankers involved in the development of the additional financial support, there were occasional expressions of concern as to whether the new arrangements would prove adequate for the situation since they did not provide 100 per cent back-up coverage for all outstanding commercial paper of the issuers. In

the case of very large issuers of commercial paper, complete back-up coverage would have exceeded the combined legal lending limits of the issuers' banks. Although there was some discussion of the authority of the Federal Reserve Banks as lenders of last resort to provide help, the emphasis of officials of the Federal Reserve Bank of New York in their conversations with member banks was to encourage the member banks to make credit available to credit-worthy borrowers to the extent they could do so within their legal limits and common prudence. In these conversations, the officials reiterated their assurances as to the availability of the discount window in the case of need and the System's preparedness to supply reserves to support shifts from the commercial paper market to the banks.

In the period May 27 to July 1, non-bank-related commercial paper outstanding declined by \$2,444 million. In the seven-day period ending July 1, such paper declined by \$2,106 million. In the latter period, paper placed through one dealer declined by \$670 million while the directly placed paper of one finance company fell by \$468 million and that of another by \$383 million. Neither of the finance companies have lines of credit with banks that provide 100 per cent coverage of their commercial paper outstanding. Within the past week, the commercial banks for both finance companies arranged for additional financial assistance to the companies through increasing the companies' credit lines to their legal limits and the other measures referred to above. It appears that the banks involved may have reached the limit of their ability to provide financial assistance to the companies. At this point,

there is a grave question as to whether it would be fruitful for the companies to attempt to establish new lines with other commercial banks; according to the bankers with whom we discussed this matter, the additional credit that might be available from other banks would most likely be inadequate in relationship to the underlying needs, and arranging additional credit would be time consuming. The attempt to negotiate such lines at this time might also raise questions as to the seriousness of the situation facing the companies and thus aggravate the problem. A frantic effort to increase lines now might thus prove counter-productive.

The possibility of either or both of these finance companies being unable, in a matter of days, to obtain additional financial assistance from banks or other financial institutions immediately brings into consideration the question of possible action by Federal Reserve Banks as lenders of last resort. Federal Reserve Banks may extend credit to individuals, partnerships and corporations under the third and thirteenth paragraphs of section 13 of the Federal Reserve Act. The thirteenth paragraph is of no practical significance in this case in view of its requirement of collateral in the form of direct obligations of the United States or United States agency obligations.

The third paragraph of section 13 reads as follows:

"In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts,

and bills of exchange of the kinds and maturities made eligible for discount for member banks under other provisions of this Act when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: Provided, That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe." (underscoring supplied)

The principal prerequisite to the extension of credit by a Federal Reserve Bank under the third paragraph of section 13 is a finding by the Board of Governors that "unusual or exigent circumstances" exist. In our view, the inability of a credit-worthy major issuer of commercial paper to pay its paper at maturity would present "unusual or exigent circumstances". Such a failure to pay would have serious repercussions for the commercial paper market, other markets, and the banking system. Non-bank-related commercial paper outstanding as of July 1, 1970 totaled approximately \$30 billion. Much of this paper has maturities of 30 days or less. In the event of a loss of confidence in commercial paper as the result of the failure of a major issuer, the banking system could be faced with crisis conditions. Such a result would be particularly unfortunate - and in our opinion unnecessary - in a case in which the issuer of the paper is a credit-worthy firm and its failure is due merely to a market situation.

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Because of the possible urgency of the current situation, we believe that the Board of Governors should stand ready to make a finding that "unusual and exigent circumstances" exist and to authorize the Federal Reserve Banks to provide credit to individuals, partnerships and corporations under the third paragraph of section 13. We are not suggesting that the Board make such a finding at this time, but that it be prepared to do so on short notice.

In these circumstances, we have been reviewing various standards and procedures to be followed in the event that there is actual consideration of extending credit under the third paragraph of section 13. In our view, it is of primary importance that the borrower be credit worthy. The purpose of Federal Reserve credit in these cases is to provide financial assistance to companies experiencing difficulties because of market developments and not to postpone bankruptcies. The requirement that a borrower be credit worthy is consistent with the general principle that a Reserve Bank must expect that the borrower's obligation will be fully liquidated



in due course, either from sources available to the borrower or by recourse to endorsements or collateral security.

Another significant requirement is a finding that the borrower is unable to secure adequate credit accommodations from other banking institutions. In this respect, it should be determined whether the borrower has made reasonable efforts to obtain as much credit as possible from his established banking connections, to sell receivables to them, to obtain lines of credit with other banks and to sell receivables to other banks. It should also be determined, not as a requirement of law but as a proper business judgment, whether efforts have been made to secure credit from other types of financial institutions. No credit should be extended by a Federal Reserve Bank unless it is reasonably clear that the Reserve Bank is in fact the lender of last resort. In making a determination that a prospective borrower has made a reasonable effort to secure credit elsewhere, due consideration should be given, as mentioned earlier, to the possibility that a last-minute effort of the borrower to increase credit lines could damage, rather than improve, the borrower's position. Once a credit has been made, the borrower should be encouraged to find refinancing through more normal channels in an orderly fashion. In general, any Federal Reserve credit should be repaid prior to the repayment of other bank credit.

Reference has been made to the requirement that a borrower be credit worthy. This, of course, requires careful analysis by the Federal Reserve Bank. The Credit and Discount Department of this Bank is actively engaged in an analysis of the

financial condition of the finance companies referred to earlier. In this connection, the third paragraph of section 13 requires that the note be "indorsed or otherwise secured to the satisfaction of the Federal Reserve bank". A lack of "free" collateral may require negotiations with other creditors in respect of their waiving various negative covenants or apportioning collateral. In the event there is reliance on an endorsement, the endorsement must be of significance from a credit standpoint. As a general rule, a Reserve Bank should not attempt to over-collateralize its loan. Our Credit and Discount, and Legal Departments are reviewing the potential collateral situation in the case of the two companies. If it appears highly likely that an extension of Federal Reserve credit will be necessary, we plan to establish direct contact with the potential borrower and its counsel.

No rate of discount has been established for advances and discounts under the third paragraph of section 13. This Bank, through its Board of Directors, is prepared to act promptly to establish, subject to review and determination of the Board of Governors, such a discount rate if it should appear necessary to do so.