Bankers' acceptances revisited

Jack L. Hervey

The ten-fold increase in world trade over the past twelve years, to more than $1.8 trillion in exports in 1982, has been accompanied by the rapid growth of short-term credit to finance the international movement of goods. The U.S. bankers' acceptance market has played an important part in providing this expansion in credit financing for both U.S. and worldwide trade.

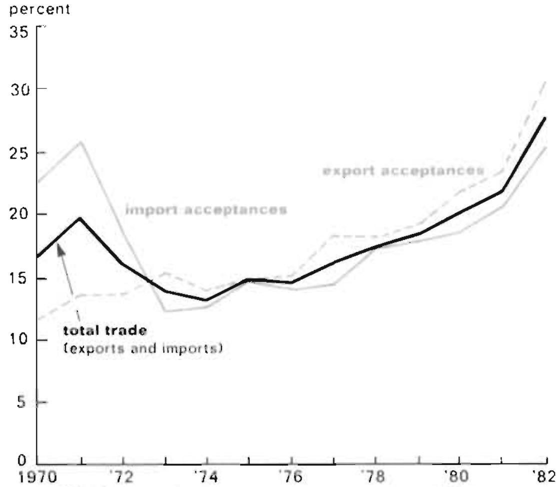
An estimated 17 percent of the total U.S. export-import trade in 1970 was financed in the bankers' acceptance market (see Figure 1).[1] By 1974 only 13 percent of U.S. export-import trade was financed through acceptances. This downward trend was reversed in the last half of the 1970s when both export and import acceptances expanded rapidly. The portion of U.S. trade financed by acceptances increased to about 22 percent by 1981. The proportion expanded further in 1982—to 28 percent—as a result of a continued expansion in the acceptance market that occurred at the same time that exports and imports were contracting.

International trade credit is particularly important because of the often lengthy time between shipment by the exporter and delivery to the importer. In some cases, the importer prepays prior to shipment of the goods; in others, the exporter extends credit on "open account" until delivery. Often, however, the transaction involves a third party who agrees to pay the exporter upon shipment and to receive payment from the importer at some agreed upon future date.

For this credit service, the third party receives the principal and an interest return plus a fee, or commission, associated with the services provided, including the risk of nonpayment by the importer. Open account credit continues as an important component of trade financing, especially when trading partners are well known to each other and the risk of nonperformance is low. However, when the transaction involves a relatively high degree of risk, such as when buyer and seller are not well known to each other, third party involvement (with a better information network) typically takes place.

The risk of nonperformance increases the expected costs associated with an export-import transaction and acts as a deterrent to trade. Therefore, trade can be facilitated if this risk can be shifted to a third-party at a known cost. More complete information typically, through foreign correspondents, in addition to risk pooling, allows the third party, who specializes in credit, to bear such risks at a lower expected cost than

Figure 1
The share of U.S. international trade financed by acceptances



NOTE: Shares are based on average acceptance maturities of 90 days.

Jack L. Hervey is a Senior Economist at the Federal Reserve Bank of Chicago. This article updates and extends "Bankers acceptances", *Business Conditions*, Federal Reserve Bank of Chicago (May 1976), pp. 3-11.

[1]The estimates are based on the average amount of export and import acceptances created and assume a 90-day average maturity. (Outstandings are from the Federal Reserve Bank of New York, "Banker's Dollar Acceptances—United States," a monthly release of the Office of Public Information, selected issues.) A shorter or longer average maturity would alter the estimates. If a 60-day average maturity were assumed, for example, the volume of export and import acceptances created in 1970 and 1982 as a proportion of total U.S. exports and imports would increase to 25 percent and 40 percent, respectively. Commercial bankers indicate that average maturity varies over time but that a 90-day average is a reasonable assumption.

an exporter who specializes in goods. Historically, the desire for such risk shifting in trade arrangements led to the development of bills of exchange such as bankers' acceptances.[2]

A bankers' acceptance

A bankers' acceptance originates from a draft drawn to finance the exchange or temporary storage of specified goods. It is a time draft that specifies the payment of a stated amount at maturity, typically less than six months in the future. The draft becomes a "bankers' acceptance" when a bank stamps and endorses it as "accepted."[3] For the price of its commission, the bank lends its name, integrity, and credit rating to the instrument and assumes primary responsibility for payment to the acceptance holder at maturity. The drawer of the draft retains a secondary liability to the acceptance holder, contingent upon the inability of the accepting bank to honor the claim at maturity.

The draft underlying an acceptance sometimes is preauthorized by a "letter of credit" issued by the importer's home bank. The largest dollar volume, however, are "outright" or "clean" acceptances—often arising from an agreement between a foreign bank (for their customer) and the accepting U.S. bank.

