CONFIDENTIAL (FR)

To: Board of Governors

From: Robert C. Holland

Subject: Revised Contingency Plan Documents for Emergency Lending by Federal Reserve Banks

The contingency planning documents distributed to the Presidents at the joint meeting on July 21 have been revised by the Contingency Planning Staff Group in the light of comments and suggestions received from the Federal Reserve Banks. The chief changes made in the documents are as follows:

With respect to the guidelines for earmarked loans, Guideline 3 (alternative) from the July 13, 1970, draft has been adopted. This makes it clear that a member bank should repay its loan if its position eases even if its loan to the ultimate borrower still is outstanding.

Guideline 4 provides that a Reserve Bank should stand in a "last in-first out" position if it can do so without jeopardizing the objectives of the program. Guideline 5 emphasizes that the member bank remains liable on its note to the Reserve Bank if its loan to the ultimate borrower is not repaid.

Guideline 7 has been revised to provide that the Reserve Banks should monitor earmarked loans more closely than was implied in the earlier version.

With respect to the draft circular on Par. 3 loans, several banks suggested that the prohibition against commitments to extend or to renew (last paragraph, Section 5) be dropped. The Contingency Planning Staff Group elected to retain this provision, but to add a statement that a Reserve Bank would "consider sympathetically" requests for extension or renewal if circumstances warranted.

The limitation on the aggregate amount of a loan to one borrower without the permission of the Board has been changed from a percentage of capital and surplus to a flat dollar amount. The amount indicated ($20 million) was chosen because that amount had been discussed at a meeting of the Board. In view of the size of the loans that might be requested under Par. 3, the staff believes that a larger amount, perhaps $50 million, would be more appropriate.

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Attachments 4 and 5 have been added to specify procedures for participating Par. 3 loans among Reserve Banks and for establishing reserves against possible losses.

Attached is a draft of a letter which, if the Board approves, we will send to the Presidents of the Federal Reserve Banks with the revised contingency planning documents. The letter again emphasizes that these plans are not final. They will remain under continuing review until such time as it might become necessary to implement one or more of them.

Attachments

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

Dear Sir:

The documents distributed at the joint meeting on July 21 have been revised in the light of comments received from Federal Reserve Banks. The documents still are to be regarded as contingency plans and are not necessarily in "final" form in the event that it should become necessary to implement any of them.

I. Earmarked Loans

Reserve Bank discount windows currently are being operated under the emergency provision in Regulation A and generally in line with the approach described by Mr. Treiber at the joint meeting of the Board and the Presidents on June 22, 1970, and amplified in discount officer calls of June 22, and July 6. Commercial banks under pressure from take-downs on lines of credit to issuers of commercial paper are being accommodated at the window for borrowing periods longer than normal. However, the discipline of the window still applies and banks are expected to repay the indebtedness as quickly as they obtain funds in the normal course.

The evidence is that this general commitment will be adequate to meet the situation. However, circumstances could develop in which the general commitment would not be sufficient to induce banks to lend to creditworthy and necessitous borrowers. We have identified two circumstances in which member banks might request additional assistance. One is a situation in which the required loan probably would carry a long maturity and the bank's prospective sources of funds were all short-term. Another is the bank that, for whatever reason, simply has no funds available to meet additional loan demands.

In these circumstances the next step in emergency lending may be required--namely, an earmarked loan to a member bank, specifically linked to the member bank's loan to an identified borrower. A Reserve Bank would agree (1) to put a member bank in funds to make a particular loan (or to purchase assets of a nonmember organization); (2) to consider favorably successive renewals of the Reserve Bank credit; and (3) to require repayment by the member bank only as funds are repaid to the bank by the borrower or the liquidity position of the bank becomes such that it is clear that support of the credit at the discount window is no longer necessary. It should be understood by all parties that the member bank loan to the business firm, and the Reserve Bank loan to the member bank, are of an emergency nature and are to be repaid as soon as circumstances permit.

