THE BANKER'S ACCEPTANCE: AN EXAMINATION AND ANALYSIS
OF THE INSTRUMENT AND MARKET

DISSERTATION

Presented to the Graduate Council of the
North Texas State University in Partial
Fulfillment of the Requirements

For the Degree of

DOCTOR OF PHILOSOPHY

By

Hoyet W. Wilson, B.B.A., M.B.A.

Denton, Texas

May, 1980

The purpose of this dissertation is to examine and analyze the banker's acceptance and the bankers' acceptance market. A banker's acceptance is a money market instrument used to finance the export, import, movement, and storage of goods; it begins as a trade draft, and it is termed accepted when a commercial bank guarantees payment. Volume is presently about $40 billion and growing rapidly.

The banker's acceptance represents an historical evolution of the medieval bill of exchange. The banker's acceptance as we know it today first appeared in England in the 1820s. The birth of the banker's acceptance in the United States occurred with passage of the Federal Reserve Act in 1913. Volume in the bankers' acceptance market from 1917 through 1979 progressively increased in economic expansions, steadily declined in prolonged economic contractions, and reached low points during wartime activity.

A banker's acceptance is termed commercial paper under the Uniform Commercial Code. Commercial banks record a contingent liability on the balance sheet when they accept a draft. The growth of acceptance financing has produced
billion dollar assets and billion dollar liabilities on U.S. commercial bank balance sheets.

A survey was made of the twenty largest U.S. commercial banks in order to determine certain perceived characteristics of the banker's acceptance and the bankers' acceptance market. Four questions were presented on the survey questionnaire. The first question on the survey questionnaire asked the respondent for his perceptions regarding the competitive disadvantages surrounding the instrument. The second question on the survey questionnaire asked the respondent to indicate whether he perceived prime bankers' acceptances could be pooled to make them more marketable. The third question on the survey questionnaire asked the respondent whether he perceived a clearinghouse technique would be practical in pooling bankers' acceptances. The fourth question on the survey questionnaire asked the respondent whether he perceived a commercial bank could issue a certificate or instrument representing an undivided interest in a pool of prime bankers' acceptances of comparable maturity.

As a result of the survey, a new money market instrument is suggested. The new money market instrument is to be called a Banker's Acceptance Participation Certificate. The Banker's Acceptance Participation Certificate would represent an undivided interest in a group of bankers'
acceptances, each underlying acceptance representing the financing of a specific foreign trade transaction that would be of a self-liquidating nature. The Banker's Acceptance Participation Certificate would have a three-tier set of guarantees: on the first tier, the guarantee of the clearinghouse; on the second tier, the guarantee of the accepting bank for each individual acceptance; and on the third tier, the self-liquidating nature of the individual foreign trade transaction.
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I.</td>
<td>THE BANKER'S ACCEPTANCE: A GENERAL DESCRIPTION OF AND BACKGROUND ON THE INSTRUMENT</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>The Mechanics of the Banker's Acceptance</td>
<td></td>
</tr>
<tr>
<td>II.</td>
<td>HISTORY OF THE BANKER'S ACCEPTANCE AND THE BANKERS' ACCEPTANCE MARKET TO 1965</td>
<td>18</td>
</tr>
<tr>
<td></td>
<td>History of the Banker's Acceptance</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The Early History of the Banker's Acceptance in the United States</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The Growth of the Bankers' Acceptance Market from 1956 to 1965</td>
<td></td>
</tr>
<tr>
<td>III.</td>
<td>THE BANKER'S ACCEPTANCE AND THE BANKERS' ACCEPTANCE MARKET SINCE 1965</td>
<td>37</td>
</tr>
<tr>
<td></td>
<td>The Relationship between Bankers' Acceptances: U.S. Exports and U.S. Imports</td>
<td></td>
</tr>
<tr>
<td>IV.</td>
<td>TECHNICAL ASPECTS OF THE BANKER'S ACCEPTANCE AND THE BANKERS' ACCEPTANCE MARKET</td>
<td>56</td>
</tr>
<tr>
<td></td>
<td>Taxation Aspects of the Banker's Acceptance</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Legal Aspects of Bankers' Acceptances</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accounting for Bankers' Acceptances</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Federal Reserve Eligibility Requirements for Bankers' Acceptances</td>
<td></td>
</tr>
<tr>
<td>V.</td>
<td>THE STRUCTURE AND FUNCTIONING OF THE BANKERS' ACCEPTANCE MARKET</td>
<td>93</td>
</tr>
<tr>
<td></td>
<td>The Structure of the Bankers' Acceptance Market</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Pricing and Trading in the Bankers' Acceptance Market</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dealer Trading Relationship with the Federal Reserve</td>
<td></td>
</tr>
</tbody>
</table>
## TABLE OF CONTENTS--Continued

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>VI. A PROPOSED FRAMEWORK FOR THE IMPROVED MARKET-ABILITY OF THE BANKER'S ACCEPTANCE</td>
<td>110</td>
</tr>
<tr>
<td>The Survey of Commercial Banks</td>
<td></td>
</tr>
<tr>
<td>An Evaluation of the Results of the Study</td>
<td></td>
</tr>
<tr>
<td>The Conceptual Framework for Polling or Combining Bankers' Acceptances</td>
<td></td>
</tr>
<tr>
<td>Summary and Conclusions</td>
<td></td>
</tr>
<tr>
<td>VII. SUMMARY AND CONCLUSIONS</td>
<td>128</td>
</tr>
<tr>
<td>History of the Banker's Acceptance</td>
<td></td>
</tr>
<tr>
<td>The Banker's Acceptance Today</td>
<td></td>
</tr>
<tr>
<td>The Banker's Acceptance Tomorrow</td>
<td></td>
</tr>
<tr>
<td>APPENDIX A: QUESTIONNAIRE ON THE BANKERS' ACCEPTANCE MARKET</td>
<td>142</td>
</tr>
<tr>
<td>APPENDIX B: CORRESPONDENCE WITH THE ACCEPTANCE COMMUNITY</td>
<td>145</td>
</tr>
<tr>
<td>APPENDIX C: THE PRIMARY DEALERS IN BANKERS' ACCEPTANCES</td>
<td>160</td>
</tr>
<tr>
<td>BIBLIOGRAPHY</td>
<td>162</td>
</tr>
</tbody>
</table>
# LIST OF TABLES

<table>
<thead>
<tr>
<th>Table</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. The Dollar Volume of Bankers' Acceptances Outstanding, 1956-1965 (in Millions)</td>
<td>35</td>
</tr>
<tr>
<td>II. The Dollar Volume of Bankers' Acceptances Outstanding, 1965-1977 (in Millions)</td>
<td>38</td>
</tr>
<tr>
<td>III. U.S. Exports and GNP</td>
<td>40</td>
</tr>
<tr>
<td>IV. Acceptances Made for Account of Foreigners and Held by Commercial Banks, 1969-1978 (in Millions)</td>
<td>42</td>
</tr>
<tr>
<td>V. Acceptances Made for Account of Foreigners and Held by Commercial Banks, 1969-1978 (in Millions)</td>
<td>43</td>
</tr>
<tr>
<td>VI. A Profile of the Holders of Bankers' Acceptances, 1968-1976</td>
<td>48</td>
</tr>
<tr>
<td>VII. Commercial Paper Supported by Letter of Credit Outstanding as of February 28, 1979</td>
<td>54</td>
</tr>
<tr>
<td>VIII. Bankers' Acceptances on the Balance Sheets of the Five Largest U.S. Commercial Banks, December 31, 1977 (000's Omitted)</td>
<td>89</td>
</tr>
<tr>
<td>IX. Quarterly Trading Spreads between 90-Day Prime Bankers' Acceptances and Three-Month Treasury Bills, 1973-1979</td>
<td>102</td>
</tr>
<tr>
<td>XI. The Twenty Largest Commercial Bank Companies</td>
<td>112</td>
</tr>
<tr>
<td>XII. A Tabulation of the Results of the Survey of the Bankers' Acceptance Market</td>
<td>117</td>
</tr>
<tr>
<td>Figure</td>
<td>Description</td>
</tr>
<tr>
<td>--------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>1.</td>
<td>The Mechanics of the Banker's Acceptance</td>
</tr>
<tr>
<td>2.</td>
<td>The Mechanics of the Eurocurrency Banker's Acceptance</td>
</tr>
<tr>
<td>3.</td>
<td>The Transactions Described in the Bill of Exchange Drawn by Barna of Lucca, October 5, 1339</td>
</tr>
<tr>
<td>4.</td>
<td>The Volume of Bankers' Acceptances, 1917-1955</td>
</tr>
<tr>
<td>5.</td>
<td>The Volume of Bankers' Acceptances, 1966-1977</td>
</tr>
<tr>
<td>7.</td>
<td>A Trade Acceptance</td>
</tr>
<tr>
<td>8.</td>
<td>A Banker's Acceptance</td>
</tr>
<tr>
<td>11.</td>
<td>A Proposed Clearinghouse Technique for Bankers' Acceptances</td>
</tr>
</tbody>
</table>
CHAPTER I

THE BANKER'S ACCEPTANCE: A GENERAL DESCRIPTION OF
AND BACKGROUND ON THE INSTRUMENT

A banker's acceptance is a money market instrument used to finance the export, import, movement, or storage of goods, and it is termed accepted when a commercial bank guarantees payment. A banker's acceptance differs from a trade acceptance in that the former is accepted, i.e., guaranteed for payment, by a commercial bank, while the latter is usually accepted by a relatively unknown party, such as an importer. Should the accepting commercial bank be a recognized institution in the market, the banker's acceptance is termed a prime banker's acceptance. Bankers' acceptances are money market instruments because they usually have maturities of one year or less.

The essence of a banker's acceptance is credit substitution. The credit and reputation of a recognized, public institution—a commercial bank—are substituted for those of a less widely-known business firm. The credit and reputation of the Bank of America are widely recognized. The credit and reputation of XYZ Trading Co. are by comparison virtually unknown. When the Bank of America accepts a draft drawn by XYZ Trading Co., the bank commits
its substantial resources and credit to the ultimate payment of the draft. A banker's acceptance thus represents the substitution of the credit of a commercial bank for the credit of an unknown exporter, i.e., the bank's credit and reputation result in the banker's acceptance being in fact acceptable.

Because the banker's acceptance is so well traveled along foreign trade channels, it is known by different terms in the world's major trading languages as shown below:

- Dutch--bankaccept
- French--acceptation de banque
- German--Bankakzept
- Italian--accettazione bancaria
- Japanese--銀行引受手形
- Spanish--aceptación bancaria

The instrument arose in eighteenth-century English business practices (Chapter II details the historical evolution) and is known in England today as the bank acceptance. Thus the banker's acceptance is an instrument that has a long and widely-known heritage in foreign commerce.

The purpose of this chapter is to examine the function and mechanics of the banker's acceptance. After a detailed illustration of the mechanics of the instrument, some variations upon the basic banker's acceptance theme will be examined such as the "pre-export acceptance," used to
finance the accumulation of goods for export sale; the "post-import acceptance," used to finance an importer seeking to place merchandise in channels of distribution; and the "dollar exchange acceptance," which has no specific underlying foreign trade transaction.

The Mechanics of the Banker's Acceptance

A foreign trade transaction involving a banker's acceptance is drawn under a letter of credit. A letter of credit is a formal document in letter form addressed to and authorizing the beneficiary (e.g., exporter) to draw a draft to a stated amount of money against the accepting bank. The letter of credit serves notice that a draft may be drawn upon the bank to finance a specific foreign trade transaction. The letter of credit may be one of four basic types:¹

1. An irrevocable letter of credit issued by a U.S. commercial bank and confirmed irrevocably by a foreign commercial bank, thus representing the obligation of two banks.

2. An irrevocable letter of credit issued by a U.S. commercial bank at the request of a foreign bank, thereby representing the obligation of only one commercial bank, i.e., the U.S. bank.

3. An irrevocable letter of credit issued by a foreign commercial bank and for which a U.S. commercial bank merely advises the importer that the letter has been issued, thus representing the responsibility of one bank, i.e., the foreign bank.

4. A revocable letter of credit, representing the responsibility of neither the importer's bank nor the exporter's bank. Exporters prefer the irrevocable letter of credit because it constitutes the guarantee of a commercial bank, whereas the revocable letter of credit is merely a letter advising that the transaction is passing through banking channels.