The drawer of the acceptance may extend credit to the importer by simply holding it until maturity and then collecting payment of the face amount from the accepting bank. Alternatively, the drawer can receive immediate payment by selling the acceptance at a discount, typically to the bank that created it.[4] The bank that discounts the acceptance may hold the instrument in its investment portfolio, treating it like any other loan financed from the bank's general funds. More commonly, the bank sells the acceptance in the secondary market, either to a specialized acceptance dealer or directly to an investor. At year-end 1982 about 88 percent of total bankers' acceptances created were "outstanding"—i.e., not held in the accounts of the accepting banks.

Acceptance market growth

Bankers' acceptances are used for two principal types of financing—for domestic trade and storage and international trade. An additional small volume of acceptances are created for the acquisition of the dollar exchange by certain countries that have periodic or seasonal shortages in their dollar foreign exchange reserves.

Although the dollar volume of trade acceptances has grown rapidly since the early 1970s, domestic acceptances have remained a small though relatively stable proportion of total acceptances over the past decade. Domestic acceptances increased from about $200 million at year-end 1969 to more than $3 billion at the end of 1982, about 4 percent of total acceptances.

Passage of the Export Trading Company Act of 1982 may facilitate a substantial expansion in the size and relative importance of bankers' acceptances for domestic shipments. This act, effective October 8, 1982, removed a longstanding statutory requirement that title documents must accompany a bankers' acceptance originated for domestic shipments in order for such an acceptance to qualify as eligible for discount by the Federal Reserve. Because this previous requirement discouraged the use of bankers' acceptances for shipments of domestic goods, 80 percent or more of the volume of domestic acceptance creation typically has been originated to finance storage rather than trade.

International trade acceptances account for the bulk of U.S. bankers' acceptance activity, typically representing more than 90 percent of the total acceptance market. International acceptances are of three basic types: acceptances to finance U.S. exports; acceptances to finance U.S. imports; and third-country acceptances to finance trade between foreign countries or goods storage within a foreign country.

The phenomenal growth of U.S. export-import acceptances has been fostered by the

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[2]Historians have traced the origin of these instruments to the twelfth century.

[3]Drafts drawn on and accepted by nonbank entities are called "trade acceptances."

[4]Typically the terms of the letter of credit specify whether the buyer or seller is responsible for payment of the commission (discount) due to the bank. If the responsibility for the discount is not specified in the agreement, convention dictates that the seller is liable for the charges.

increased proportion of U.S. trade financed by acceptances, which to a large degree is due to increased attention to liability management by bankers, as well as by the expanded value of U.S. trade. Gross acceptances created to finance U.S. exports increased from $1.2 billion at year-end 1969 to $16.3 billion at the end of 1982. Over the same period, acceptances to finance imports increased from $1.9 billion to $17.7 billion.

Even more impressive has been the growth in third-country acceptances which have increased from $2.3 billion at year-end 1969 to $42.3 billion at year-end 1982. Accompanying this 18-fold increase in dollar volume, third-country acceptances have captured a larger share of the (total) international acceptance market—rising from 42 percent to 53 percent of gross acceptances created in the 1970-82 period. Expansion of the third-country market largely reflects increased usage of U.S. acceptances by Japanese, South Korean, and other Asian traders, especially in the wake of higher oil import costs for these nations after the oil price increases of 1973-74 and 1979-80.

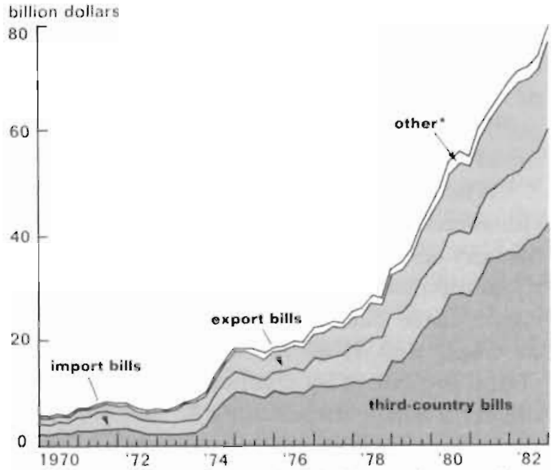
Bankers active in the acceptance market indicate that a substantial proportion of third-country acceptances are for financing oil shipments, and growth in third-country import bills appears consistent with this claim (see Figure 2). During 1974, third-country acceptances increased from $2.7 billion to $10.1 billion. The volume increased from $16.2 billion to $35.3 billion during the period 1979 to mid-1981.

Dollar exchange acceptances, arising from exchange shortages brought about by seasonal trade patterns in some countries, are the only acceptances not based on specific merchandise trade or storage. They are available only in foreign countries designated by the Board of Governors of the Federal Reserve System. Such acceptances are relatively minor in volume, constituting only about 0.2 percent of total acceptances at year-end 1982.

Investment in acceptances

Acceptances have characteristics that are attractive to borrowers, bankers, and investors when compared to other short-term financial

Figure 2
U.S. bankers' acceptance market expanded rapidly over the past decade



*Includes acceptances to finance domestic shipments and storage and dollar exchange acceptances.