Reserve Bank loans to member banks under such arrangements could be made under Section 13 or Section 10(b) of the Federal Reserve Act. There are advantages to requiring that the loan by the member bank be secured by the paper of the ultimate borrower which in most cases would require a Section 10(b) loan. However, the form of the loan and the type of security accepted are left to the discretion of the Reserve Bank in the interest of achieving the basic objective--avoiding the disruptive effects of a crisis in confidence.

Apart from the standards set forth in Guidelines 1 and 2 (attached), there should be no discrimination among potential borrowers by size, by industry group, by conditions in a financial market in which the borrower ordinarily raises funds, or by any other arbitrary definition. Once the Board has acted to initiate the procedure, earmarked loans should be available to all necessitous borrowers who meet the criteria set forth in the attached guidelines.

Since the member bank is taking the risk, requests for earmarked loans normally should be initiated by the member bank rather than by the Reserve Bank.

II. Direct Loans under Par. 3, Section 13

At least two circumstances have been identified in which earmarked loans to member banks might not be effective in warding off failure of a creditworthy firm: (1) the firm's bank (or banks) of account may have loaned up to the prudent limit to the prospective borrower and additional credit is not available from other sources; and (2) a bank may make an adverse credit judgment which a Reserve Bank believes to be unwarranted in the circumstances.

Paragraph 3 of Section 13 states that notes, drafts, and bills of exchange submitted for discount under that paragraph must be "eligible for discount for member banks under other provisions of this Act," and must be "indorsed or otherwise secured to the satisfaction of the Federal Reserve bank."

The possibility of broadening the definition of eligible paper is being reviewed separately. With respect to the degree of risk that is acceptable, the Board's Circular X-9464-a of February 1, 1936, stated (Sec. 5(c)), that the Federal Reserve Bank must ascertain "that the indorsement or the security offered is adequate to protect the Federal Reserve bank against loss." This principle was amplified recently by the Board's General Counsel who said that the Reserve Bank should reasonably expect that the loan would be repaid in due course (but not necessarily at the stated maturity).

As in the case of earmarked loans, there should be no discrimination among Par. 3 borrowers by size, by industry, or by conditions in a particular financial market.

The question of substituting a Reserve Bank's judgment for that of a member bank is troublesome. However, there may be instances in which a member bank sharply upgrades its credit quality because of a general unavailability of funds and in which the loan may be in the national interest. In such circumstances the Reserve Bank should consider, based on its own credit analysis, whether to make the loan after the applicant had been turned down by a member bank.

There are attached drafts of a revision of the Board's 1936 circular and supplemental guidelines for Par. 3 lending, that might be used if that paragraph were activated, together with suggested administrative procedures dealing with System participation in Par. 3 loans, and with making provision against losses on such loans. The question of the rates to be charged on Par. 3 loans is being considered separately.

The Board continues to believe that the details of this contingency planning should be closely held within the System. If a case should arise which, in the judgment of a Reserve Bank, would seem to justify use of the earmarked loan procedure, a Reserve Bank should consult with the Board before discussing the draft guidelines

with the member banks. The Board at that time would consider whether a general announcement of the availability of this procedure was desirable.

Sincerely yours,

Robert C. Holland,
Secretary.

Attachments.

Drafts of:

1.--Guidelines for Making Earmarked Loans
2.--Revision of 1936 Circular
3.--Supplemental Guidelines for Par. 3 Loans
4.--Procedure for Participating Par. 3 Loans
5.--Provision Against Losses on Par. 3 Loans