A comprehensive foreign trade transaction involving a banker's acceptance drawn under a letter of credit is presented in Figure 1. The example is that involving an import banker's acceptance: a U.S. importer seeks to purchase wine from a French exporter. Because the importer's credit standing is unknown in France but is known in the United States, a letter of credit issued by a major commercial bank provides the means of reconciling the credit interests of both parties. The U.S. importer and the French exporter agree upon the terms of the commercial transaction (Step 1), after which the importer obtains a letter of credit from his commercial bank (Step 2). Upon execution of the letter of credit the importer or
Fig. 1--The mechanics of the banker's acceptance
<table>
<thead>
<tr>
<th>Transaction</th>
<th>Brief Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Importer and exporter agree upon terms of transaction.</td>
</tr>
<tr>
<td>2</td>
<td>Importer obtains letter of credit from his bank.</td>
</tr>
<tr>
<td>3</td>
<td>Importer or importer's bank sends letter of credit to exporter.</td>
</tr>
<tr>
<td>4</td>
<td>Exporter receives letter of credit and ships merchandise to importer.</td>
</tr>
<tr>
<td>5</td>
<td>Exporter presents documents and draft to his bank.</td>
</tr>
<tr>
<td>6</td>
<td>Exporter receives discounted value of draft.</td>
</tr>
<tr>
<td>7</td>
<td>Exporter's bank sends documents and draft to its correspondent.</td>
</tr>
<tr>
<td>8</td>
<td>Correspondent presents documents and draft to importer's bank.</td>
</tr>
<tr>
<td>9</td>
<td>Importer's bank accepts draft as per letter of credit.</td>
</tr>
<tr>
<td>10</td>
<td>Importer's bank releases documents to importer permitting him to obtain merchandise.</td>
</tr>
<tr>
<td>11</td>
<td>Correspondent sells banker's acceptance in money market.</td>
</tr>
<tr>
<td>12</td>
<td>Correspondent receives discounted value of banker's acceptance.</td>
</tr>
<tr>
<td>13</td>
<td>Correspondent remits or invests proceeds of 12 for exporter's bank.</td>
</tr>
<tr>
<td>14</td>
<td>Importer pays his bank the face amount of the banker's acceptance.</td>
</tr>
<tr>
<td>15</td>
<td>Banker's acceptance is presented to importer's bank for payment.</td>
</tr>
<tr>
<td>16</td>
<td>Banker's acceptance is paid by importer's bank.</td>
</tr>
</tbody>
</table>

Fig. 1--Continued
his bank sends the letter of credit to the exporter (step 3).

Upon receipt of the letter of credit, the exporter ships the French wine to the U.S. importer (Step 4), and the exporter presents the documents including the draft to his bank (Step 5). It is important to note that documentation passes through the banking system, while the merchandise is sent through shipping channels. Further, the draft or bill of exchange has yet to become a banker's acceptance. The documents most frequently involved in addition to the draft are the commercial invoice, which describes the merchandise involved along with the terms of trade; the bill of lading, which provides evidence of shipment and conveys title; and the insurance certificate, which confirms the goods have been insured.

After presentation of documentation to his bank, the exporter receives the discounted value of the draft (Step 6). The banking system at this stage is providing export financing for the transaction enabling the exporter to be paid earlier than would otherwise occur in an export sale. The exporter's French bank sends the document and draft to its New York correspondent (Step 7), and the correspondent presents the documents and draft to the importer's bank (Step 8).
The importer's bank accepts the draft in accordance with the terms of the letter of credit (Step 9). It is at this stage that a commercial bank creates the banker's acceptance, viz., by stamping "accepted" on the face of the draft and thereby magically adding a commercial bank guarantee to the draft. The importer's bank releases the documents so that the importer may secure the French wine (Step 10). Upon receipt of the accepted draft (Step 9), the correspondent is presented with three alternatives: (1) retain the acceptance until maturity (2) discount the draft in the money market and invest in another money market instrument, or (3) discount the draft in the money market and remit the proceeds to the exporter's bank. It is assumed in the illustration that the correspondent bank sells the banker's acceptance in the New York money market (Step 11) and receives the discounted value of the acceptance (Step 12). Thus in this example the New York money market is a financial intermediary between importer and exporter providing financing for a foreign trade transaction.

The correspondent then remits or invests the proceeds of the discounted acceptance (Step 13). In this example it is assumed the correspondent discounted the acceptance in the money market. Before the acceptance matures, the importer must pay his bank the face amount of the banker's
acceptance (Step 14), and when the banker's acceptance is presented to the importer's bank (Step 15), the holder is paid.

As a result of these transactions, the New York money market has financed a foreign trade transaction, the shipment of wine from France to the United States. And the commercial banking system has provided credit substitution, the addition of a commercial bank's name to a draft. The instrument that has accomplished this is the banker's acceptance.

There are many variations on the international transaction diagramed and described above. The exporter rather than the importer may make arrangements for the acceptance credit. Or the exporter may draw a sight draft upon the importer and the importer might obtain credit from his bank by drawing a time draft upon his bank. Another variation is that the exporter may use acceptance credit to finance the accumulation of goods prior to a contracted shipment; such is an example of a "pre-export acceptance."² The pre-export acceptance works as follows: (1) a foreign exporter contracts to sell goods abroad, (2) the exporter arranges through his local bank to have an American bank accept his draft, (3) the exporter presents the draft

through banking channels, (4) the American bank accepts the draft and remits the proceeds through banking channels to the foreign exporter, (5) the foreign exporter uses the proceeds of acceptance credit to purchase the goods and ship the goods to the importer. The foreign exporter is the drawer of the pre-export acceptance, and the American bank is the acceptor of the draft. The maturity date of the pre-export acceptance is set to coincide with the expected payment date of the importer. The pre-export acceptance differs from a conventional banker's acceptance in that the pre-export acceptance provides credit to purchase the merchandise of the exporter.

Acceptance credit may also be used to finance an importer who has received merchandise and is seeking to place the merchandise in channels of distribution; such is an example of a "post-import acceptance." The post-import acceptance works as follows: (1) the importer arranges through a letter of credit with his bank to finance the temporary carrying of imported goods, (2) the importer presents the draft to his bank, (3) the importer's bank accepts the draft and remits the proceeds to the importer, (4) the importer uses the proceeds of the acceptance credit to finance the goods, which are expected to move into channels of trade within a relatively short period of time.

\^{3}\textit{Ibid.}, p. 129.
The importer is the drawer of the post-import acceptance and the importer's bank is the acceptor of the draft. The maturity date of the post-import acceptance is set to coincide with the expected payment date of the importer's customer.

Bankers' acceptances may be used to finance domestic trade, such as the storage of readily marketable commodities and the shipment of goods within the United States. The domestic banker's acceptance works as follows: (1) the domestic buyer and the domestic seller agree upon the terms of the transaction, (2) the buyer obtains a letter of credit from his bank and sends the letter of credit to the seller, (3) the seller ships the merchandise to the buyer, (4) the seller sends the draft and supporting documentation through banking channels to the buyer's bank, (5) the buyer's bank accepts the draft and returns the draft to the seller, (6) the buyer's bank releases the documents to the buyer, (7) the buyer pays the face amount of the draft.

Commercial banks may also issue acceptances on commodities evidenced by warehouse receipts. The banker's acceptance based upon a warehouse receipt works as follows: (1) the domestic producer (e.g., a West coast canner) arranges the terms of sale with a domestic buyer, (2) the domestic producer obtains a letter of credit with his
bank, (3) the domestic producer places the merchandise in the custody of a warehouseman pending a future sale, (4) the warehouseman issues a warehouse receipt, (5) the domestic producer's bank extends credit up to 100 per cent of the merchandise by discounting the draft. Acceptance maturities are set to coincide with anticipated sales dates. The domestic producer is the drawer of the draft and the domestic producer's bank is the acceptor of the draft.

Although domestic acceptance increases in tight money periods, it represents a small portion of the bankers' acceptance market. Sales on open account do not require extensive documentation and credit histories are more widely developed in the United States, and for these reasons domestic bankers' acceptances have not gained great favor. The New York money market may be employed to finance the domestic transaction.

Dollar exchange acceptances are for the purpose of creating dollar exchange in foreign countries, principally Latin America. Dollar exchange acceptances represent time drafts drawn usually by the central bank in certain foreign countries and accepted by U.S. commercial banks. Because

---


---

*Cooper, p. 130.*
they are time drafts drawn by foreign banks and accepted by major U.S. commercial banks, there is no single underlying commercial trade transaction. Rather they are used to generate dollar exchange credits in foreign countries during seasonal shortages.

The dollar exchange acceptance works as follows: (1) the U.S. commercial bank and the foreign central bank agree upon the terms and the limit of credit to be extended; (2) the foreign central bank draws a time draft upon the U.S. commercial bank; (3) the U.S. commercial bank accepts the draft, sells it in the money market, and remits the proceeds to the foreign central bank; (4) the foreign central bank uses the proceeds to extend credit locally; (5) the foreign central bank is repaid in the course of trade within the local country and uses the proceeds to liquidate the acceptance liability. The Federal Reserve prescribes regulations regarding maturity limits and those foreign countries eligible for dollar exchange acceptances.\(^6\) Dollar exchange acceptances, just as acceptances used to finance domestic trade, represent a relatively small part of the total U.S. acceptance market.

Additional variations on the basic acceptance pattern exist, for example, the Eurocurrency banker's acceptance. In this instance the banker's acceptance is denominated

\(^6\)Ibid., p. 131.
in a Eurocurrency, most frequently dollars, and the draft is drawn on a major Eurobank. The mechanics of the Eurocurrency banker's acceptance are illustrated in Figure 2. The addition of a major Eurobank name enhances marketability of the acceptance in the London discount market.\(^7\) The Eurocurrency banker's acceptance is thus an instrument which allows exporters and importers to finance trade in the extensive Eurodollar market.

Prime banker's acceptances are instruments accepted by major commercial banks and those banks which have a reputation for knowledge of and skill in international banking. A smaller bank with proven experience may discount acceptances in the money market at the same rate as the largest accepting banks.\(^8\) Medium-sized and smaller banks which have never sold acceptances in the market may nevertheless gain access to the bankers' acceptance market. The small bank wishing to finance a customer's exports or imports extends an unsecured loan by discounting the customer's foreign trade bill. The foreign trade bill is drawn on the small bank's customer. The foreign trade bill is payable to the supplier of the small bank's customer. The foreign trade bill is paid from the proceeds of the unsecured loan. At the same time the small bank


\(^8\)Cooper, p. 132.
Fig. 2--The mechanics of the Eurocurrency banker's acceptance
<table>
<thead>
<tr>
<th>Transaction</th>
<th>Brief Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Importer and exporter agree on terms of transaction.</td>
</tr>
<tr>
<td>2</td>
<td>Importer obtains letter of credit from his bank.</td>
</tr>
<tr>
<td>3</td>
<td>Importer or importer's bank sends letter of credit to exporter.</td>
</tr>
<tr>
<td>4</td>
<td>Exporter receives letter of credit and ships merchandise to importer.</td>
</tr>
<tr>
<td>5</td>
<td>Exporter presents documents and draft to his bank.</td>
</tr>
<tr>
<td>6</td>
<td>Exporter receives discounted value of draft.</td>
</tr>
<tr>
<td>7</td>
<td>Exporter's bank sends documents and draft to its correspondent.</td>
</tr>
<tr>
<td>8</td>
<td>Correspondent presents documents and draft to importer's bank.</td>
</tr>
<tr>
<td>9</td>
<td>Importer's bank accepts draft as per letter of credit.</td>
</tr>
<tr>
<td>10</td>
<td>Importer's bank releases documents to importer permitting him to obtain merchandise.</td>
</tr>
<tr>
<td>11</td>
<td>Correspondent discounts banker's acceptance in money market.</td>
</tr>
<tr>
<td>12</td>
<td>Correspondent receives discounted value of banker's acceptance.</td>
</tr>
<tr>
<td>13</td>
<td>Correspondent remits or invests proceeds of 12 for exporter's bank.</td>
</tr>
<tr>
<td>14</td>
<td>Importer pays his bank the face amount of the banker's acceptance.</td>
</tr>
<tr>
<td>15</td>
<td>Banker's acceptance is presented to importer's bank for payment.</td>
</tr>
<tr>
<td>16</td>
<td>Banker's acceptance is paid by importer's bank.</td>
</tr>
</tbody>
</table>

Fig. 2--Continued
extends the unsecured loan, it draws a time draft on its New York correspondent. The New York correspondent accepts the draft and credits the proceeds to the account of the smaller bank.⁹ In this manner the small bank gains access to the New York money market for financing foreign trade transactions.

⁹Schneider, pp. 291-292.
CHAPTER II

HISTORY OF THE BANKER'S ACCEPTANCE AND THE
BANKERS' ACCEPTANCE MARKET TO 1965

The purpose of this chapter is to examine the history of the banker's acceptance and the bankers' acceptance market to 1965. First, a medieval bill of exchange created in 1339 and the underlying trade transaction are analyzed. Second, the first banker's acceptance arising in English banking practices in the 1820s and early abuses of the banker's acceptance are traced. Third, the early history of the banker's acceptance in the United States is examined from the National Bank Act of 1864, which was silent regarding the use of acceptance financing, to early court cases preventing the use of acceptance financing, and then finally the enabling legislation, the Federal Reserve Act of 1913. The Federal Reserve Act was sponsored by Carter Glass, who may be appropriately called the father of the American banker's acceptance. Fourth, the growth in volume of bankers' acceptances from 1917 to 1965 is analyzed.