Note: Total acceptances as of the end of the quarter including acceptances held by accepting bank

instruments. This appeal has been basic to the recent rapid growth of the acceptance market.

Borrower costs for bankers' acceptances compare favorably with the interest and noninterest charges on conventional bank loans. In comparing interest rates on acceptances and other bank loans, the acceptance rate must be adjusted upward to reflect that it is quoted on a discount basis. Although typically not quoted on a discount basis, interest rates on conventional bank loans must be adjusted upward in cases where the loan contract requires a borrower to maintain compensating balances in excess of normal working balances at the lending bank. Maintaining these noninterest-earning deposits increases the effective cost of the bank loan.

Interest rates on acceptances also compare favorably with commercial paper rates. Many borrowers lack sufficient size or credit standing to issue these unsecured notes at competitive rates. For small borrowers, issuing costs or commissions add appreciably to the costs of commercial paper.

Bankers' acceptances have several characteristics that enhance their attractiveness to bankers and make them competitive with alternative money-market instruments. A bank earns a commission, currently from 50 to 100 basis points, simply by originating an acceptance. In the process, the bank does not commit its own funds unless it chooses to discount the acceptance. Once discounted, the acceptance can be sold in the well-developed secondary market, providing the bank with a degree of liquidity and portfolio flexibility not afforded by most conventional loans.

The amount of credit extended to an individual customer may also be expanded through bankers' acceptances. Statutory restrictions limit the amount of conventional credit extended to a single bank customer by a Federal Reserve member bank. However, by the creation, discount, and sale of acceptances in the secondary market, a bank can facilitate a further extension of credit to a single customer up to an additional 10 percent of the bank's capital, provided that the acceptances are eligible for discount by the Federal Reserve.[5]

Bank funds received by the sale of eligible-for-discount acceptances in the secondary market are not subject to reserve requirements under current Federal Reserve regulations. This practice has proved especially useful for channeling funds from the nonbank sector to bank credit customers during tight credit periods when Regulation Q ceilings have reduced the flow of funds to banks.[6]

[5]An outstanding acceptance of a member bank that meets the eligible for discount requirements specified in Section 13 of the Federal Reserve Act is not included in that bank's legal lending limit for conventional loans—equal to 15 percent of paid-in capital and surplus, undivided profits, subordinated debt, and 50 percent of its loan loss reserve, to any one borrower. An outstanding acceptance—which meets Section 13(7) conditions of the Federal Reserve Act—of a U.S. branch or agency of a foreign bank subject to reserve requirements under Section 7 of the International Banking Act of 1978 is also excluded from that bank's per customer limit for conventional loans. State-chartered nonmember banks and state-chartered U.S. branches and agencies of foreign banks are subject to state-imposed limitations on loans. In Illinois, for example, state-chartered nonmember U.S. banks have a legal limit for conventional loans to a single borrower of 15 percent of capital and surplus, excluding undivided profits. An Illinois-chartered nonmember bank may create acceptances for a single borrower, separate from its legal lending limit on conventional loans, in an amount up to 15 percent of capital and surplus or, if the excess is secured, up to 50 percent of capital and surplus.

[6]See Gary L. Alford, "Tight credit and the banks . . . 1966 and 1969 compared," *Business Conditions*, Federal Reserve Bank of Chicago (May 1970) pp. 4-11.

Investors hold bankers' acceptances for yield, security, and liquidity. The rates of return on acceptances have been competitive with the returns on other money-market instruments such as commercial paper and negotiable certificates of deposit. Many investors view acceptances as one of the safest forms of investment, given the primary obligation for repayment of the accepting bank and the secondary liability of the acceptance drawer. Top quality acceptances are highly liquid in the active secondary market.

Federal Reserve acceptance activities

Federal Reserve authority to regulate the creation of bankers' acceptances by depository institutions and to acquire bankers' acceptances for its own portfolio is derived from the Federal Reserve Act of 1913. Such authority has been modified by the 1915 amendments to the Act, provisions of the Monetary Control Act of 1980, and Section 207 of the Export Trading Company Act of 1982. This legislative authority provides the basis for the bankers' acceptance regulations of the Board of Governors of the Federal Reserve System—primarily Regulations A, D, and K and regulations relating to Federal Reserve open-market operations. The regulations are augmented by published Board interpretations of rules governing creation, discount, and rediscount of acceptances.

Early Federal Reserve regulations of acceptances created by its member banks focused on assurances of the quality of the instruments and the soundness of the creating banks. The Board also placed limits on the volume of acceptances available for potential discount at the Federal Reserve. Three avenues were provided for the Federal Reserve to legally acquire bankers' acceptances. The twelve Reserve Banks in the Federal Reserve System were permitted to discount (technically rediscount) member bank acceptances deemed "eligible for discount," to advance funds secured by member bank acceptances, and finally, the Federal Reserve could purchase and sell bankers' acceptances through open-market operations. Each of these transactions affected total reserves in the banking system.