Attachment 1
DRAFT
8/7/70

Guidelines for Making Earmarked Loans to Member Banks

1. The firm to which the earmarked loan would go should be creditworthy and should have exhausted all regular sources of credit.
2. An earmarked loan should be restricted to cases where a temporary lack of funds might force the suspension of operations, which in turn would be deemed to have a major adverse effect on the nation's economy or on the economy of the community in which the borrower is located.
3. Earmarked loans to member banks under these provisions should be considered as separate from and in addition to a member bank's normal access to the discount window. It is understood that a Reserve Bank may continue its loan to a member bank as long as the corresponding loan made by the member bank is outstanding; however, the Reserve Bank may require repayment by the member bank if the liquidity position of the member bank becomes such that support of the loan at the discount window is no longer necessary.
4. To the extent possible without jeopardizing the purpose of the earmark program, the Reserve Bank should reach an understanding with the member bank that the Reserve Bank is in a "last in,

first out" position relative to repayments by the ultimate borrower. This may be done by mutual agreement upon a realistic repayment schedule.

5. The member bank should understand clearly that it bears the risk on the earmarked loan. Subject to the provision stated in Guideline 3 above, the Reserve Bank's loan may remain outstanding as long as the ultimate borrower's loan is not repaid. However, in the event that the borrower becomes unable to repay, e.g., if he becomes bankrupt, the member bank would be expected to repay its loan as soon as the bank has resources to do so.

6. Earmarked loans may be made under Section 13 or Section 10(b) of the Federal Reserve Act, whichever provision seems appropriate in the individual case. If the member bank decides to extend the needed emergency funds by purchase of some of the customers' assets rather than by a loan, the Reserve Bank may make an earmarked loan to the member bank to provide funds for this purpose.

7. In addition to assuring that a realistic repayment schedule has been established, the Reserve Bank should satisfy itself that the loan to the ultimate borrower does not remain outstanding longer than is necessary to meet the objectives set forth in Guidelines 1 and 2. Where appropriate, the paper of the ultimate borrower should be held by the Reserve Bank to secure the member bank's note. The Reserve Bank should not be involved in fixing

the terms and conditions of the member bank's loan to the ultimate borrower unless it appears that the terms and conditions are unreasonable or exorbitant in the circumstances.

Attachment 2
DRAFT
8/7/70

SUBJECT: DISCOUNTS FOR INDIVIDUALS, PARTNERSHIPS AND CORPORATIONS

TO ALL FEDERAL RESERVE BANKS

The third paragraph of Section 13 of the Federal Reserve Act, as amended by the Acts of July 21, 1932, and August 23, 1935, provides 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."

In view of the fact that the power conferred by this provision can be exercised only in "unusual and exigent circumstances", the Board of Governors of the Federal Reserve System has not prescribed any formal regulations governing the exercise of this power; but the requirements of the law and the procedure which the Board

will expect to be followed are outlined below for the information of the Federal Reserve Banks and any individuals, partnerships or corporations that may contemplate applying to them for discounts.

1. LEGAL REQUIREMENTS

It will be observed that, by the express terms of the law:

(a) The power conferred upon the Board of Governors of the Federal Reserve System to authorize Federal Reserve Banks to discount eligible paper for individuals, partnerships or corporations may be exercised only:

(1) In unusual and exigent circumstances,

(2) By the affirmative vote of not less than five members of the Board of Governors, and

(3) For such periods as the Board of Governors may determine.

(b) When so authorized, a Federal Reserve Bank may discount for individuals, partnerships or corporations only notes, drafts and bills of exchange of the kinds and maturities made eligible for discount for member banks, under other provisions (Sections 13, 13a, and 24) of the Federal Reserve Act. (Such paper must, therefore, comply with the applicable requirements of the Regulations of the Board of Governors of the Federal Reserve System.)

(c) Paper discounted for individuals, partnerships or corporations must be either (1) indorsed or (2) otherwise secured to the satisfaction of the Federal Reserve Bank.

(d) Before discounting paper for any individual, partnership or corporation, a Federal Reserve Bank must obtain evidence that such individual, partnership or corporation is unable to secure adequate credit accommodations from other banks or financial institutions.

(e) Such discounts may be made only at rates established by the Federal Reserve Banks, subject to review and determination by the Board of Governors of the Federal Reserve System.

(f) All discounts for individuals, partnerships or corporations are subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.