History of the Banker's Acceptance

The genealogical roots of the banker's acceptance may be traced to the bill of exchange, an instrument of foreign
trade developed in the Middle Ages. The bill of exchange, identified in early English commerce as the "letter of payment" and in early Italian records as the trata, was to become the most sophisticated financial instrument of the late Middle Ages. Crossing far-reaching frontiers, the bill of exchange provided a substitute for the cumbersome physical transfer of money required to complete a commercial transaction. The document was to combine the unique features of acceptability and negotiability. By the late fifteenth century the bill of exchange consisted of four parties: the maker of the instrument (drawer), the payer (the individual to whom the bill was addressed), the payee (called the Capon in Italian), and the initial creditor (the Delbeue).¹ The modern bill of exchange consists of three parties, the fourth (initial creditor) having disappeared.

One of the earliest known bills of exchange, drafted in 1339, illustrates the level of sophistication that had been achieved with the bill of exchange:²

Avignon, October 5, 1339
In the name of God, amen. To Bartolo and partners, Barna of Lucca and partners (send) greetings from Avignon.


You shall pay by this letter on November 20, (1)339, to Landuccio Busdraghi and partners, of Lucca, gold florins three hundred twelve and three fourths for the exchange of gold florins three hundred, because I have received such money today from Tancredi Bonagiunta and partners at the rate of 4½ per 100 to their advantage. And charge it to our account.

Done on October 5, (1)339 . . .

To Bartolo Casini and partners, in Pisa.

(Mark of Barna of Lucca) First.

A diagram is drawn to aid in understanding the sequence of events involved in the bill of exchange of 1339 (see Figure 3). The bill of exchange drafted by Barna of Lucca consists of four parties: the maker of the instrument or the drawer (Barna of Lucca), the payer (Bartolo Casini), the payee (Landuccio Busdraghi), and the initial creditor (Tancredi Bonagiunta). Rather than physically transfer gold florins from Avignon in France to Pisa in Italy, a distance of about four hundred miles, the partners of Barna of Lucca (at Avignon) utilize a bill of exchange directing Bartolo (at Pisa) to pay a claimant of Barna of Lucca who is then in Pisa. The bill of exchange has served to pay a distant claimant without an immediate physical transfer of funds across a great distance; i.e., credit by means of accounting entries has substituted for the long-distance flow of currencies. The bill of exchange causes Barna at Avignon and Bartolo in Pisa to be financial intermediaries between an initial creditor and the payee. As Postan observes, "[I]t is no wonder that it [the bill of exchange] became the most cosmopolitan
Fig. 3--The transactions described in the bill of exchange drawn by Barna of Lucca, October 5, 1339.
of all diplomatic inventions of the later Middle Ages."³ The medieval bill of exchange was indeed a sophisticated financial instrument.

The bill of exchange was an efficient instrument for accomplishing payment of a foreign trade transaction between distant parties. Further, it was an instrument adaptable to the extension of credit: the drawer could utilize a time draft (a bill of exchange payable at a fixed or determinable time rather than at sight) resulting in delayed payment, or the instrument could be discounted.⁴

When it began to be found that, by the addition of machinery which we call discount, credit to the buyer could be combined with ready money to the seller, and that this beneficient transaction spread its circle of gratification even so far as a third party—the discounter—the simple but pregnant invention was established as part of the running gear of the commercial mechanism. The mutuality of confidence necessary for the operation of the bill of exchange was itself a new economic phenomenon, endowed with infinite potentiality.

As foreign trade expanded, however, buyers and sellers of unknown credit reputation began transacting business, shaking the cornerstone of mutuality of confidence. The negotiability of the bill of exchange was limited by the ability of the parties to honor the debt; the greater the

³Postan, p. 54.

financial reputation of the parties, the greater the negotiability of the draft.

England was the major world trade power in the nineteenth century. Her export trade was diversified throughout the country and financing was provided by a well-developed banking system, a banking system consisting of London banks (or London agents) and country banks. "In the course of the nineteenth century the function of the London agent was often extended to the acceptance, on behalf of the country bank, of bills for customers of the country bank. Arrangements for this kind have been noticed elsewhere as early as the 1820's . . . ." Thus the banker's acceptance was born in England following the Napoleonic Wars. By accepting drafts of customers of their country cousins, major London banks intervened to add their well-known reputations to bills of exchange, thus creating the banker's acceptance. London banks became engaged in accepting drafts in non-British trade with the result that the financing of world trade soon gravitated to the London money market. London became the focal point of the banker's acceptance market, an instrument that London banks pioneered.

---


6Powell, p. 375.
The acceptance business of the English banks increased markedly in the 1860s, a result of London's premier position in world trade and competition from Scottish bank branches in England. The sterling balances in acceptances at the great London joint stock banks evidence the role of these banks in the development of the acceptance market: acceptances on December 31, 1868, at the Union Bank were £6,250,000 and at the City Bank were £2,721,000. Expressed as a per cent of total cash deposits, Union Bank acceptances represented 73 per cent of cash deposits and City Bank acceptances represented 86 per cent of cash deposits. Clearly the London banks had become committed to the concept of the banker's acceptance. The overextension of credit and potential for abuse became apparent when the City of Glasgow Bank failed in the Panic of 1857. Excessive loans to a few borrowers caused the bank to suspend payment, at which time it was learned that the balance sheet acceptance figure was understated by no less than £1,253,861. The growth of the London bankers' acceptance

---


8The Bankers' Magazine, XXXVIII (1878), 917-921, as cited by Anderson and Cottrell, pp. 308-312.
market in the nineteenth century was marked by periods of rapid and sometimes unsound extension of credit.

The Early History of the Banker's Acceptance in the United States

While the bankers' acceptance market was developing in England during the nineteenth century, no similar market existed in the United States. The lack of any bankers' acceptance market in the U.S. was due to the provisions of the National Bank Act of 1864. The Act itself and related statutes were silent with regard to the power of commercial banks to create acceptances, and of this the courts took notice. Early federal court opinions held that since national banks had been granted the power to accept drafts neither by the National Bank Act nor by any other statutes, then the creation of acceptances by national banks represented an ultra vires act. Only the state banks could

---

9 United States Statutes at Large, XII, 28th Congress, First Session, Chap. 106 (Boston, Little, Brown, 1966), 99-118.

10 Early court cases held that since national banks were not authorized to accept drafts, such acceptances represented ultra vires acts: Commercial National Bank v. Pirie, 82 F. 799, 27 C.C.A. 171 (1897); Bowen v. Needles National Bank, 87 F. 430 (1899). In First National Bank v. American National Bank, 72 S.W. 1059, 173 Mo. 153 (1903), the court held that since the statutes (specifically Rev. St. U.S. 5136) did not empower national banks to create acceptances, such actions would be ultra vires acts. And this was extended to letters of credit authorizing bank acceptances in Thilmany v. Iowa Paper-Bag Co., 79 N.W. 68, Iowa 333 (1899).
accept drafts, and such state bankers' acceptances were negligible.\textsuperscript{11} The emergence of the bankers' acceptance market in the United States was not to occur until passage of the Federal Reserve Act in 1913.

As a result of judicial opinion blocking creation of the bank acceptance, trade acceptances were sold through bill brokers to commercial banks, resulting in the large growth in holdings of promissory notes by the banking system.\textsuperscript{12} Interest rates for trade acceptances or drafts without any commercial bank guarantee were unrealistic because these rates reflected non-trade factors. While in Europe there existed a separate rate for bankers' acceptances, in New York the rate for trade acceptances was based on the interest rate for call loans which bore only an indirect relation to foreign trade.\textsuperscript{13} And while European rates were quite stable, U.S. interest rates were most volatile. The net result was a U.S. market consisting of

\textsuperscript{11}\textsuperscript{Frederick Bradford, Money and Banking (New York, Longmans, Green and Co., 1936), p. 355. Although state banks could accept drafts prior to 1913, there was little advantage to doing such because the secondary market was nonexistent by virtue of national banks being precluded from creating acceptances. Thus, it was not a case of the tail wagging the dog, but rather of the dog being without a tail. Louis A. Refener, Money and Banking in the United States (Boston, Houghton Mifflin, 1934), p. 519.}

\textsuperscript{12}\textsuperscript{L. M. Jacobs, Bank Acceptances (Washington, National Monetary Commission, Senate Document 569, 61st Congress, Second Session, 1910), p. 5.}

\textsuperscript{13}\textsuperscript{Ibid., p. 6.}
an embryonic banker's acceptance, the trade acceptance, and a market from which all but the strongest and largest borrowers were excluded.  

The birth of the banker's acceptance in the United States occurred with passage of the Federal Reserve Act on December 23, 1913. The initial legislation was sponsored by Carter Glass, the Chairman of the House Committee on Banking and Currency. One of the express intentions of the Owen-Glass Bill, which became the Federal Reserve Act, was to permit national banks to accept drafts involving international trade transactions.  

While the National Bank Act omitted any mention of the power of national banks to accept bills of exchange, the Federal Reserve Act was quite specific regarding such powers:  

Any member bank may accept drafts or bills of exchange drawn upon it and growing out of transactions involving the importation or exportation of goods having not more than six months sight to run; but no bank shall accept such bills to an amount equal at any time in the aggregate to more than one-half of its paid-up capital stock and surplus.

Member banks of the Federal Reserve were thus empowered within limits to create the banker's acceptance. Carter

---

14Ibid., p. 9.


16United States Statutes at Large, XXXVIII, 63rd Congress, Second Session, Chap. 6 (Washington, Government Printing Office, 1915), 264.
Glass, who is called the father of the Federal Reserve System, is also the father of the American banker's acceptance.

After passage of the Federal Reserve Act, many expected the bankers' acceptance market to materialize overnight. One banker stated in 1915, "... the safest and most liquid form of investment known to the banking world has been added as an element of strength and safety to the assets of our banks."\(^{17}\) Armed with a new financial instrument, the banking community was quite happy and optimistic. There were those who believed the banker's acceptance would replace the Treasury bill and that the latter would probably disappear altogether from the market as the U.S. debt was paid off.\(^ {18}\) But the events which followed did not parallel the hopes of the banking community or the desires of the drafters of the Federal Reserve Act.

The drafters of the Federal Reserve Act intended that bankers' acceptances would be used to finance specific foreign trade transactions of a short-term nature, and not to provide permanent financing, to finance working capital requirements, or to finance speculation in

\(^{17}\) Warburg, II, 340.

\(^{18}\) Ibid., pp. 584-585.
securities or commodities. Abuses in the use of acceptances occurred soon after passage of the Federal Reserve Act. In some instances acceptances were used under revolving credit agreements to finance the French government and French merchants during World War I. There also developed the practice of pyramiding acceptances, i.e., drawing more than one acceptance against the same commercial transaction or using an acceptance as collateral for another acceptance. Prior to the recession of 1920-21, bankers' acceptances were used to finance long-term and speculative investments, to grant loans to borrowers beyond the statutory limit, and to obtain overdrafts. "Deterioration in the quality of acceptances was recognized long before the 1920-21 depression. It was not the result of the depression but occurred earlier and aggravated its severity." The Federal Reserve maintained artificially low discount rates for acceptances and also maintained lax policies regarding the quality of acceptances. "Thus the management of the bankers' acceptance market tended to make the New York call loan market more important than

---

\(^{19}\) Ibid., pp. 625-644.


\(^{21}\) Ibid.

\(^{22}\) Ibid., p. 247.
it was before the Federal Reserve System." All of the potential abuses which had been envisioned in fact occurred.

New York became the principal market in the United States for bankers' acceptances at least as early as 1918, five years after passage of the Federal Reserve Act. This was not only a result of New York City being the chief foreign trade center in the United States, but it was also a result of activities by the Federal Reserve Bank of New York. The Federal Reserve Bank of New York, in order to maintain an open market, made substantial purchases of bankers' acceptances. As a result of such purchases, reserves of the Federal Reserve Bank of New York approached minimum legal limits, at which time other Federal Reserve Banks with surplus funds made large purchases from the Federal Reserve Bank of New York. For these reasons New York City became the focal point for trading in bankers' acceptances in the United States.


25 Clark, pp. 375-376.

Federal Reserve open market operations began in bankers' acceptances. As early as October, 1920, the Conference of Federal Reserve Bank Presidents appointed a standing committee to stay abreast of market conditions and practices in the bankers' acceptance market:\(^{27}\)

The Committee was expected to develop uniform practices and policies for the Reserve Banks, suggest buying rates and, in general, work toward broadening and developing an open market for acceptances. The Committee appointed a secretary who had an office in the Federal Reserve Bank of New York. Each Federal Reserve Bank telegraphed a weekly report to the secretary, giving information on rates at which the Reserve Bank had purchased bills, the amount purchased, the amount of repurchase agreements and rates at which they were negotiated, and the general demand and supply situation for acceptance in its district.

Federal Reserve open market operations in bankers' acceptances preceded by some two years open market operations in government securities.

