November 5, 1970

To: Board of Governors

From: Robert C. Holland

SUBJECT: Revised contingency plan documents for emergency lending by Federal Reserve Banks

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On September 9, 1970, the contingency planning documents distributed to the Board with my memorandum of August 10, 1970, were sent to the Presidents of the Federal Reserve Banks. The transmittal letter pointed out that the Board had not had an opportunity to consider the revised documents, that the documents still were under continuing review, and that additional Reserve Bank comments and suggestions would be welcome.

The contingency planning documents were on the agenda of a discount officers' conference call on September 23, 1970 (memorandum to the Board from the Division of Federal Reserve Bank Operations dated September 25, 1970). During that call a majority of the Reserve Banks expressed reservations with respect to the procedure (outlined in Attachment 4) for participating loans made under Par. 3, Section 13 of the Federal Reserve Act. The Reserve Banks were concerned that they would not have an opportunity to exercise their own credit judgment, and that the loans would be made outside the purview of their credit or discount committees and their Boards of Directors.

The Reserve Banks recognized that the capital structure of an individual Reserve Bank might be impaired if a large direct loan went bad. However, it was suggested that this could be guarded against by an extension of the existing loss-sharing agreement to cover possible losses on Par. 3 loans.

The Contingency Planning Staff Group has discussed the Reserve Bank position and has concluded that, while an extension of the loss-sharing agreement would meet the objective of distributing the risks of Par. 3 loans, it would not solve the problem of showing on the published balance sheet of a Reserve Bank direct loans which might substantially exceed the capital and surplus of the Bank. The Staff Group concluded that both an extension of the loss-sharing agreement and the participation procedure were appropriate measures to be included in contingency plans.

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The Staff Group also agreed that minimum limits for participations, suggested by several Reserve Banks, were appropriate. We suggest that Par. 3 loans be participated when the total of such loans on the books of an individual Reserve Bank exceeds 50 per cent of the Bank's capital and surplus or $50 million. This formula recognizes the differences in the capital structures of the Reserve Banks.

Accordingly, a new section 7, "Distribution of Risk" has been added to the draft circular on discounts for individuals, partnerships and corporations (Attachment 2). This section provides that direct loans will be participated among the Reserve Banks if they exceed the limits described above. The section also provides that any loss on participated loans will be shared by the Reserve Banks in proportion to the share participated. This latter provision might be dropped if the loss-sharing agreement were amended as proposed.

The limitation of $20 million on the aggregate amount of direct loans that may be made by a Reserve Bank to a single borrower without the Board's permission (Section 6 of the draft circular) has been increased to $50 million.

The Staff Group hopes that the Reserve Banks will recognize the need for the participation procedure as a part of contingency plans for emergency lending. In any event, Mr. Hackley is of the opinion that Sec. 11(b) of the Federal Reserve Act, plus the last sentence of Par. 3, Sec. 13, gives the Board the authority to include the suggested provision in the draft circular.1/

1/ Sec. 11(b) of the Federal Reserve Act authorizes the Board "To permit or, on affirmative vote of at least five members of the Board of Governors of the Federal Reserve System to require Federal reserve banks to rediscount the discounted paper of other Federal reserve banks at rates of interest to be fixed by the Board of Governors of the Federal Reserve System."

The last sentence of Par. 3, Sec. 13 of the Federal Reserve Act says that "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 provide."

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In the interest of achieving more agreement with the participation technique, the Board could ask the Conference of Presidents to consider various possible procedures for participating loans that might reduce the concern expressed by the Reserve Banks.

The Contingency Planning Staff Group also recommends that the Board ask Mr. Hickman, Chairman of the Conference of Presidents, to assign to the Insurance Committee of the Federal Reserve Banks the task of drafting an amendment to the loss-sharing agreement to include any possible losses on loans made under Par. 3, Sec. 13 of the Federal Reserve Act.

If the Board approves the general content of these documents they will be distributed again to the Presidents of the Federal Reserve Banks for comment. The Board and the Presidents may wish to discuss these plans again at a joint meeting. In the meantime these documents can be considered, as were their predecessors, to be in place for quick approval if needed, but in the interim to be subject to continuing refinement.