2. AUTHORIZATION BY THE BOARD OF GOVERNORS.

The Board of Governors of the Federal Reserve System, pursuant to the power conferred upon it by the amendment hereinbefore quoted, hereby authorizes all Federal Reserve Banks, for a period ending at the close of business on _____ to discount eligible notes, drafts and bills of exchange for individuals, partnerships and corporations, subject to the provisions of the law, the Board's regulations, and this circular.

3. FOR WHOM PAPER MAY BE DISCOUNTED.

A Federal Reserve Bank may discount for individuals, partnerships or corporations notes, drafts or bills of exchange, which are the obligations of such individuals, partnerships, or corporations or which are the obligations of other parties actually owned by such individuals, partnerships or corporations.

Within the meaning of this circular, the term "corporations" does not include banks.

4. APPLICATIONS FOR DISCOUNT.

Each application of an individual, partnership or corporation for the discount of eligible paper by the Federal Reserve Bank must be addressed to a Federal Reserve Bank as appropriate in the circumstances, must be made in writing on a form furnished for that purpose by the Federal Reserve Bank and must contain, or be accompanied by, the following:

(a) A statement of the circumstances giving rise to the application and of the purposes for which the proceeds of the discount are to be used;

(b) Evidence sufficient to satisfy the Federal Reserve Bank as to (1) the legal eligibility of the paper offered for discount under the provisions of the Federal Reserve Act and the Regulations of the Board of Governors of the Federal Reserve System and (2) its acceptability from a credit standpoint;

(c) A statement of the efforts made by the applicant to obtain adequate credit accommodations from other banks or financial institutions, including the names and addresses of all other banks or financial institutions to which applications for such credit accommodations were made, the dates upon which such applications were made, whether such applications were definitely refused and the reasons, if any, given for such refusal;

(d) A list showing each bank with which the applicant has had banking relations, either as a depositor or as a borrower, during the preceding year, with the approximate date upon which such banking relations commenced and, if such banking relations have been terminated, the approximate date of their termination;

(e) Complete credit data regarding the financial condition of the principal obligors and indorsers, if any, on the paper offered for discount;

(f) A list and description of any collateral or other security offered by the applicant;

(g) A waiver by the applicant of demand, notice and protest as to applicant's obligation on all paper discounted by the Federal Reserve Bank or held by the Federal Reserve Bank as security; and

(h) An agreement by the applicant, in form satisfactory to the Federal Reserve Bank, (1) to furnish additional credit information to the Federal Reserve Bank, when requested, (2) to submit to audits, credit investigations or examinations by representatives of the Federal Reserve Bank at the expense of the applicant, whenever requested by the Federal Reserve Bank, and (3) to furnish additional security whenever requested to do so by the Federal Reserve Bank.

5. GRANT OR REFUSAL OF APPLICATION

Before discounting notes, drafts, or bills of exchange for any individual, partnership or corporation, the Federal Reserve Bank shall ascertain to its satisfaction in the circumstances by such means as it may deem appropriate:

(a) That the financial condition and credit standing of the applicant justify the granting of such credit accommodations;

(b) That the paper offered for discount is acceptable from a credit standpoint and eligible from a legal standpoint;

(c) That the indorsement or the security offered appears to be adequate to protect the Federal Reserve Bank against loss;

(d) That there is reasonable need for such credit accommodations; and

(e) That the applicant is unable to obtain adequate credit accommodations from other banks or financial institutions.

A special effort should be made to determine whether the banking institution with which the applicant ordinarily transacts his banking business or any other financial institution to which the applicant ordinarily would have access is willing to grant such credit accommodations.

A Federal Reserve Bank should not discount such paper unless it appears that the proceeds of such discounts will be used to finance current business operations and not for speculative purposes, for permanent or fixed investments, or for any other capital purposes. Except with the permission of the Board of Governors of the Federal Reserve System, no such paper should be discounted if it appears that the proceeds will be used for the purpose of paying off existing indebtedness to other banking institutions.