Repurchase operations also began with bankers' acceptances. The Board of Governors approved the use of repurchase agreements with dealers in 1921.\(^{28}\) "Initially, repurchase agreements were used to help dealers carry an inventory of acceptances and securities in times of stringency . . . The ultimate objective was to encourage development of the market for acceptances."\(^{29}\) Thus, Federal


\(^{28}\)Ibid., pp. 53-54.

\(^{29}\)Ibid.
Reserve open market operations and repurchase agreements with dealers helped the market for bankers' acceptances develop in the early 1920s.

Some governmental officials sought to establish a preferential discount or buying rate for acceptances. The Under Secretary of the Treasury suggested a preferential discount rate for bankers' acceptances in 1923.\textsuperscript{30} Preferential rates would have broadened the acceptance market. But Federal Reserve officials opposed the Under Secretary's proposal for two reasons.\textsuperscript{31} First, a preferential rate tends to become the lowest rate, because banks discount paper carrying the lowest rate where possible. Second, the proposal was perceived as discriminatory against country banks, which usually did not hold bankers' acceptances. Again, in the late summer of 1928, the Board recommended a preferential discount rate for bankers' acceptances.\textsuperscript{32} The Presidents of the Reserve Board opposed the proposal, however, and it was never adopted.

The volume of bankers' acceptances for the forty years following the Federal Reserve Act showed substantial fluctuation. The dollar volume of acceptances from 1917 through 1955 is shown in Figure 4. As may be seen from the figure, volume increased rapidly following the enabling legislation in 1913. Volume was approximately $450 million

\textsuperscript{30}Ibid., p. 44. \textsuperscript{31}Ibid. \textsuperscript{32}Ibid., p. 58.
Fig. 4--The volume of bankers' acceptances, 1917-1955*

in 1917 vis-à-vis a virtually nonexistent market in 1912. Bankers' acceptance volume peaked in 1920, declined in 1921 paralleling the U.S. recession of those years, and then expanded through the 1920s, reaching a high point in 1929. Volume declined in the 1930s, as did world trade and economic activity. Volume continued to decline during the early war years of the 1940s, reaching a point in 1943 that was substantially less than 1917. From the end of World War II through 1955 there was a substantial increase in the volume of bankers' acceptances, and in 1955 volume had reached activity previously recorded in the mid-1930s. The volume of bankers' acceptances during the period 1917 through 1955 reflected the growth or decline of foreign trade and economic activity. Volume progressively increased in economic expansions, steadily declined in economic contractions, and reached low points during wartime activity. Thus, bankers' acceptance volume rather closely mirrored the pattern of world trade itself during the years 1917 through 1955.

The Growth of the Bankers' Acceptance Market from 1956 to 1965

The market for prime bankers' acceptances grew at a very steady rate for the ten-year period from 1956 to 1965. The total dollar volume, as shown in Table I, increased to $3,392 million in 1965 from $967 million in 1956. This
TABLE I

THE DOLLAR VOLUME OF BANKERS' ACCEPTANCES
OUTSTANDING, 1956-1965*
(IN MILLIONS)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Accept.</th>
<th>Import Accept.</th>
<th>Export Accept.</th>
<th>Other Accept.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>3,392</td>
<td>792</td>
<td>974</td>
<td>1,626</td>
</tr>
<tr>
<td>1964</td>
<td>3,385</td>
<td>667</td>
<td>999</td>
<td>1,719</td>
</tr>
<tr>
<td>1963</td>
<td>2,890</td>
<td>567</td>
<td>908</td>
<td>1,415</td>
</tr>
<tr>
<td>1962</td>
<td>2,650</td>
<td>541</td>
<td>778</td>
<td>1,331</td>
</tr>
<tr>
<td>1961</td>
<td>2,683</td>
<td>485</td>
<td>969</td>
<td>1,229</td>
</tr>
<tr>
<td>1960</td>
<td>2,027</td>
<td>403</td>
<td>669</td>
<td>955</td>
</tr>
<tr>
<td>1959</td>
<td>1,151</td>
<td>357</td>
<td>309</td>
<td>485</td>
</tr>
<tr>
<td>1958</td>
<td>1,194</td>
<td>254</td>
<td>349</td>
<td>591</td>
</tr>
<tr>
<td>1957</td>
<td>1,307</td>
<td>278</td>
<td>456</td>
<td>573</td>
</tr>
<tr>
<td>1956</td>
<td>967</td>
<td>261</td>
<td>329</td>
<td>377</td>
</tr>
</tbody>
</table>

Compound Growth Rate

- Total Accept. 15.0%
- Import Accept. 13.1%
- Export Accept. 12.8%
- Other Accept. 17.6%

*Source: Federal Reserve Bulletins, March issue of each year.

represented a threefold increase, a 15 per cent compound annual growth rate. The first component of the total market, acceptances to finance U.S. imports and identified as import acceptances in Table I, rose to $792 million in 1965 from $261 million in 1956, a 13 per cent compound annual growth rate. The second component, acceptances to finance U.S. exports and identified as export acceptances in Table I, rose to $974 million in 1965 from $329 million.
in 1956, a 13 per cent compound annual growth rate. The third component of the total market is shown as **other acceptances** in Table I and represents primarily bankers' acceptances used to finance non-U.S. foreign trade and also to finance the movement and storage of goods within the United States. This residual category increased at an 18 per cent compound annual growth rate over the ten-year span. Clearly the increase in the total market reflects a steady growth in all the component elements, import acceptances, export acceptances, and other acceptances.
CHAPTER III

THE BANKER'S ACCEPTANCE AND THE BANKERS' ACCEPTANCE MARKET SINCE 1965

The market for prime bankers' acceptances has experienced significant growth over the past dozen years, paralleling the growth of foreign trade itself. The total dollar volume of bankers' acceptances, as shown in Table II and Figure 5, increased to $25,654 million at the end of 1977 from $3,392 million in 1965. This represents a sevenfold increase, an 18 per cent compound annual growth rate. The first component of the total market, acceptances used to finance U.S. imports and identified as import acceptances in Table II, rose to $6,532 million in 1977 from $792 million in 1965, a 19 per cent compound annual growth rate, while the second component, acceptances used to finance U.S. exports and identified as export acceptances in Table II, rose to $5,895 million in 1977 from $974 million in 1965, a compound annual growth rate of 16 per cent. The third component of the total market, representing primarily bankers' acceptances used to finance non-U.S. foreign trade and to finance the movement and storage of goods within the United States, is identified as other acceptances. This residual category increased

37
at a 19 per cent compound annual growth over the twelve-year span. The increase in the total bankers' acceptance market was reflected in all three categories of the bankers' acceptance market, import acceptances, export acceptances, and other acceptances.

TABLE II

THE DOLLAR VOLUME OF BANKERS' ACCEPTANCES OUTSTANDING, 1965-1977*
(IN MILLIONS)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Accept.</th>
<th>Import Accept.</th>
<th>Export Accept.</th>
<th>Other Accept.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>25,654</td>
<td>6,532</td>
<td>5,895</td>
<td>13,227</td>
</tr>
<tr>
<td>1976</td>
<td>22,523</td>
<td>4,992</td>
<td>4,818</td>
<td>12,713</td>
</tr>
<tr>
<td>1975</td>
<td>18,727</td>
<td>3,726</td>
<td>4,001</td>
<td>11,000</td>
</tr>
<tr>
<td>1974</td>
<td>18,484</td>
<td>4,023</td>
<td>4,067</td>
<td>10,394</td>
</tr>
<tr>
<td>1973</td>
<td>8,892</td>
<td>2,273</td>
<td>3,499</td>
<td>3,120</td>
</tr>
<tr>
<td>1972</td>
<td>6,898</td>
<td>2,531</td>
<td>1,909</td>
<td>2,458</td>
</tr>
<tr>
<td>1971</td>
<td>7,889</td>
<td>2,834</td>
<td>1,546</td>
<td>3,509</td>
</tr>
<tr>
<td>1970</td>
<td>7,058</td>
<td>2,601</td>
<td>1,561</td>
<td>2,896</td>
</tr>
<tr>
<td>1969</td>
<td>5,451</td>
<td>1,889</td>
<td>1,153</td>
<td>2,409</td>
</tr>
<tr>
<td>1968</td>
<td>4,428</td>
<td>1,423</td>
<td>952</td>
<td>2,053</td>
</tr>
<tr>
<td>1967</td>
<td>4,317</td>
<td>1,086</td>
<td>989</td>
<td>2,242</td>
</tr>
<tr>
<td>1966</td>
<td>3,603</td>
<td>997</td>
<td>829</td>
<td>1,777</td>
</tr>
<tr>
<td>1965</td>
<td>3,392</td>
<td>792</td>
<td>974</td>
<td>1,626</td>
</tr>
</tbody>
</table>

| Compound Growth Rate | 18.4% | 19.2% | 16.2% | 19.1% |

*Source: Federal Reserve Bulletins, March issue of each year.

The expansion of the bankers' acceptance market may be partially explained by the increasing importance of
Fig. 5--The volume of banker's acceptances, 1966-1977*

*Source: Information derived from Table II.

As shown in Table III, exports in relation to gross national product have been increasing in recent years, the percentage being 9.7 in 1977 and 4.4 in 1970. The increase in the volume of export acceptances may be explained by the increase in not only the level of U.S. exports, but the relative importance of U.S. exports to the total economy as well.

**TABLE III**

<table>
<thead>
<tr>
<th>Year</th>
<th>A-Exports°</th>
<th>B-GNP†</th>
<th>A/B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>$183,205</td>
<td>$1,887.2</td>
<td>9.7%</td>
</tr>
<tr>
<td>1976</td>
<td>171,274</td>
<td>1,700.1</td>
<td>10.1%</td>
</tr>
<tr>
<td>1975</td>
<td>155,656</td>
<td>1,528.8</td>
<td>10.1%</td>
</tr>
<tr>
<td>1974</td>
<td>144,773</td>
<td>1,412.9</td>
<td>10.2%</td>
</tr>
<tr>
<td>1973</td>
<td>102,154</td>
<td>1,306.6</td>
<td>7.8%</td>
</tr>
<tr>
<td>1972</td>
<td>72,600</td>
<td>1,171.1</td>
<td>6.2%</td>
</tr>
<tr>
<td>1971</td>
<td>65,449</td>
<td>1,063.4</td>
<td>6.2%</td>
</tr>
<tr>
<td>1970</td>
<td>43,224</td>
<td>982.4</td>
<td>4.4%</td>
</tr>
</tbody>
</table>

*Source: Survey of Current Business, January issue of each year.

°Excludes transfers under military grants; figures in millions.

†Figures in billions.

Another explanation of the expansion of the bankers' acceptance market is the use of the U.S. bankers' acceptance market by the Asian and Latin American countries. The increase in acceptances made for the account of
foreigners and held by U.S. commercial banks is shown in Table IV. The increase in the Latin American category, to $2,834 million in 1976 from $629 million in 1969, reflects the creation of dollar exchange. The function of dollar exchange acceptance is to lessen the shortage of dollar exchange arising from seasonal shortages.\(^1\) Thus the origin of this type of banker's acceptance is not a merchandise transaction, but rather the need for dollar currency reserves by Latin American countries with which to finance their foreign trade. The dollar exchange acceptance is yet another example of the flexibility of the banker's acceptance.

A dollar exchange acceptance works as follows: (1) the U.S. commercial bank and the foreign central bank agree upon the terms and the limits of credit to be extended, (2) the foreign central bank draws a time draft upon the U.S. commercial bank, (3) the U.S. commercial bank accepts the draft and remits the proceeds to the foreign central bank, (4) the foreign central bank uses the proceeds to extend credit locally, (5) the foreign central bank is repaid in the course of trade within the local country and uses the proceeds to liquidate the acceptance liability.

Dollar exchange acceptances, just as acceptances used to

TABLE IV

ACCEPTANCES MADE FOR ACCOUNT OF FOREIGNERS AND HELD BY COMMERCIAL BANKS, 1969-1978*
(IN MILLIONS)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Asia</th>
<th>Latin America</th>
<th>Europe</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>$14,898</td>
<td>$9,751</td>
<td>$2,313</td>
<td>$1,917</td>
<td>$  917</td>
</tr>
<tr>
<td>1977</td>
<td>14,913</td>
<td>9,213</td>
<td>2,702</td>
<td>937</td>
<td>1,341</td>
</tr>
<tr>
<td>1976</td>
<td>12,371</td>
<td>7,813</td>
<td>2,834</td>
<td>626</td>
<td>1,098</td>
</tr>
<tr>
<td>1975</td>
<td>11,124</td>
<td>7,526</td>
<td>2,482</td>
<td>400</td>
<td>986</td>
</tr>
<tr>
<td>1974</td>
<td>11,188</td>
<td>8,065</td>
<td>2,112</td>
<td>285</td>
<td>726</td>
</tr>
<tr>
<td>1973</td>
<td>4,155</td>
<td>2,691</td>
<td>921</td>
<td>232</td>
<td>311</td>
</tr>
<tr>
<td>1972</td>
<td>3,215</td>
<td>1,983</td>
<td>648</td>
<td>299</td>
<td>285</td>
</tr>
<tr>
<td>1971</td>
<td>4,260</td>
<td>2,712</td>
<td>815</td>
<td>450</td>
<td>283</td>
</tr>
<tr>
<td>1970</td>
<td>3,966</td>
<td>2,560</td>
<td>861</td>
<td>379</td>
<td>166</td>
</tr>
<tr>
<td>1969</td>
<td>2,922</td>
<td>1,832</td>
<td>629</td>
<td>289</td>
<td>172</td>
</tr>
</tbody>
</table>

*Source: Treasury Bulletins, February issue of each year.

finance domestic trade, represent a relatively small part of the total U.S. bankers' acceptance market.