Historically, most Federal Reserve transactions in acceptances arose through open-market operations.[7] Until March 1977 the Fed's Domestic Open Market Desk, located at the Federal Reserve Bank of New York, bought and sold bankers' acceptances. Fed purchases or sales from dealers in the secondary acceptance market increased or decreased reserves, respectively, in the banking system in the same manner as its dealer purchases and sales of U.S. Treasury securities. Compared to total open market operations, however, Fed purchases and sales of acceptances were small.

The Federal Reserve Open Market Committee in March 1977 directed the Open Market Desk to discontinue the outright purchase of bankers' acceptances for the Fed's own account. One reason for the discontinuance was that Federal Reserve direct purchases and sales were no longer deemed necessary to support the well-developed secondary market for acceptances. Acceptance activity for the Fed's own account now is confined to repurchase agreements.

The Fed also acts as an "agent" for foreign central banks wishing to acquire acceptances for investment purposes. Until the practice was discontinued in November 1974, the Federal Reserve also added its endorsement to such acceptances, thus enhancing the security of the instruments by effectively guaranteeing payment.

Acceptance eligibility

The Federal Reserve Act (section 13.7) specifies the general conditions under which a member bank can create an acceptance and limits the dollar volume of acceptances that may be outstanding by an individual bank. Acceptances that meet the requirements specified in Section 13(7) (see Table 1) are *eligible for discount* at the Federal Reserve, as specified in Section 13(6). Supervision and regulation of bankers' acceptances have evolved around this concept of eligibility, thereby influencing the structure of the market. Eligibility also has served as a quality benchmark in the secondary market.

Some bankers' acceptances are *eligible for purchase* by the Federal Reserve (according to rules of the Federal Open Market Committee) under marginally less stringent conditions than are those that are eligible for discount (see Table 1). It should be noted that any acceptance that is *eligible for discount,* that is, meets the conditions of 13(7) of the Federal Reserve Act, is also eligible for purchase. The reverse, however, is not true. An acceptance that meets all the conditions of 13(7) save that it has a maturity greater than six months and up to nine months is eligible for purchase but not for discount. *Eligible for purchase* is also somewhat misleading. Under current regulations this terminology actually refers to requirements that apply to repurchase agreements between acceptance dealers and the Fed, not an outright purchase for the Fed's own account. Before the Federal Reserve will enter into a repurchase agreement for an individual acceptance, the bank creating it must have established itself in the market and must have met Federal Reserve requirements that qualify the bank as a "prime bank."[8] The prime bank requirements must be met for acceptances in each eligibility category—discount or purchase—before the acceptance can be used in a Fed repurchase agreement. Bankers' acceptances that do not qualify as eligible for discount or purchase by the Federal Reserve are referred to as *ineligible* acceptances. In effect, this means that all acceptances that do not meet the conditions of Section 13(7) are ineligible. Such a classification could include acceptances that are eligible for purchase but are of "long" maturities. The market treats such acceptances as ineligible.

Reserve requirements against funds obtained from the rediscount of acceptances in the sec-

[7]Federal Reserve System monetary policy was initially conducted through the rediscount of bankers' acceptances and other eligible paper. However, by the mid-1920s purchases of government securities exceeded holdings of discounted bills. In subsequent years open market operations of the System dominated rediscounting. For a discussion of the historical background of bankers' acceptances, see an article by Michael A. Goldberg, "Commercial Letters of Credit and Bankers Acceptances," pp. 175-185, in *Below the Bottom Line: The Use of Contingencies and Commitments by Commercial Banks*, Staff Studies 113 (Board of Governors of the Federal Reserve System, 1982).

[8]For a discussion of the conditions necessary for a bank to be designated a prime bank, see Ralph T. Helfrich, "Trading in Bankers' Acceptances: A View from the Acceptance Desk of the Federal Reserve Bank of New York," *Monthly Review*, Federal Reserve Bank of New York (February 1976) pp. 56-57.

Table 1: bankers' acceptances—characteristics governing eligibility, reserve requirements, and aggregate acceptance limits

