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Comments of William F. Treiber on proposals regarding
Extensions of Reserve Bank Credit
Under paragraph 3 of section 13 of
Federal Reserve Act

This memorandum supplements the memorandum of the Federal Reserve Bank of New York, dated July 10, 1970, entitled: "Discount Window Accommodation of Issuers of Commercial Paper under the Third Paragraph of Section 13 of the Federal Reserve Act".

In the period June 24 to July 15, non-bank commercial paper outstanding declined by about \$3 billion. In the single week ended July 1, such paper declined by \$2,111 million. In the following week there was an increase of \$93 million, but in the week ended July 15 there was a decline of about \$1 billion.

In the three week period paper placed by dealers declined by about \$1-1/2 billion, with one dealer accounting for a decline of \$1 billion. Over the same period paper placed directly by finance companies declined by about \$1-1/2 billion. Two finance companies accounted for \$1-1/4 billion of the decline. One had a drop of more than 50 per cent, from \$1,453 million to \$657 million. The other had a 25 per cent drop from \$1,959 million to \$1,478 million. In both cases the finance companies were controlled by industrial companies, and there was some questioning in the market regarding the earning capacity of the parent corporations.

Neither of the two finance companies had lines of credit with banks covering 100 per cent of their commercial paper outstanding. The commercial banks for such companies promptly arranged for additional

financial assistance to them by increasing credit lines and purchasing assets, but a substantial amount of their outstanding commercial paper is still not covered by bank lines. The banks involved may well have reached the limit of their ability to provide financial assistance to the companies.

Some leading bankers involved in the development of the additional credit packages for commercial paper issuers have occasionally expressed concern, in conversations with us, as to whether the new arrangements would prove adequate for the situation since they do not provide complete 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 exceed the combined legal lending limits of the issuers' banks. Although we have responded to some questions from these bankers as to the authority of the Federal Reserve Banks as lenders of last resort to provide help in these circumstances, our emphasis in our conversations has been to encourage the member banks to make credit available to credit-worthy borrowers to the extent they could do so within their legal lending limits and common prudence. In these conversations, we reiterated our 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.

The possibility of a large company being unable, in a matter of days, to obtain additional financial assistance from banks or other financial institutions brings into consideration the question of possible

action by Federal Reserve Banks as lenders of last resort.

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We are hopeful that it will prove unnecessary for any issuer of commercial paper to seek direct assistance from the Federal Reserve. Nevertheless, we have deemed it expedient to do some contingency planning. Our Credit and Discount Department, and our Legal Department have drafted various documents that might be used for such assistance, and they have been developing information with respect to large issuers of commercial paper that have experienced substantial drains.

We have also had inquiries from two major issuers of commercial paper relating to the workings of the third paragraph of section 13. The inquiries reflected remote contingency planning. In response, we have reviewed the provisions of the paragraph, its enactment in the depression years, and its use then. In those conversations, we have stressed the desirability of issuers of commercial paper meeting their financial needs through normal financial channels and have commented on the rigid tests that a nonmember institution must meet to obtain Federal Reserve credit. It appeared to be the clear preference of the companies to avoid recourse to Federal Reserve credit if at all possible.

In the event that extensions of credit under the third paragraph of section 13 should appear to be called for, it will be necessary to

to consider the rate to be charged. No rate has been established by the Federal Reserve Bank of New York for discounts under the third paragraph of section 13. In the 1930's, the rate was fixed at 6 per cent, while the basic discount rate ranged from 1-1/2 per cent to 3-1/2 per cent. At present, our basic discount rate is 6 per cent; our rate on advances to member banks under section 10(b) secured by ineligible assets is 6-1/2 per cent; and our rate on advances to individuals, partnerships, and corporations, under the last paragraph of section 13, secured by U. S. Government and Agency obligations, is 7-1/2 per cent.

Current rates on commercial paper are in the 8 to 8-1/4 per cent range for shorter maturities. In many cases, the long-standing bank credit lines of the large issuers call for advances at the prime rate which is now 8 per cent. In addition, the commercial banks require the borrowers to maintain compensating deposit balances; such a requirement increases the cost of the money to the borrower. In the recent credit packages that the commercial banks have assembled, sales of assets have been at a cost equivalent to a 10-1/2 per cent rate coupled with a 3/4 of 1 per cent commitment fee.