A further explanation of the increase in the market for bankers' acceptances is that part of Japanese foreign trade is being financed in the U.S. money market. The largest percentage of acceptances made for the account of foreigners and held by commercial banks originates from the Asia category (see Table IV). The financing of Japanese foreign trade is the most important element of the Asia category, and in fact, as shown in Table V, Japanese foreign trade financing accounts for a very substantial portion of all acceptances made for the account of
foreigners, representing about one-third in 1976. The U.S. money market is a factor in financing world trade, especially the foreign trade of Japan and Latin America.

TABLE V

ACCEPTANCES MADE FOR ACCOUNT OF FOREIGNERS AND HELD BY COMMERCIAL BANKS, 1969-1978*
(IN MILLIONS)

<table>
<thead>
<tr>
<th>Year</th>
<th>A-Total</th>
<th>B-Japan</th>
<th>A/B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>$14,898</td>
<td>$5,577</td>
<td>37.4%</td>
</tr>
<tr>
<td>1977</td>
<td>14,193</td>
<td>4,811</td>
<td>33.9%</td>
</tr>
<tr>
<td>1976</td>
<td>12,371</td>
<td>4,214</td>
<td>34.1%</td>
</tr>
<tr>
<td>1975</td>
<td>11,124</td>
<td>4,362</td>
<td>39.2%</td>
</tr>
<tr>
<td>1974</td>
<td>11,188</td>
<td>6,305</td>
<td>56.4%</td>
</tr>
<tr>
<td>1973</td>
<td>4,155</td>
<td>2,181</td>
<td>52.5%</td>
</tr>
<tr>
<td>1972</td>
<td>3,215</td>
<td>1,360</td>
<td>42.3%</td>
</tr>
<tr>
<td>1971</td>
<td>4,260</td>
<td>2,117</td>
<td>49.7%</td>
</tr>
<tr>
<td>1970</td>
<td>3,966</td>
<td>2,140</td>
<td>54.0%</td>
</tr>
<tr>
<td>1969</td>
<td>2,922</td>
<td>1,571</td>
<td>53.8%</td>
</tr>
</tbody>
</table>

*Source: Treasury Bulletins, February issue of each year.

The Relationship between Bankers' Acceptances: U.S. Exports and U.S. Imports

Much of the U.S. import trade as well as export trade is being financed through the United States banking system and the United States money market. A correlation of bankers' acceptances used to finance exports from the U.S. with total U.S. exports on an annual basis from 1956 to 1976 inclusive produces a coefficient of determination
(R²) of 99 per cent.² This is to be expected since the major New York, West Coast, and inland commercial banks finance the U.S. export trade, and the U.S. money market is by far the most developed money market in the world. A correlation of bankers' acceptances used to finance imports into the United States with the total U.S. imports on an annual basis for the same time period, 1956 to 1976 inclusive, produces a coefficient of determination of 96 per cent.³ The lower R² for imports would be expected because of leakage, i.e., some foreign exports to the U.S. are financed exclusively by foreign banks and by foreign money market centers. The evidence is clear enough that the vast majority of U.S. foreign trade is being financed through the American banking system and the American money market.

The residual category of bankers' acceptances, other acceptances, increased rapidly from 1965 through 1977. This component consists primarily of bankers' acceptances used to finance non-U.S. foreign trade and to finance the domestic shipment and storage of goods within the United States. Because sales on open account do not require extensive acceptance documentation and because credit

²Based upon computer runs by the author in the North Texas State University Computing Center.

³Based upon computer runs by the author in the North Texas State University Computing Center.
histories are well developed in the United States, domestic bankers' acceptances are not widely used in this country. The category "other acceptances" consists, then, chiefly of bankers' acceptances used to finance non-U.S. foreign trade. The growth in the other acceptance category reflects the growth of world trade and the fact that this growth in world trade is being financed in the United States money market.

The banker's acceptance is a useful and profitable method of financing in periods of tight money. The instrument by its very nature is well suited for use when money is tight. As Westfall observes:

After all, a banker's acceptance is, in essence, a form of short-term borrowing by a bank enabling it to lend money without conventional marginal reserve requirements. The bank simply co-signs the borrower's note and thus "accepts" the full obligation to repay that particular loan. In effect, then, the bank is essentially using its own name and balance sheet to create short-term commercial paper for a preferred customer who is unable to do it himself. Thus, in tight-money situations the use of banker's acceptances has some very real advantages for a bank.

There are four reasons why acceptance financing should increase in tight-money periods. First, the banker's

4Cooper, p. 130.


6Ibid., pp. 22-23.
acceptance generates liquidity for the fully loaned up bank. Certain customers may be converted from working capital loans to acceptance paper and the acceptance paper sold in the money market. Banks may thus free-up reserves during times of tight money. Second, acceptance financing is profitable to commercial banks. The accepting bank which invests in its own paper receives not only the discount fee, but the 1.5 per cent acceptance fee as well. The accepting bank charges the acceptance fee for the use of its name and balance sheet in support of the bankers' acceptance. Third, the banker's acceptance provides the bank with portfolio flexibility. By placing customers on acceptance financing and retaining the accepted paper, commercial banks may sell the banker's acceptance at any time. Fourth, acceptance financing allows a commercial bank to tighten credit control. "Acceptances normally create shorter note maturities with mechanics for guaranteed liquidation. Further, they normally require collateral control provisions, and these provisions generally involve third-party risk underwriting." In the 65-year history of bankers' acceptances there is no recorded instance of any default on the instrument. For these

7 Ibid., p. 23.

reasons bankers' acceptances are a useful and profitable method of financing when money and credit are tight.

Acceptance financing has increased rapidly in the tight money years of the 1970s. In the tight money period 1969-1970, total acceptance financing rose to $7,058 million in 1970 from $5,451 million in 1969 (refer to Table II). This represents a 129 per cent increase. In mid-1974, money and credit again became tight. Between 1973 and 1974 total acceptance financing rose to $18,484 million in 1974 from $8,892 million in 1973. This represents a 208 per cent increase.

Financing with bankers' acceptances has indeed increased in tight-money periods. Commercial banks have four basic reasons for the use of acceptance financing in times of restricted credit availability, and the rapid volume increases during these times indicate commercial banks resort to the banker's acceptance.

The Holders of Bankers' Acceptances

An examination of the holders of bankers' acceptances indicates who is providing the financing. The trend since 1968 has been for commercial banks to increase their holdings of prime bankers' acceptances (see Table VI and Figure 6). For example, banks held 35 per cent of the

\[ ^9\text{Ibid.} \]
\[ ^{10}\text{Ibid.} \]
TABLE VI
A PROFILE OF THE HOLDERS OF BANKERS' ACCEPTANCES, 1968-1976*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accepting bank</td>
<td>$10,442</td>
<td>46%</td>
<td>$7,333</td>
<td>39%</td>
<td>$4,226</td>
</tr>
<tr>
<td>Federal Reserve banks</td>
<td>1,366</td>
<td>6%</td>
<td>1,419</td>
<td>8%</td>
<td>2,108</td>
</tr>
<tr>
<td>Others</td>
<td>10,715</td>
<td>48%</td>
<td>9,975</td>
<td>53%</td>
<td>12,150</td>
</tr>
<tr>
<td></td>
<td>$22,523</td>
<td>100%</td>
<td>$18,727</td>
<td>100%</td>
<td>$18,484</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accepting bank</td>
<td>$3,480</td>
<td>44%</td>
<td>$2,695</td>
<td>38%</td>
</tr>
<tr>
<td>Federal Reserve banks</td>
<td>515</td>
<td>7%</td>
<td>307</td>
<td>5%</td>
</tr>
<tr>
<td>Others</td>
<td>3,894</td>
<td>49%</td>
<td>4,057</td>
<td>57%</td>
</tr>
<tr>
<td></td>
<td>$7,889</td>
<td>100%</td>
<td>$7,059</td>
<td>100%</td>
</tr>
</tbody>
</table>

*Source: Federal Reserve Bulletins, February issue of each year.
Fig. 6--A profile of the holders of bankers' acceptances, 1968-1976*

*Source: Information derived from Table VI.
total dollar volume of bankers' acceptances in 1968 and 46 per cent of the total dollar volume in 1976, increasing their total share of this market by 11 per cent. When the accepting bank retains one of its own acceptances, that acceptance becomes a part of the total loan portfolio. The figures in Table VI reflect the bankers' acceptances originating with the accepting bank as well as those bankers' acceptances which have been purchased by the bank. Of the total market for prime bankers' acceptances, commercial banks have been increasing their share of the market in recent years.

The willingness of commercial banks to increase their holdings of bankers' acceptances may be explained by the flexibility of the instrument itself. A prime banker's acceptance is by definition an acceptance of a commercial bank which has earned recognition in the money market by being active in creating bankers' acceptances. While the quality of the instrument is dependent upon the commercial bank, the drawer of the draft and any unqualified indorsers are contingently liable for payment. Additionally, the goods being financed are usually readily salable, thus representing a source of liquidity with which to pay the obligation. The liquidity of the instrument is further enhanced by its eligibility for discount by a commercial bank in accordance with Regulation C.
Establishment of an Acceptance as "Prime" and Quality Consciousness in the Bankers' Acceptance Market

The appellation "prime" is conferred by the marketplace on bankers' acceptances which meet certain requirements. The Federal Reserve perception of a prime banker's acceptance is based upon the volume of acceptance transactions by a commercial bank, the frequency of transactions of a commercial bank, and the financial condition and reputation of the accepting bank.11 Michael Gabriel, an Investment Officer at the First National Bank in Boston, indicates in private correspondence that the market perception of a prime banker's acceptance is based upon the earnings record of the commercial bank, the history of financial strength of the commercial bank, the large loan loss history of the commercial bank, and wide acceptance of the banker's acceptance in the investing community. The latter requirement, he states, is the ultimate test.12

The financial condition and reputation of the accepting commercial bank are reflected by "tiering" in the bankers' acceptance market. The largest bankers' acceptance

---


dealer in the United States is Bankers Discount Corporation. Frederick Walker, a Vice-President at Bankers Discount, writes in private correspondence, "Since the Franklin, U.S. National of San Diego, Herstatt, etc., failures and other near misses, investors have become quality conscious and the market place reflects this by two inter-related methods which reflects tiering, exclusion, or pricing." Quality consciousness is evident in the bankers' acceptance market.

The tiering aspect is evident in the secondary market. Mr. Gabriel of the First National Bank of Boston notes that acceptances of Bank of America, Manufacturers Hanover, Bankers Trust, and Morgan Guaranty trade the same, i.e., there is no interest rate differential among these issues. The acceptances of Mellon and Continental also trade the same (there is no interest rate differential) in a stable market. In an unstable market the acceptances of Mellon and Continental trade to offer increased rate yields vis-à-vis Bank of America yields to compensate investors for the perceived increased risk.

The pricing aspect is also evident in the secondary market. Mr. Walker of Bankers Discount states that

---

13 Letter from Frederick Walker, Jr., Vice-President, Bankers Discount Corporation of California.

14 Gabriel.
investors restrict their investments to (1) the top ten U.S. banks, (2) the top twenty-five banks, (3) the top fifty to 100 U.S. banks, (4) other U.S. banks, (5) Edge Act subsidiaries, (6) ineligible acceptances of U.S. banks, (7) eligible acceptances of U.S. branches and agencies of foreign banks. He writes that price differentials offered between the seven categories range from five to seven basis points in a stable market.\(^\text{15}\)

Quality consciousness is evident in the bankers' acceptance market based upon tiering in the banker's acceptance market and pricing in the bankers' acceptance market.

**The Documented Discount Note**

A development closely related to the banker's acceptance is the documented discount note. The documented discount note is a commercial paper note supported by and with a letter of credit attached to the note. Commercial paper supported by letter of credit--documented discount notes--outstanding as of February 28, 1979, is shown in Table VII. As shown in the table, there were seventeen issues outstanding on February 28, 1979. Four notes bear fixed termination dates, the issuers being Carty Services, Inc.; MYA Fuel Company; Realty and Mortgage Investment Company; and Southern Union Refining.