	Federal Reserve System treatment			
	Eligible for discount[1]	Eligible for purchase[2]	Reserve requirements apply if sold[3]	Aggregate acceptance limits apply[4]
Bankers' acceptance categories				
1. Specific international transactions				
a. U.S. exports or imports				
Tenor - 6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
b. Shipment of goods **between** foreign countries:				
Tenor - 6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
c. Shipment of goods **within** a foreign country:				
Tenor - any term	no	no	yes	no
d. Storage of goods within a foreign country—**readily marketable** staples secured by warehouse receipt issued by an independent warehouseman:[6]				
Tenor - 6 months or less	yes[5]	no	no	yes
6 months to 9 months	no	no	yes	no
e. Dollar exchange - required by usages of trade in approved countries only:				
Tenor - 3 months or less	yes	no	no[7]	yes
more than 3 months	no	no	yes	no
2. Specific domestic transactions (i.e., within the U.S.)				
a. Domestic shipment of goods[8]:				
Tenor - 6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
b. Domestic storage - **readily marketable** staples secured by warehouse receipt issued by independent warehouseman:[6]				
Tenor - 6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
c. Domestic storage - **any** goods in the U.S. under contract of sale or going into channels of trade secured throughout their life by warehouse receipt:				
Tenor - 6 months or less	no	yes	yes	no
6 months to 9 months	no	yes	yes	no
3. Marketable time deposits (finance bills or working capital acceptances) not related to any specific transaction				
Tenor - any term	no	no	yes	no

This table is an adaptation from a table presented in an unpublished paper from the 7th Annual CIB Conference at New Orleans, October 13, 1975 by Arthur Bardenhagen, Vice President, Irving Trust Company, New York.

[1]In accordance with Regulation A of the Board of Governors as provided by the Federal Reserve Act.

[2]Authorizations for the purchase of acceptances as announced by the Federal Open Market Committee on April 1, 1974.

[3]In accordance with Regulation D of the Board of Governors as provided by the Federal Reserve Act.

[4]Member banks may accept bills in an amount not exceeding at any time 150 percent (or 200 percent if approved by the Board of Governors of (as defined the Federal Reserve System) of unimpaired capital stock in FRB, Chicago Circular No. 2156 of April 2, 1971) Acceptances growing out of domestic transactions are not to exceed 50 percent of the total of a bank's total acceptance ceiling.

[5]The tenor of nonagricultural bills may not exceed 90 days at the time they are presented for discount with the Federal Reserve.

[6]As of May 10, 1978, the Board of Governors issued the interpretation that bankers' acceptances secured by field warehouse receipts covering readily marketable staples are eligible for discount. Readily marketable staples are defined, in general, as nonbranded goods for which a ready and open market exists. There is a regularly quoted, easily accessible, objective price setting mechanism that determines the market price of the goods.

[7]Proceeds from the sale of an eligible for discount dollar exchange acceptance are not specifically exempted from reserve requirements under Regulation D, Section 204.2 a(vii) (E) effective November 13, 1980, of the Board of Governors as are other acceptances that meet the condition of Section 13(7) of the Federal Reserve act. However, the Federal Reserve Board's legal staff issued an opinion January 15, 1981, stating that the proceeds from the sale of eligible dollar exchange acceptances are exempt from reserve requirements.

[8]Prior to the amendment to Section 13(7) of the Federal Reserve act (October 8, 1982) domestic shipment acceptances required documents conveying title be attached for eligible for discount to apply.

NOTE: Tenor refers to the duration of the acceptance from its creation to maturity. An eligible for discount acceptance must be created by or endorsed by a member bank, according to Section 13(6) of the Federal Reserve Act.

ondary market are an important consideration in acceptance creation and regulation. Until 1973 member banks' funds derived from the sale of eligible as well as ineligible acceptances were free from reserve requirements. In mid-1973 the Federal Reserve Board ruled that member banks who derived funds from ineligible acceptances—those that did not meet Section 13(7) conditions—had reserve requirements on those funds.[9]

The Monetary Control Act of 1980 brought nonmember institutions under the reserve requirement authority of the Federal Reserve.[10] Regulations to implement this act also extended reserve-free treatment to funds derived from the sale of acceptances in the secondary market by these institutions. To qualify as nonreservable funds the underlying acceptances (technically eligible for purchase) were to be "of the type" specified in Section 13(7) of the Federal Reserve Act.

These rules have blurred the distinctions between acceptance eligibility for discount and for purchase. Member bank officials indicate that most acceptances created by these banks are eligible for discount. The secondary market applies a lower discount (i.e., interest rate) to acceptances that are eligible for discount and to all eligible acceptances from prime banks.

To the limited extent that nonmember depository institutions create acceptances, their instruments tend to meet the conditions of Section 13(7). Therefore, the funds obtained through rediscount in the secondary market are treated as nonreservable.

Most institutions avoid creating ineligible acceptances, because such instruments are not well received in the secondary market. In addition, reserve requirements apply when these acceptances are rediscounted in the secondary market. To the extent ineligible acceptances arise, they are usually held in the account of the bank that created them.

The secondary market

Banks place acceptances in the secondary market through two channels—direct placements and a network of dealers who "make a market" in the instruments.

The direct sale of acceptances in-house by banks' newly established money-market and investment departments has helped these banks to satisfy customer demand for short-term investments with relatively high yields. Such direct sales allow banks to avoid the added costs of selling through acceptance dealers—still the primary outlet for acceptances.

Bankers' acceptances are sold in the secondary market by a small group of money-market dealers who act as intermediaries between banks and investors. The dealer network is centered in New York City, where about 50 percent of the dollar volume of all acceptances is created. The Open Market Desk of the Federal Reserve Bank of New York is the center of Federal Reserve acceptance activity.