For your convenience the attached Appendix lists all changes made in these documents since they were considered at a meeting of the Board on July 14, 1970, including those described in my memorandum to the Board dated August 10, 1970.

Attachments

APPENDIX

I. Guidelines for making earmarked loans to member banks (Attachment 1).

1. In Guideline 2 the term "major adverse effect" has been changed to "significant adverse effect" to be consistent with similar language in Guideline 1 (Attachment 3). Further, the word "community" used in the earlier draft has been changed to "market area" to meet objections that the former was too narrowly defined.

2. Guideline 3 is the "alternative Guideline 3" set forth in the earlier draft. This guideline 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.

3. Guideline 4 has been added to provide that a Reserve Bank should be in a "last in--first out" position if it can do so without endangering the objectives of the program.

4. Guideline 5 has been added to emphasize that a member bank remains liable on its note to the Reserve Bank if its loan to the ultimate borrower is not repaid.

5. Guideline 7 has been revised to provide that Reserve Banks should monitor earmarked loans more closely than was implied in the earlier draft. Further, the term "the collateral offered by the ultimate borrower" has been substituted for "the paper of the ultimate borrower."

II. Draft circular covering loans under Par. 3, Sec. 13 of the Federal Reserve Act.

1. The "Authorization" section (Section 2) has been changed to specify the circumstances under which the authorization is given, i.e., "unusual and exigent circumstances."

2. The term "or nonmember deposit-type financial institutions" has been added to the last paragraph of Section 3 to emphasize that this circular is not intended to supersede procedures already in place for making direct loans to such institutions.

3. The limitation on the aggregate amount that may be loaned to one borrower without the permission of the Board has been raised from $20 million to $50 million.

4. A new Section 7 "Distribution of Risk" has been added.

III. Supplemental Guidelines for Par. 3 loans (Attachment 3).

The word "community" has been changed to "market area" to meet objections that the former was too narrowly defined.

IV. Guidelines for procedures for participating Par. 3 loans (Attachment 4).

This guideline, added since the Board's discussion of July 14, has been modified to reflect the limits on participations described by the memorandum, and to make clear that the participation procedure does not apply to direct loans to deposit-type institutions made under existing authorization.

V. Guidelines for establishing reserves against losses on Par. 3 loans (Attachment 5).

This guideline has been added since the Board's discussion of July 14 and has been modified to make clear that the guidelines do not apply to direct loans to deposit-type institutions made under existing authorization.

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Attachment 1

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 significant adverse effect on the nation's economy or on the economy of the market area 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 collateral offered by 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.

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Attachment 2

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, having determined that unusual and exigent circumstances exist, hereby authorizes all Federal Reserve Banks, pursuant to paragraph 3 of section 13 of the Federal Reserve Act and 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 or nonmember deposit-type financial institutions.

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 $50 million except with the permission of the Board of Governors of the Federal Reserve System.

7. DISTRIBUTION OF RISK

At any time that the aggregate amount of paper discounted by a Federal Reserve Bank for individuals, partnerships, or corporations (other than banks and other deposit-type financial institutions) under Par. 3, Section 13 of the Federal Reserve Act exceeds 50 per cent of the Federal Reserve Bank's capital and surplus, or $50 million, the amount in excess of these aggregates shall be participated among all Federal Reserve Banks in accordance with a procedure to be set forth by the Board of Governors of the Federal Reserve System. Any loss on loans so participated will be shared by all Federal Reserve Banks in proportion to their participation percentages.

8. ADDITIONAL REQUIREMENTS

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

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Attachment 3

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 market area 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.

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Attachment 4

Procedure for Participating in Loans
Made Under Paragraph 3 of Section 13
of the Federal Reserve Act

1. Loans made under Par. 3 of Sec. 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 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 among the Reserve Banks, on the basis of each Bank's capital and surplus, the aggregate amount by which the total of Par. 3 loans at each Reserve Bank (excluding such loans to banks and other deposit-type financial institutions) exceeds 50 per cent of that Bank's capital and surplus, or $50 million. 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."

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Attachment 5

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 to individuals, partnerships, or corporations under Par. 3 of Section 13 of the Federal Reserve Act, (excluding such loans to banks and other deposit-type financial institutions) 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 amount 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.