\(^{15}\)Walker.
# TABLE VII

**COMMERCIAL PAPER SUPPORTED BY LETTER OF CREDIT OUTSTANDING AS OF FEBRUARY 28, 1979**

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Bank Providing Letter of Credit</th>
<th>Termination Date</th>
<th>Moody's Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carolina Resources Trust</td>
<td>Security Pacific National</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>Carty Services, Inc.</td>
<td>Bankers Trust Company</td>
<td>December 31, 1984</td>
<td>P-1</td>
</tr>
<tr>
<td>Equilease Corporation</td>
<td>Manufacturers Hanover</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>Fidelity Bond and Mortgage Company</td>
<td>Citibank</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>Kawasaki Motors, U.S.A.</td>
<td>Wells Fargo Bank</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>MYA Fuel Company</td>
<td>Manufacturers Hanover</td>
<td>August 26, 1981</td>
<td>P-1</td>
</tr>
<tr>
<td>Nisso-Iwai American</td>
<td>Mellon Bank</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>Northland Mortgage Company</td>
<td>First National Bank of Minneapolis</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>Olin-American</td>
<td>Manufacturers Hanover</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>Realty and Mortgage Investment</td>
<td>Wells Fargo Bank</td>
<td>November 30, 1982</td>
<td>P-1</td>
</tr>
<tr>
<td>SN-1 Fuel, Inc.</td>
<td>Manufacturers Hanover</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>San Onofre Fuel Company</td>
<td>Manufacturers Hanover</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>Sierra Trust</td>
<td>Security Pacific National</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>Songs Fuel Company</td>
<td>Manufacturers Hanover</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>Southern Union Refining</td>
<td>Manufacturers Hanover</td>
<td>April 30, 1982</td>
<td>P-1</td>
</tr>
<tr>
<td>Toshiba International</td>
<td>Wells Fargo Bank</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
<tr>
<td>Waterford Fuel Supply Trust</td>
<td>Manufacturers Hanover</td>
<td>Upon written notice</td>
<td>P-1</td>
</tr>
</tbody>
</table>

*Source: Moody's Bond Record, March, 1979.*
The remaining thirteen documented discount notes are subject to termination upon written notice. Manufacturers Hanover Trust is the bank providing letter of credit facilities for eight of the seventeen documented discount notes. All issues presently outstanding are rated P-1, i.e., Prime-1, the Moody's rating assigned to commercial paper of the highest quality. Previously documented discount notes were rated "Prime-1 LOC," "Prime-2 LOC," and "Prime-3 LOC." The practice was discontinued effective February 1, 1979. The documented discount note is a money market instrument similar to the banker's acceptance in that both instruments are drawn under a letter of credit.

---

16Moody's Bond Record, March, 1979, p. 68.
CHAPTER IV

TECHNICAL ASPECTS OF THE BANKER'S ACCEPTANCE
AND THE BANKERS' ACCEPTANCE MARKET

The purpose of this chapter is to examine the technical aspects of the banker's acceptance and the bankers' acceptance market. First, the taxation of acceptance interest income and capital gains is examined. Second, the special role of the banker's acceptance under the Uniform Commercial Code is analyzed. Third, current accounting theory and techniques applicable to bankers' acceptances are discussed. And finally, the Federal Reserve eligibility requirements for bankers' acceptances are examined.

Taxation Aspects of the Banker's Acceptance

The general tax rule regarding interest is that all interest received or accrued is fully taxable.\(^1\) One principal exception to this rule is that interest income from state and municipal obligations is tax exempt. Based upon the general rule, then, interest income from obligations sold on a discount basis—such as the banker's acceptance—is fully taxable.

\(^1\)Internal Revenue Regulation §1.61-7.
Interest income on a banker's acceptance is fully taxable with one interesting exception. Since 1952, interest income on bankers' acceptances received by non-resident aliens has been tax exempt. The non-resident alien may not be engaged in a trade or business in the United States. Thus, an Englishman living in England purchasing a banker’s acceptance is required to pay no U.S. tax on the interest income he receives, assuming he is not engaged in a trade or business in the United States.

Because bankers' acceptances are sold on a discount basis, one might expect the potential for capital gain or loss treatment. Capital gain or loss treatment would not be applicable to a seller of merchandise holding a banker's acceptance, however, a capital asset being defined by the Internal Revenue Regulations as follows:

[The Code] excludes from the definition of a "capital asset" accounts or notes receivable acquired in

---

2Deputy Commissioner Letter Ruling dated March 12, 1952. The Commerce Clearinghouse digest of the letter ruling is as follows:

The excess of the proceeds of bankers' acceptances and commercial paper at maturity over cost to the holder is not interest and is not taxable to non-resident alien individuals not engaged in trade or business in the U.S. at any time during the taxable year or to nonresident foreign corporations. The excess over the purchase price of bankers' acceptances and commercial paper from sale prior to maturity is not interest and is not taxable to a non-resident corporation, but it may be to nonresident alien individuals. CCH-Standard Federal Tax Reports 4149.022.

3Internal Revenue Regulation §1.1221-1(d).
the ordinary course of trade or business for services rendered or from the sale of stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business.

The Regulations continue with an example of method by which the instrument is taxed:

Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount previously reported, the excess is treated as ordinary income.

Specific tax litigation has denied capital gain or loss treatment to sellers acquiring trade acceptances in the course of business under the provisions of the above regulation. For investors in bankers' acceptances in the money market, capital gain or loss potential is virtually impossible because the holding period to qualify for capital gain treatment is in excess of one year beginning after 1977. Capital gain treatment to holders of bankers' acceptances is thus not possible because maturities of the instruments are almost always less than one year. In summary, capital gain or loss treatment is denied to sellers acquiring bankers' acceptances in the course of

---

4 Internal Revenue Regulation §1.1221-1(d).

5 The Board of Tax Appeals held that trade acceptances represent property held for sale to customers in the ordinary course of trade or business, and capital loss provisions are therefore not applicable. Hercules Motor Corp., 40 BTA 999.
trade and to investors purchasing bankers' acceptances in the course of investment.

Legal Aspects of Bankers' Acceptances

For many years the term "negotiable instrument" was used to describe a certain type of written contract able to represent credit, to function as a substitute for money, and to be freely transferable. Negotiable is derived from the Latin word negotiatus, the prefix neg meaning "not" and the root otium indicating "leisure," the combination being therefore "not-leisure." The connotation is that certain kinds of paper, negotiable paper, are readily transferable from person to person.

Negotiable instruments today are termed "commercial paper" in the parlance of the Uniform Commercial Code (U.C.C.). The four kinds of commercial paper identified by the U.C.C. are:

(a) a "draft" (bill of exchange) if it is an order.
(b) a "check" if it is a draft drawn on a bank and payable on demand.
(c) a "certificate of deposit" if it is an acknowledgment by a bank of receipt of money with an engagement to repay it.
(d) a "note" if it is a promise other than a certificate of deposit.

The banker's acceptance is a draft or bill of exchange and falls in the first category. Commercial paper is identified

6The general law of commercial paper is found in Article 3 of the Uniform Commercial Code (U.C.C.).
7U.C.C. Section 3-104(2).
by the number of parties necessary to create the paper. Drafts (bills of exchange) and checks are three-party paper; notes and certificates of deposit are two-party paper.

Bankers' acceptances are called "documentary drafts" under the Code and are defined as follows:  

A documentary draft or a documentary demand for payment is one honor of which is conditioned upon the presentation of a document or documents. Document means any paper including documents of title, security, invoice, certificate, note of default, and the like. The term "document" as used in this section would include a bill of lading, commercial invoice, and letter of credit, three important documents in the foreign trade transaction.

Two articles of the U.C.C. may govern bankers' acceptances. "A draft accompanying security instruments may be under proper circumstances negotiable commercial paper, controlled by Article 3, or it may be so related to the security transaction that its negotiable attributes will be determined by Article 9." Article 3 of the Code deals with commercial paper; Article 9 deals with secured transactions. Operation of Article 9 would require words on the face of the acceptance relating the draft to a very specific foreign trade transaction.

---

8 U.C.C. Section 5-103(b).

9 Essel Dillavou and others, Principles of Business Law, alternate 7th edition (Englewood Cliffs, New Jersey, Prentice-Hall, Inc., 1964), p. 446. This has been an invaluable source of material for this section.
The laws of negotiable instruments have been codified only within the past one hundred years. The bill of exchange was in wide use in Europe at the close of the seventeenth century, though the instrument was not recognized by the English common law courts. As Dillavou notes, no mention of commercial paper is made at all in early English law reports.\textsuperscript{10} Disagreements between merchants were settled in special courts created by the merchants themselves. From these legal disputes emerged a special form of law, \textit{lex mercatorum}, or the law merchant. At the great European fairs of the 1700s, disagreements were settled by the law merchant. Expediency being an important element in the dispensing of justice, these courts were called Courts of Piepoudres (pieds poudres) because disputes were settled as dust fell from the parties' feet. Though the mercantile courts were later absorbed by the kings' courts, the law merchant lived on and was officially codified by Parliament with the Bills of Exchange Act in 1882. Under sponsorship of the American Bar Association the equivalent code was completed in the United States in 1896 as the Negotiable Instruments Law. This was revised and modernized by the Uniform Commercial Code, promulgated in 1952 and which became effective in Oregon on September 1, 1963. Oregon

\textsuperscript{10} Ibid., p. 434.
was the first state in the Pacific Northwest and the first state on the West Coast to adopt the Code.  

In order for an instrument to qualify as commercial paper and as a negotiable banker's acceptance, the U.C.C. imposes four requirements. These are that the instrument must (1) be signed by the maker or drawer, (2) contain an unconditional promise to pay a sum certain in money, (3) be payable on demand or at a definite time, and (4) be payable to order or to bearer. With regard to the last requirement, it should be noted that most bankers' acceptances are payable to order rather than to bearer. A time draft is shown in Figure 7 and the accepted draft, the banker's acceptance, is shown in Figure 8.

The first requirement of the U.C.C. for the creation of commercial paper is that the instrument be signed by the maker or drawer. The signature need not appear any special place upon the instrument and no particular type or kind of writing is required. The acceptance in Figure 6 would be signed by an authorized representative of the maker of the acceptance, Guarani Mendoza & Co. The

---

11The first state to adopt the Code was Pennsylvania in 1954. The first states to adopt the Code in the West were New Mexico (January 1, 1963) and Wyoming (January 2, 1963).

12Code requirements for the creation of commercial paper are within the general framework of Article 3.

13Dillavou, p. 454.
NO. 4326 | SANTOS, BRAZIL, APRIL 20th 19* | U.S. $ 50,000.00 | 1-23 3/10

NINETY (90) ----------------------------- DAYS AFTER SIGHT PAY TO THE ORDER OF

OURSelves

FIFTY THOUSAND AND 00/100 ----------------------------- DOLLARS

Drawn under Morgan Guaranty Trust Company of New York, L/C No. 89054, dated New York
April 2nd 19* covering shipment of 1,000 bags coffee.

TO

MORGAN GUARANTY TRUST COMPANY
OF NEW YORK
NEW YORK, NEW YORK

GUARANI MENDOZA & CO.

63
Fig. 8--A banker's acceptance
banker's acceptance in Figure 8 is created by the stamp and signature of the authorized officer of the drawee, Morgan Guaranty Trust Co.

The second requirement of the Code for the creation of commercial paper is that the instrument contain an unconditional promise to pay a sum certain in money. The acceptance in Figure 8 satisfies this requirement. The words "pay to the order of" represent an unconditional promise to pay a sum certain in money. A promise to pay subject to the terms of some other agreement is not conditional. While the draft in Figure 8 refers to the underlying trade transaction and the applicable letter of credit ("Drawn under Morgan Guaranty Trust Company of New York L/C No. 89054, dated New York April 2nd 19* covering shipment of 1,000 bags of coffee."), payment is not conditioned upon the success or failure of the export sale. The purpose of the notation is to inform, not to restrict. Language with regard to the amount of money to be paid must be certain. The trade draft in Figure 7 indicates the $50,000 amount of the transaction both in figures and in numbers. Thus, the instruments illustrated satisfy the second Code requirement of an unconditional promise to pay a sum certain in money.

The fourth requirement of the Code for the creation of commercial paper is that the instrument be payable to
order or to bearer. The purpose of this requirement is to ensure that the drawer or the maker clearly indicates the intention to create negotiable paper. Bankers' acceptances are almost always order instruments, and the acceptance in Figure 8 uses the words "Pay to the order of ourselves," i.e., it is payable to the order of the drawer, Guarani Mendoza & Co.

The third requirement of the U.C.C. for the creation of commercial paper is that the instrument be payable on demand when it so states, when it is payable upon presentation or sight, or when no time of payment is written. A banker's acceptance is payable at a definite time when it so states. The acceptance in Figure 8 satisfies the requirement by indicating that it is payable "Ninety (90) days after sight."