The dealer market has five tiers. The first tier consists of the ten largest acceptance creating domestic banks. Because acceptances of the top-tier banks are generally viewed as the safest and most marketable, these instruments command the lowest rates (i.e., discounts) in the dealer market. Second-tier banks are the next-to-largest U.S. banks in terms of acceptance creation. By virtue of their reputation among dealers and investors, second-tier acceptances usually trade at rates very close to rates for the first tier. Third- and fourth-tier institutions are those remaining U.S. banks that are somewhat active in the dealer acceptance market. Secondary market rates on lower tier acceptances vary considerably across these instruments, but are substantially higher than rates for the top two tiers.

The fifth tier of banks consists of foreign-owned institutions. A subcategory within this tier includes acceptances originated by U.S. branches of Japanese banks. These "Yankee BAs" and others in the fifth tier trade at considerably higher rates than acceptances of comparable U.S.

[9]In the early 1970s funds derived from the sale of ineligible acceptances were not subject to reserve requirements. A number of banks used this fact to advantage during periods of tight credit by creating a substantial volume of finance bills, or working capital acceptances (ineligible), and placing them in the secondary market. The Board of Governors imposed reserve requirements in mid-1973 on bank funds acquired through such instruments, sharply curtailing banks' activity in ineligibles.

[10]Prior to the Monetary Control Act of 1980, reserve requirements on nonmember bank funds acquired from the sale of ineligible bankers' acceptances in the secondary market were set by state banking laws.

banks. The main reason appears to be the lack of investor recognition of the names and credit standings of these foreign banks—even those among the largest banks in the world. Presumably, rate differentials between fifth-tier acceptances and those in the upper tiers will be lower in the future if information and efficiency in the secondary market improves.[11]

Acceptances in the top two tiers are eligible for discount, having been created by member banks.[12] Indeed, dealers are disinclined to trade acceptances that are ineligible for discount or that meet only minimum requirements of eligibility for Fed purchase. All dealers exclude ineligible acceptances from the conventional tier structure, and some dealers refuse to trade ineligible acceptances.

Current regulatory issues

Prior to the amendment of Section 13(7) of the Federal Reserve Act in October 1982, total outstanding acceptances of an individual bank—acceptances created but not held by the bank—were limited to an amount equal to or less than ". . . one-half of its paid-up and unimpaired capital stock and surplus." Subject to approval from the Federal Reserve Board, the limit on outstanding acceptances could be raised to an amount up to 100 percent of paid-in capital and surplus.

These ceilings posed problems for many major acceptance banks in the late 1970s, even though all major acceptance creating banks had been allowed to expand their individual limits ("aggregate ceilings") on the total volume of acceptances outstanding to 100 percent of capital stock plus surplus.[13] Rapid growth in acceptance volume outpaced the modest growth in banks' capital and threatened to slow the growth of the acceptance market or divert much of the growth to smaller regional banks and U.S. branches of foreign banks.

Legislation relaxing the ceiling on outstanding acceptances, introduced in the Congress in 1981, finally was enacted in October 1982 as part of the Export Trading Company Act of 1982. Section 207 of this act amended Section 13(7) of the Federal Reserve Act in five significant areas, including increases in the aggregate ceilings on acceptances (see box on recent legislation). For the most part, this legislation avoided a number of fundamental issues and simply focused on relaxing the permissible ceiling for acceptances as an expedient for market expansion. Further flexibility for individual institutions was provided by permission for "covered" institutions to "participate out" acceptances with other "covered" institutions (member banks and U.S. branches of foreign banks). Through such participations, they are, in effect, permitted to pool the amount of acceptances as a percentage of their joint capital. The acceptance creating bank is allowed to remove the participated acceptance from the amount that counts against its total aggregate ceiling and the amount is added to the total that counts against the other bank's aggregate ceiling.

The debate over this legislation has prompted renewed interest in a broad range of issues, including concentration in the primary and secondary acceptance markets, application of reserve requirements to acceptances, regulatory and institutional features of the secondary market, and the more basic issue of the uniqueness of acceptances for regulatory purposes.

The provisions of the Export Trading Com-

[11]For additional details on the operation of the secondary market, see William C. Melton and Jean M. Mahr, "Bankers Acceptances" *Quarterly Review* of the Federal Reserve Bank of New York, Vol. 6, No. 2 (Summer 1981) pp. 39-55.

[12]Recall that a member bank acceptance that meets the requirements of Section 13(7) is eligible for discount. For a nonmember bank, an acceptance meeting the same conditions is eligible for purchase (see Table 1). A member or nonmember bank may create an acceptance that is eligible for purchase but that does not meet the requirements of Section 13(7), because its original maturity is in excess of 180 days. Proceeds from the sale of such an ineligible acceptance in the secondary market would be subject to reserve requirements.