As lender of last resort, we believe that we should not establish a "bargain" rate for emergency loans to nonmember institutions. We do not want to appear to be inviting such loans. On the other hand, we would not favor an excessive penalty rate. Our purpose in making such a loan is not to realize income but to avoid a financial crisis. In addition, the cost of funds is not a factor for us. While any such

loan would contain an element of risk, no loan would be made except to a "credit-worthy" company from which we could reasonably expect repayment over time. On the other hand, we do think that the rate should be sufficiently high to be a factor in the borrower's determination to pay down the loan promptly. In all the circumstances, we, in New York, are thinking of a rate in the area of 9 per cent at the present time.

If the Federal Reserve Bank is asked to make a loan under the third paragraph of section 13, the amount of the loan could be large. It could easily be \$100 million or more. In this connection, we should bear in mind that at the end of 1969, the paid-in capital and surplus of the 12 Reserve Banks amounted to \$1,338 million; the paid-in capital and surplus of the FRBNY amounted to \$353 million. In 1969, the 12 Reserve Banks paid to the U. S. Treasury over \$3 billion; the New York Bank paid over \$3/4 billion. If such a loan were to result in a substantial financial loss to the Reserve Banks, presumably the amount of the loss would reduce the payments made to the Treasury.

In its memorandum of February 1, 1936 to the Federal Reserve Banks with respect to discounts under the third paragraph of section 13, the Board of Governors stated that "except with the permission of Board*** no Federal reserve bank shall discount for any one individual, partnership or corporation paper amounting in the aggregate to more than one per cent of the paid-in capital stock and surplus of such Federal reserve bank". Imposition of such a limitation in today's circumstances would vitiate any Federal Reserve program of providing financial assistance to credit-worthy issuers of commercial paper.

Such a limitation would appear to be inappropriate at this time in respect of a central bank operation as lender of last resort when, to achieve an important monetary objective, hundreds of millions of dollars may be needed to do the job. As in the case of borrowings by member banks under section 13, the third paragraph of section 13 sets no dollar or formula limitation on borrowings by individuals, partnerships or corporations, although it does authorize the Board of Governors to prescribe "limitations".

When a member bank approaches its Federal Reserve Bank as lender of last resort, the limitation on the amount of its borrowings is the practical limitation of the amount of collateral available to the member bank. Discounts under the third paragraph of section 13 must be indorsed or otherwise secured to the satisfaction of the Reserve Bank. We believe that when a nonmember institution is permitted, in order to accomplish an objective of the central bank, to have recourse to the central bank as lender of last recourse, the limit of that recourse should likewise be measured by the availability to the borrower of adequate collateral or indorsements.

Since Federal Reserve credit to issuers of commercial paper, if initiated, would probably involve large sums, possibly hundreds of millions of dollars, it would seem desirable to consider the participation of those loans among the twelve Federal Reserve Banks. Participating such loans would also be consistent with our practice of participating loans on gold to foreign central banks.

One of the supplemental guidelines suggested in the memorandum by the Board's staff, dated July 13, 1970, would limit the maturity of

loans to 30 days or less. I see no reason to be so specific. The maturities can't exceed 90 days in any event since the borrower's paper must meet the test of eligibility. Let's not circumscribe flexibility in the case of an emergency loan.

At the meeting of our directors last Thursday, I reviewed with them recent developments in the commercial paper market and discussed the background and provisions of the third paragraph of section 13. Although the directors shared our hope that it will not be necessary to make any loans under the third paragraph, they looked with favor on the making of such loans in exigent circumstances and thought that a rate of about 9 per cent would be appropriate. Our directors are prepared to meet promptly on short notice to consider such loans and take such action as may be appropriate in the circumstances.

I understand that the Board of Governors has given careful consideration to the use of the third paragraph of section 13, and that the Board is prepared to act promptly on short notice 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 such paragraph.

Being prepared to act promptly is an important part of contingency planning.