The transfer of an instrument may be accomplished by either assignment or negotiation. Black's Law Dictionary defines an assignment as follows: "A transfer or making over to another of the whole of any property, real or personal, in possession or in action, or any estate or right therein . . . It includes transfers of all kinds of property . . . But it is ordinarily limited to transfers of choses in action . . ." A chose in action is the right

of one person to recover money or property from another in a judicial proceeding, with the right arising most frequently out of a contract. Contract rights are transferred by the legal process of assignment. Black's Law Dictionary defines negotiation as follows: "The act by which a bill of exchange or promissory note is put into circulation by being passed by one of the original parties to another person." Commercial paper, e.g., a banker's acceptance, is transferred by negotiation. Transfer by negotiation conveys superior rights to the transferee. Assume X owes Y $500 for goods sold by Y to X. Y thus has the right that he be paid $500 by X. Such a contractual right is a chose in action. This right may be transferred by the process of assignment. Suppose Y assigns this right to Z. Z is the assignee and he acquires no better right against X than the right that Y, the assignor, has. However, if the instrument is commercial paper, the right of Z is superior to a simple contract right. Such is the unique feature of negotiability. "This feature is the essence of negotiability. Business convenience requires this characteristic; it is the very reason for which the paper is created." Transfer by negotiation places the transferee in the superior position; transfer by assignment places the assignee in the inferior position.

Dillavou, p. 436.
The Code states, "The transfer of an instrument vests in the transferee such rights as the transferor has..." 16 Two methods of negotiation exist. A banker's acceptance payable to order is transferred by indorsement and delivery. The banker's acceptance in Figure 8 would be indorsed on the reverse side by the drawee and presented to the payee; the instrument would thus be negotiated. A banker's acceptance payable to bearer would be negotiated by mere delivery.

Three types of indorsements are recognized by the Code: blank, special, and restrictive. A blank indorsement is created by the indorser writing only his name on the reverse of the banker's acceptance. If an acceptance is drawn to order, a blank indorsement transforms it into bearer paper and negotiation is by delivery.

The U.C.C. states that a special indorsement "... specifies the person to whom or to whose order it makes the instrument payable. Any instrument specially indorsed becomes payable to the order of the special indorsee and may be further negotiated only by indorsement." 17 A banker's acceptance indorsed "Pay to William L. Beatty" bears a special indorsement and subsequent negotiation would be by the further indorsement of William L. Beatty.

16 U.C.C. Section 3-201.
17 U.C.C. Section 3-204.
A restrictive indorsement imposes qualifications by the indorsement. The language of the Code is:\textsuperscript{18}

An indorsement is restrictive which either
(a) is conditional; or
(b) purports to prohibit further transfer of the instrument; or
(c) includes the words "for collection," "for deposit," "pay any bank," or like terms signifying a purpose of deposit or collection; or
(d) otherwise states that it is for the benefit or use or the indorser or other persons.

An example of a restrictive indorsement is "Pay to the order of Helen Mathews upon delivery of Container No. 1036543R-95 to the Port of Houston on December 31, 1978."

Thus there are three basic types of indorsements: blank, special, and restrictive.\textsuperscript{19}

For purposes of establishing the liability of parties, the parties to commercial paper are divided into two groups--primary parties and secondary parties. Primary parties are the makers of notes and the acceptors of drafts. Secondary parties are the drawers of drafts, the drawers of checks, and all indorsers. Referring to Figure 8, the drawer of the banker's acceptance (Guarani Mendoza & Co.) is a secondary party, the acceptor of the banker's acceptance (Morgan Guaranty Trust Co.) is a primary party, and each indorser (Guarani Mendoza & Co. would be the first)

\textsuperscript{18}U.C.C. Section 3-205.

\textsuperscript{19}While the Negotiable Instruments Law provided for a conditional indorsement, the Code considers a conditional indorsement as a type of restrictive indorsement.
is a secondary party. The importance of determining the status of primary party or secondary party is explained by Dillavou:\textsuperscript{20}

A primary party is primarily liable; that is, he is the person who, by the terms of the instrument is absolutely required to pay the same. A secondary party is secondarily liable; that is, he becomes liable only when the primary party fails to pay and the holder performs certain conditions precedent; namely presentment, notice, and dishonor . . .

From a practical standpoint the banker's acceptance trades in the market on the strength of the acceptor's name. The name of Morgan Guaranty Trust Co. would ensure that the banker's acceptance is classified as a "prime" acceptance. The purchase of the acceptance in the money market would have the guarantee of the commercial bank. Additionally, there is the support of the self-liquidating nature of the underlying foreign trade transaction itself.

The Code demands that negotiable commercial paper be in writing and signed by the maker or drawer. In the language of the U.C.C.,\textsuperscript{21}

(1) No person is liable on an instrument unless his signature appears thereon.
(2) A signature is made by use of any name, including any trade or assumed name, upon an instrument, or by any word or mark used in lieu of a written signature.

\textsuperscript{20}Dillavou, p. 493.

\textsuperscript{21}U.C.C. Section 3-401.
The completed banker's acceptance (Figure 8) bears the signatures of the drawer (Guarani Mendoza & Co.) and the acceptor (by an authorized agent of Morgan Guaranty Trust Co.). A signature which appears on commercial paper indicating an undefined capacity is deemed to be that of an indorser. Words indicating the signer is not in fact an indorser are interpreted as such. "Thus the signatures 'John Jones, Maker,' 'Henry Brown, Acceptor,' 'Pete Smith, Surety' clearly indicate an intention to be bound, but not as indorsers."

Bankers' acceptances are accepted by agents acting on behalf of principals, i.e., commercial bank officers acting on behalf of their commercial banks. Specific provision is provided in the Uniform Commercial Code whereby an authorized agent may release himself from personal liability by a proper signature. The basic provisions are:

(1) A signature may be made by an agent or other representative, and his authority to make it may be established as in other cases of representation. No particular form of appointment is necessary to establish such authority.

(2) An authorized representative who signs his own name to an instrument (a) is personally obligated if the instrument neither names the person represented nor

---


23Dillavou, p. 546.

24Ibid., p. 547.
shows that the representative signed in a representative capacity;
(b) except as otherwise established between the immediate parties, is personally obligated if the instrument names the person represented but does not show that the representative signed in a representative capacity, or if the instrument does not name the person represented but does show that the representative signed in a representative capacity.
(3) Except as otherwise established the name of an organization preceded or followed by the name and office of an authorized individual is a signature made in a representative capacity.

In the banker's acceptance illustrated (Figure 8), the officer's signature appears on the line following "Payable at 15 Broad Street, New York, Morgan Guaranty Trust Company of New York." The officer's signature is followed by his position and thus releases him from the personal liability provisions of the Code.

Regarding any unauthorized signatures the U.C.C. states:

(1) Any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it; but it operates as the signature of the unauthorized signer in favor of any person who in good faith pays the instrument or takes it for value.
(2) Any unauthorized signature may be ratified for all purposes of this Article. Such ratification does not of itself affect any rights of the person ratifying against the actual signer.

The term "unauthorized signature" includes forgeries and signatures of agents who exceed their authorities. A

\[25\text{U.C.C. Section 3-404.}\]
banker's acceptance bearing a forged signature or bearing the signature of one who is not an authorized agent is in the language of the Code wholly inoperative. The person whose signature is forged is not liable if he does not ratify the transaction. The forger or agent is, however, bound on the instrument.

If a commercial bank pays an order banker's acceptance to the wrong person because of a forged or unauthorized signature or indorsement, it is liable to the proper payee for payment. In the illustration being used (Figure 8), if the drawee bank pays a party other than the payee Guarani Mendoza & Co. because of a forged signature, the drawee bank is nevertheless liable to the payee, Guarani Mendoza & Co. The "Rule of Price V. Neal" bars recovery by a drawee bank which honors an instrument bearing a forged drawer signature. If a bank honors a banker's acceptance bearing a signature of an agent lacking authority, "the bank will be held liable if it were charged with knowledge of the lack of authority and the principal can recover from the bank the amount paid out on such forged indorsement."

---


What right does the drawer have? "The drawer can insist that the drawee recredit his account with the amount of any unauthorized payment." Thus, commercial banks have a special liability to the parties to a banker's acceptance.

Commercial paper qualifying as a negotiable instrument within the provisions of the Code is a contract. As such, the basis for liability is consideration. Consideration is defined as the "... surrender of or a promise to surrender a legal right at the request of another. Actually, it is the price for which the promisor bargains in exchange for his promise." The consideration in the banker's acceptance shown in Figure 8 is $50,000. Contracts and commercial paper lacking consideration are generally unenforceable. As a practical matter, commercial paper will seldom lack consideration.

The Negotiable Instruments Law held that a draft itself was not an assignment of funds and the drawee was not liable until he accepted. The Code continues these provisions. By accepting an instrument the drawee-acceptor

\[^{29}\text{Ibid.}, \text{p. 550. The case citation is Stone \& Webster Engineering Corp. v. First National Bank \& Trust Co. of Greenfield, 184 N.E. 2d 358 (1962).}\]

\[^{30}\text{Ibid.}, \text{p. 199.}\]

\[^{31}\text{Stelmarck et al. v. Glen Alden Coal Co., 339 Pa. 410 A 2d 127 (1940).}\]

\[^{32}\text{Negotiable Instruments Law Section 127.}\]
becomes a primary obligor, but until that time he has no liability on the instrument. The U.C.C. defines and explains the operation of acceptance as follows: 33

(1) Acceptance is the drawee's signed engagement to honor the draft as presented. It must be written on the draft, and may consist of his signature alone. It becomes operative when completed by delivery and negotiation.

(2) A draft may be accepted although it has not been signed by the drawer or is otherwise incomplete or is overdue or has been dishonored.

(3) Where the draft is payable at a fixed period after sight and the acceptor fails to date his acceptance the holder may complete it by supplying a date in good faith.

The banker's acceptance illustrated would bear the signature of an agent of Morgan Guaranty Trust Co. and the instrument bears the stamped term "Accepted." The instrument should be dated by the drawee bank because it is payable 90 days after sight. "Present banking practice requires the paper to be forwarded to the drawee for either acceptance upon the paper, or upon the understanding that the obligation to pay has been previously secured by letter of credit." 34

Because the drawee bank lends its name and credit to the instrument, it is an "accommodation party." 35 An

33 U.C.C. Section 3-406.
34 Dillavou, p. 559. The applicable U.C.C. provision is Article 5, Letters of Credit.
accommodation party is always a surety under the Uniform Commercial Code. This is important to money market purchasers of bankers' acceptances, for a surety is liable on the same obligation with the principal obligor, while a guarantor promises to pay if the principal obligor defaults.

The drawee bank is a surety and thus the purchaser of a banker's acceptance need not worry whether the payor of the acceptance honors his obligation. An accommodation party is defined and the contract of accommodation is explained as follows:

(1) An accommodation party is one who signs the instrument in any capacity for the purpose of lending his name to another party to it.

(2) When the instrument has been taken for value before it is due the accommodation party is liable in the capacity in which he has signed even though the taker knows of the accommodation.

(3) As against a holder in due course and without notice of the accommodation oral proof of the accommodation is not admissible to give the accommodation party the benefit of discharges dependent on his character as such. In other cases the accommodation character may be shown by oral proof.

(4) An indorsement which shows that it is not in the chain of title is notice of its accommodation character.

(5) An accommodation party is not liable to the party accommodated, and if he pays the instrument has a right of recourse on the instrument against such party.

As Dillavou indicates, "... an accommodation maker or acceptor is bound as a party to the instrument without the

---

36Dillavou, p. 562. 37U.C.C. Section 3-415.
necessity or proceeding against the principal, the accom-
modated party . . . "38 It is this important Code pro-
vision and the Law of Suretyship which allow bankers' ac-
ceptances to trade in the money market. Because Morgan
Guaranty Trust Co. is a financial heavyweight, its accep-
tances (refer to Figure 8) bear the appellation "prime"
and are accordingly allowed entry into the money market.

In addition to contract liabilities of parties to
bankers' acceptances, there also exist warranty liabilities
or parties to bankers' acceptances. Two basic types of
warranties are found in the law of commercial paper: the
warranty on presentment and the warranty on transfer. Pre-
sentment warranties are given by those who receive payment
on or obtain acceptance of an instrument.

The transfer warranties listed in the U.C.C. are:39

(1) Any person who obtains payment or acceptance and
any prior transferor warrants to a person who in
good faith pays or accepts that
(a) he has good title to the instrument or is
authorized to obtain payment or acceptance
on behalf of one who has good title; and
(b) he has no knowledge that the signature of the
maker or drawer is unauthorized, except that
this warranty is not given by a holder in due
course acting in good faith
(i) to a maker with respect to the maker's
own signature; or
(ii) to a drawer with respect to the drawer's
own signature, whether or not the drawer
is also the drawee; or
(iii) to an acceptor of a draft if the holder
in due course took the draft after the

38Dillavou, p. 563. 39U.C.C. Section 3-417(1)
acceptance or obtained the acceptance without knowledge that the drawer's signature was unauthorized; and

(c) the instrument has not been materially altered, except that this warranty is not given by a holder in due course acting in good faith

(i) to the maker of the note; or

(ii) to the drawer of the draft whether or not the drawer is also the drawee; or

(iii) to the acceptor of the draft with respect to an alteration made prior to the acceptance if the holder in due course took the draft after the acceptance, even though the acceptance provided "payable as originally drawn" or equivalent terms; or

(iv) to the acceptor of the draft with respect to an alteration made after the acceptance.