[13]Ceilings on the total amount of eligible acceptances outstanding by an individual bank may have resulted in an anomaly in the market. Suppose a member bank creates an acceptance that is eligible for discount in all respects, except the bank now exceeds its Section 13(7) aggregate ceiling. Because such an acceptance does not meet all Section 13(7) requirements, it becomes ineligible for regulatory purposes and subject to reserve requirements. However, the secondary market will treat that acceptance as eligible. It should be noted that this informal interpretation is widely, but not uniformly, accepted and, consequently, needs clarification

Recent acceptance legislation

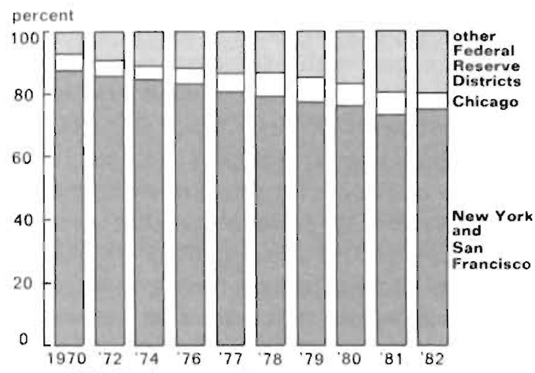
Section 13(7) of the Federal Reserve Act (12 U.S.C. 372), the principal statute governing acceptance creation, was amended in Section 207 of the Export Trading Company Act of 1982. Section 207 contains five modifications in the regulations governing acceptances, four of which deal with ceilings on outstanding acceptances of individual financial institutions.

- The volume of outstanding acceptances—those sold in the secondary market—was raised from 50 percent to 150 percent of an individual financial institution's "paid-up and unimpaired capital stocks and surplus." This 150 percent rule applies to the maximum amount of outstanding acceptances that an individual institution can have and still qualify its acceptances as eligible for discount under Section 13(6) or purchase under Federal Open Market Committee regulations. Subject to Board approval, the 150 percent rule is relaxed. The upper limit on outstanding acceptances then becomes 200 percent of a financial institution's paid-up capital and surplus. The previous limit subject to Board approval was 100 percent.
- Member banks and U.S. branches and agencies of foreign banks ("covered institutions") now are permitted to participate an acceptance with other such institutions, provided that the participation meets Federal Reserve regulation. By "participating out" a portion of its acceptances to another institution, the creator of the acceptances does not need to count the participated portion in calculating its level of outstanding acceptances—it does not count against its aggregate ceiling—provided that the participating institution is a Federal Reserve member or a qualified U.S. branch or agency of a foreign bank.
- Any federal or state branch or agency of a foreign bank subject to reserve requirements under Section 7 of the International Banking Act of 1980 now becomes subject to the provisions of Section 13(7) of the Federal Reserve Act. In particular, these institutions become subject to aggregate ceilings on outstanding acceptances, stated in terms of the outstanding acceptances of all U.S. branches and agencies of a given foreign bank as a percentage of the total capital and surplus of the parent institution. No federally imposed aggregate ceilings on outstanding acceptances previously applied to foreign institutions.
- Total acceptances arising from domestic transactions (shipping and storage) may not exceed 50 percent of an individual institution's allowable outstanding acceptances, including participations. The previous ceiling for domestic acceptances was 50 percent of an institution's paid-in capital and surplus.
- Shipping documents conveying or securing title no longer must be attached at the time of origination for eligible acceptances that finance domestic shipments. This change eliminates a crucial difference in the definition of eligible acceptances between foreign and domestic acceptances in the shipments category.

pany Act could slow, or even reverse, the restructuring of the supply side of the market in recent years, evidenced by increased acceptance origination at regional banks and U.S. branches of foreign banks (see Figures 3 and 4). A reconcentration of the market, prompted by the increase in acceptance ceilings for large banks, actually might be favored by the secondary market. Such concentration deepens the market for the most liquid acceptances in the top tiers at the expense of growth and deepening of the market for acceptances in the lower tiers.

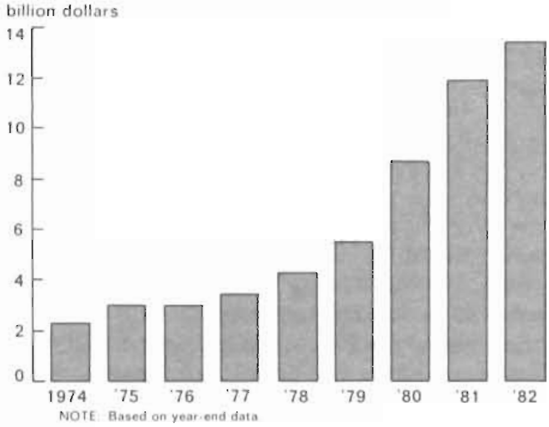
Banking, trade, transportation, and communications have changed drastically over the more than 50 years of acceptance legislation. It

Figure 3
Regional banks increase their share of the acceptance market



NOTE: Based on year-end data.