In discounting paper for individuals, partnerships or corporations, a Federal Reserve Bank should not make any commitments to renew or extend such paper or to grant further or additional discounts. However, a Reserve Bank may indicate that it will consider sympathetically requests for extension or renewal if circumstances appear to warrant it.

6. LIMITATIONS

No Federal Reserve Bank shall discount for any one individual, partnership or corporation paper amounting in the aggregate to more than $20 million except with the permission of the Board of Governors of the Federal Reserve System.

7. ADDITIONAL REQUIREMENTS.

Any Federal Reserve Bank may prescribe such additional requirements and procedure respecting discounts hereunder as it may deem necessary or advisable; provided that such requirements and procedure are consistent with the provisions of the law, the Board's regulations and the terms of this circular.

Attachment 3
DRAFT
8/7/70

SUPPLEMENTAL GUIDELINES TO RESERVE BANKS
IN ADMINISTERING LOANS UNDER PAR. 3, SEC. 13
OF THE FEDERAL RESERVE ACT

1. Par. 3 loans should be made only in cases where the failure of the applicant would have a significant adverse effect on the economy of the nation or the community in which the business is located.

2. Loans should be made for 30 days or less, subject to renewal.

3. The paper discounted under Par. 3 and supporting collateral should be controlled by the Federal Reserve, either by physical custody at a Federal Reserve office, or by arranging suitably secure custody or warehousing off Federal Reserve premises.

Attachment 4
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Procedures for Participating
in Loans made under Paragraph 3 of Section
13 of the Federal Reserve Act

1. Loans made under Par. 3 of Section 13 of the Federal Reserve Act will be carried by each Reserve Bank in a General Ledger Account entitled: "Discounts for Individuals, Partnerships and Corporations," and all disbursements and payments will be entered to this account.
2. At the close of business on each day the total of the account will be wired to the Board's Division of Federal Reserve Bank Operations.
3. Periodically, or daily if necessary, the Division of Federal Reserve Bank Operations will allocate the System total in the account to each Reserve Bank on the basis of each Reserve Bank's capital and surplus. The allocation will be made by direct entry to the Interdistrict Settlement Fund.
4. Upon receipt of the advice of allocation, each Reserve Bank will increase or decrease its share of the Interdistrict Settlement Fund and will decrease or increase its total in the account "Discounts for Individuals, Partnerships and Corporations."

Attachment 5
DRAFT
8/7/70

Plan for Establishing Reserve Against
Possible Loan Losses under Par. 3 of
Section 13 and Disposition of Loans Past Due

1. Upon opening an account for loans under Par. 3 of Section 13 of the Federal Reserve Act, each Reserve Bank will open an account entitled: "Reserve for Contingencies." The account will be reported on the condition statement in Other Capital Accounts.

2. On each Wednesday until further notice,[1/] an amount equal to 1/4 of 1 per cent of the daily average of such loans outstanding during the preceding seven days will be transferred to the account out of unallocated net earnings.

3. Charges to the account will be made only with the approval of the Board. Should charges to the account result in a minus balance, consideration will be given to larger transfers out of unallocated net earnings or direct charges to surplus.

4. Loans that are past due will be transferred to a special account in Other Assets on the condition statement and held in this account pending collection, liquidation of collateral, or other disposition. The acmount in this special account will be allocated among all Reserve Banks using the same procedure and basis for allocating current loans.

1/ It is contemplated that additions to the reserve will be discontinued when the amount is large enough to meet any eventuality.

Allocations will be made periodically or daily as necessary by the Board's Division of Federal Reserve Bank Operations through the Interdistrict Settlement Fund.

5. Whenever it appears that further collections on a past due loan are doubtful or collection of a part of the loan cannot be made, the lending Reserve Bank should request permission of the Board to write off the doubtful amount. The Division of Federal Reserve Bank Operations will advise all Reserve Banks of their share so that appropriate write-off may be made on the same day against the Reserve for Contingencies.