Figure 4
Acceptances outstanding from U.S. branches and agencies of foreign banks triple since 1978



can be argued that the regulation of bankers' acceptances has failed to keep pace. Implementation of the Monetary Control Act of 1980 left little practical application for the concept of eligibility for discount as applied to member bank acceptances. The principal application of this concept, as specified in the amended Section 13(7) of the Federal Reserve Act, arises in outlining the administrative rules for acceptances of nonmember depository institutions.

The maturity, or tenor, of created acceptances has been a point of confusion in the market. According to amended Section 13(7) and subsequent legislation, member banks may create acceptances eligible for discount with maturities up to 180 days. Under current Open Market Committee regulations, depository institutions in general may create acceptances eligible for purchase with maturities up to 180 days. Neither category with a 180-day maturity is subject to reserve requirements when sold in the secondary market. However, Open Market Committee regulations also permit the creation of acceptances eligible for purchase with maturities up to 270 days. Such acceptances with maturities over 180 days are subject to reserve requirements when sold in the secondary market. Confusion sometimes arises because of the regulatory anomaly that acceptances eligible for purchase with original maturities between 180 and 270 days are subject to reserve requirements when sold in the secondary market, even if the remaining maturity at the time of such sale does not exceed 180 days.

Two regulatory and institutional aspects of the secondary acceptance market deserve careful reexamination. One such feature is the extensive paper shuffling that results from acceptances being physically transported from banks to dealers to investors. Existing technology for book-entry and electronic transactions could be applied to make secondary market transactions substantially more efficient, especially for investors not located near dealers. A second feature needing reexamination is the tier structure of the market, which probably understates the quality of acceptances in the lower tiers, particularly the dollar acceptances of foreign banks.

Back to basics

Bankers, regulators, and economists disagree over basic issues of the uniqueness of bankers' acceptances and the appropriateness of special regulations covering these instruments. The argument for uniqueness derives from the linkage between the provision of credit and a specific trade transaction matched in maturity and amount. This linkage is considered the basic distinguishing feature of an acceptance. The opposing view, however, emphasizes that it is becoming increasingly difficult to identify many acceptances on the basis of such a linkage to trade. The importance of the linkage of an acceptance to specific imported goods derives from the traditional "self-liquidating" nature of the credit provided by an acceptance. That is, the credit obligation of the acceptance can be liquidated through the sale of the imported goods to which the acceptance is specifically tied. It can be argued, however, that the self-liquidating nature of acceptances does not provide a convincing rationale for the special regulatory status of acceptances.

To understand the funding properties of an acceptance, it is useful to compare a bank's acceptance activity to its funding of a conventional loan through the sale of a certificate of deposit (CD). Three principal differences exist for the two types of bank funding operations. The first is that under current regulations the funds obtained through the sale of an eligible bankers' acceptance in the secondary market are not subject to reserve requirements. Therefore, acceptances provide a potentially cheaper source of funds than CDs on which reserve requirements are applied.

Second, theoretically an acceptance is tied to a specific transaction for a stated time period. While it is true that the importer may extinguish its liability at any time by prepaying it to the accepting bank, there is little incentive to do so because the effective cost of the credit extended would increase. In the case of CD funding of trade credit, the maturity of the loan and the maturity of the CD funding instrument in most cases would not coincide. The loan may be secured by the trade shipment, but the loan and the traded goods are not directly related to the CD. Bank funds raised through CD issuance are fungible—i.e., these funds can be used for any permissible bank investment purpose. On the other hand, an acceptance theoretically is tied to a specific transaction. The acceptance may not be "rolled over," (unless under exceptional circumstances such as the goods being tied up at dockside due to a dock strike, for example) nor may a new acceptance be created to cover the same transaction. If an extension of credit were needed to finance the transaction for a longer period than permitted under the terms of the original acceptance an alternative credit arrangement would be required. If the lending bank were to extend the customer's credit, the funding of that loan would have to incorporate some alternative liability management arrangement. Therefore, trade financing through acceptances and through loans financed by CDs have differing implications for asset-liability management.

The third difference between these funding techniques deals with the types of investor security provided by the instruments. For a bankers' acceptance acquired in the secondary market, the investor is protected by the primary liability of the acceptance bank and the secondary, or contingent, liability of the drawer of the acceptance. The CD holder has only the primary liability of the issuing bank (plus deposit insurance protection up to $100,000).

To date, the distinctions between bankers' acceptances and other funding methods have been viewed by legislators and regulators as sufficient reasons for treating acceptances as special instruments. As a result, bankers' acceptances continue to be distinct financial instruments that are growing in importance and gaining increased market approval. This view could change in the future, however, for as the size of the market increases, the issues of uniqueness and preferential regulation are likely to receive a more critical appraisal.

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