Because the payee receives payment, the presentment warranties apply to him. A forged instrument breaches the warranty of good title. The transfer warranties listed in the U.C.C. continue:

(2) Any person who transfers an instrument and receives consideration warrants to his transferee and if the transfer is by indorsement to any subsequent holder who takes the instrument in good faith that

(a) he has good title to the instrument or is authorized to obtain payment or acceptance on behalf of one who has good title and the transfer is otherwise rightful; and

(b) all signatures are genuine or authorized; and

(c) the instrument has not been materially altered; and

(d) no defense of any party is good against him...

The purpose of the transfer warranties, as may be seen, is to protect the transferee.

⁶⁶U.C.C. Section 3-417(2).
A "holder" is defined in the law of commercial paper to be "a person who is in possession of a document of title or an instrument or an investment security drawn, issued, or indorsed to him or to his order or to bearer or in blank."¹ The holder of a banker's acceptance may transfer or negotiate it. The holder of a negotiable instrument may occupy one of two positions. He may be in the position of the assignee of a simple contract right, i.e., he is subject to the personal defenses that the maker or drawer or any other parties prior to him have against the payee. A holder in due course is, however, in a privileged position for he takes the instrument free of certain defenses. A holder in due course would take a banker's acceptance free from ²

(2) all defenses of any party to the instrument with whom the holder has not dealt except
(a) infancy, to the extent that it is a defense to a simple contract; and
(b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and
(c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and
(d) discharge in insolvency proceedings; and
(e) any other discharge of which the holder has notice when he takes the instrument.

¹U.C.C. Section 1-201(20).
²U.C.C. Section 3-305(2).
Assume W draws a draft upon Bank X to finance a foreign trade transaction. Bank X fails to verify the transaction and accepts the draft, returning it to W. W indorses the banker's acceptance and then negotiates it to Y. Y qualifies as a holder in due course and he in turn negotiates the acceptance to Z. Z learns the banker's acceptance was created through misrepresentation. Y, however, is a holder in due course and Y is therefore not subject to the defenses of Z. Y, a holder in due course, is in a position to cut off these defenses. Z, the holder, must look "upstream" in the sequence of endorsements, i.e., Z must look to W for restitution.¹³

The requirements for holder in due course status are that the holder must have taken:

1. In good faith.
2. Without notice that the instrument has been dishonored.
3. Without notice that the instrument is overdue.
4. Without notice of any claim against the instrument.
5. Without notice of any defense against the instrument.

If a holder does not satisfy all of the above requirements, he does not qualify as a holder in due course. The inferior position of a holder relative to that of a holder in due

¹³Dillavou, p. 510.
course may be seen from the fact that a mere holder is subject to:"

(a) all valid claims to it [the instrument] on the part of any person; and
(b) all defenses of any party which would be available in an action on a simple contract; and
(c) the defenses of want or failure of consideration, non-performance of any condition precedent, non-delivery, or delivery for a special purpose (Section 3-408); and
(d) the defense that he or a person through whom he holds the instrument acquired it by theft, or that payment or satisfaction to such holder would be inconsistent with the terms of a restrictive endorsement. The claim of any third person to the instrument is not otherwise available as a defense to any party liable thereon unless the third person himself defends the action for such party [emphasis added].

The holder in due course not being subject to these claims and defenses is in a clearly better position.

Section 3-307 of the Code establishes procedural aspects of commercial paper litigation with regard to the burden of establishing signatures, defenses, and due course status. There is a general presumption that all signatures on an instrument are genuine or authorized. The defendant must establish any and all defenses. And a holder has the burden of establishing holder-in-due-course status.

Presentment is defined in the Code as a "demand for acceptance or payment upon the maker, acceptor, drawee or

"4U.C.C. Section 3-306.
other payor by or on behalf of the holder.\textsuperscript{46} There are two basic types of presentment for a negotiable instrument: presentment for payment and presentment for acceptance. The latter applies to bankers' acceptances. The method of presentment is generally immaterial: the acceptance may be presented by mail or telephone, through a clearinghouse, or in any other way. "The place of presentment is usually immaterial, but a draft accepted or a note made payable at a bank must be presented at such bank."\textsuperscript{47} The banker's acceptance in Figure 8 specifies "Payable at 15 Broad Street, New York" and it must be presented to the main office of Morgan Guaranty Trust Co. The time of presentment is governed by the rules: "Where any presentment is due on a day which is not a full business day for either the person making presentment or the party to pay or accept, presentment is due on the next following day for both parties. Presentment to be sufficient must be made at a reasonable hour, and if at a bank during its banking day."\textsuperscript{48} A banker's acceptance payable on November 6 must be presented for acceptance during banking hours on or before that date, assuming November 6 is a business day.

When an instrument duly presented is refused payment, the instrument is dishonored. After dishonor, the

\textsuperscript{46}U.C.C. Section 3-504. \textsuperscript{47}Dillavou, p. 613. \textsuperscript{48}U.C.C. Section 3-503(3) and (4).
holder has the right of recourse against previous parties.

The Code states any party to a negotiable instrument may be discharged:

1. By payment or satisfaction.
2. By tender of payment.
3. By cancellation or renunciation.
4. By impairment of right of recourse or collateral.
5. By reacquisition of the instrument by a prior party.
6. By fraudulent and material alteration.
7. By certification of a check.
8. By acceptance varying a draft.
9. By unexcused delay in presentment or notice of dishonor or protest.

Additionally, "any party is also discharged from his liability on an instrument to another party by any other act or agreement with such party which would discharge his simple contract for the payment of money."\footnote{U.C.C. Section 3-601(2)}

In summary, the banker's acceptance occupies a special position in the Uniform Commercial Code, that of a documentary draft. To qualify as a negotiable instrument a banker's acceptance must be signed by the drawer, contain an unconditional promise to pay a sum certain in money, be

\footnote{U.C.C. Section 3-601.} \footnote{U.C.C. Section 3-601(2).}
payable on demand or at a definite time, and be payable to order or to bearer. Transfer of the instrument is accomplished by negotiation. The acceptor of the banker's acceptance is a primary party, while the drawer and all indorsers are secondary parties. The Code identifies contract liabilities and warranty liabilities of parties to bankers' acceptances. The person in possession of an acceptance may be a holder or in the superior position of a holder in due course. Specific provisions are also found in the Code for presentment, notice of dishonor, and discharge. The principal parties to a banker's acceptance are the drawer (frequently an exporter), the drawee-acceptor (such as Morgan Guaranty Trust Co.), the payee, and any indorsers.

Accounting for Bankers' Acceptances

When a commercial bank accepts a draft and thereby creates a banker's acceptance, the commercial bank creates from an accounting standpoint a contingent liability. Contingent liabilities may be defined "... as potential obligations the existence of which is conditional upon the happening of some future event." The banker's acceptance, a potential obligation of the accepting bank

---

payable upon presentation, is thus a contingent liability.

Accounting for contingent liabilities is the subject of FASB Statement No. 5, "Accounting for Contingencies," issued by the Financial Accounting Standards Board (FASB) in 1975. The FASB defined a contingency as an existing condition, situation, or set of circumstances producing uncertainty as to possible gain (i.e., a gain contingency) or possible loss (i.e., a loss contingency) to an accounting entity that eventually will be resolved when a future event occurs or fails to occur. The determination of uncertainty regarding a loss contingency results in the reduction of an asset or incurrence of a liability. The resolution of uncertainty concerning a banker's acceptance occurs when the drawee pays the accepting bank and the accepting bank then honors the outstanding banker's acceptance.

The FASB has stated that estimated expenses from loss contingencies should be accrued if (1) information indicates that it is probable a liability has been incurred at the balance sheet date, and (2) the amount of

\[52\text{FASB Statement No. 5, "Accounting for Contingencies" (Stamford, Financial Accounting Standards Board, 1975), p. 1.}\]

\[53\text{Meigs, pp. 408-409.}\]
the loss or expense can be reasonably estimated.\textsuperscript{54} The FASB Statement identifies examples of loss contingencies, one of which is an obligation of a commercial bank drawn under a "standby letter of credit."\textsuperscript{55} Thus, a commercial bank must account for contingent liabilities on the balance sheet resulting from the extension of acceptance credit.

Accounting for a banker's acceptance transaction may be illustrated by journal entries of the accepting bank. Assume the Second National Bank of Oregon issues a letter of credit to finance an import transaction for its customer, American Importing of Portland, in the amount of $50,000 in favor of A. Piranha Co., a Brazilian forest products company. The acceptance financing is for 60 days. The parties to the transaction are A. Piranha, drawer of the draft; American Importing Co. of Portland, drawee on the draft; and Second National Bank of Oregon, acceptor of the draft. The letter of credit should specify "about $50,000" since the exact amount of the transaction is unknown until the draft is drawn.

The draft of the exporter is presented through banking channels in the actual amount of $49,500 to the Second National Bank of Oregon. The journal entry for the accepting bank is

\textsuperscript{54}FASB Statement No. 5, p. 4. \textsuperscript{55}Ibid.
1. Customer's Liability on Acceptance  $49,500
   Liability on Acceptance        $49,500
   To record acceptance of draft under Letter
   of Credit No. ---

The accepting bank records a receivable from its customer with the debit entry and a contingent liability with the credit entry as a result of the acceptance shown in journal entry one.

The accepting bank collects the face amount of the draft from its customer (American Importing of Portland) plus the customary acceptance fee of 1.5 per cent per annum of the face amount of the draft. The journal entry for the accepting bank is

2. Cash        $49,623.75
   Customer's Liability on Acceptance  $49,500.00
   Acceptance Revenue  123.75
   To record collection of cash from cus-
   tomer and to record collection of accep-
   tance fee (1.5% of $49,500 x 2/12)
   under Letter of Credit No. ---

The accepting bank records the receipt of cash from its customer with the debit entry, the collection of a customer receivable with the first credit entry, and the recognition of revenue with the second credit entry.

The banker's acceptance is tendered by a money market investor to the Second National Bank of Oregon. The Second National Bank of Oregon pays the face amount of the draft, $49,500. The journal entry for the accepting bank is
3. Liability on Acceptance $49,500  
Cash $49,500

To record payment on outstanding acceptance issued under Letter of Credit No. ---

The accepting bank records the extinguishment of the contingent liability with the debit entry and payment of cash to the holder of the banker's acceptance as a result of journal entry three.

The result of these transactions is that the accepting bank lends its name so that a money market instrument is created and in the process creates a contingent liability.

Bankers' acceptances may represent billion dollar assets and liabilities on the balance sheets of major commercial banks. Table VIII shows the acceptance assets and acceptance liabilities of the five largest U.S. commercial banks at the end of 1977. The asset account is entitled "Customer's Liability on Acceptances." The liability account is entitled "Liability on Acceptances."

BankAmerica had the largest recorded asset account, $1,794,877,000, at the end of 1977, followed by Citicorp, $1,503,692,000. BankAmerica also had the largest recorded contingent liability account $1,800,544,000, at the end of 1977, followed by Citicorp, $1,543,053,000. The liability account in each case exceeds the asset account. This is to be expected, because the bank records the asset and liability upon acceptance and then writes off the receivable (journal entry two) prior to writing off the liability...
(journal entry three). Stated another way, the bank acceptance liability account exceeds the bank asset account because the bank collects from the customer prior to paying the holder of the acceptance. Thus, bankers' acceptances represent significant dollar amounts on the balance sheets of major commercial banks.

**TABLE VIII**

**BANKERS' ACCEPTANCES ON THE BALANCE SHEETS OF THE FIVE LARGEST U.S. COMMERCIAL BANKS, DECEMBER 31, 1977**

*(000'S OMITTED)*

<table>
<thead>
<tr>
<th>Bank</th>
<th>Customer's Liability on Acceptance</th>
<th>Liability on Acceptance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. BankAmerica</td>
<td>$1,794,877</td>
<td>$1,800,544</td>
</tr>
<tr>
<td>2. Citicorp</td>
<td>1,503,692</td>
<td>1,543,053</td>
</tr>
<tr>
<td>3. Chase Manhattan</td>
<td>758,019</td>
<td>783,338</td>
</tr>
<tr>
<td>4. Manufacturers Hanover</td>
<td>901,060</td>
<td>922,831</td>
</tr>
<tr>
<td>5. Morgan Guaranty</td>
<td>972,909</td>
<td>978,224</td>
</tr>
</tbody>
</table>


**Federal Reserve Eligibility Requirements for Bankers' Acceptances**

It is quite important for a commercial bank to create an acceptance eligible for discount at the Federal Reserve, because an ineligible banker's acceptance is subject to
reserve requirements. The imposition of reserve requirements on a draft greatly lessens the profit to a bank of acceptance financing; thus complying with the mechanical requirements of the Fed is critical.

Federal Reserve banks have been empowered to discount bankers' acceptances since passage of the Federal Reserve Act in 1913. The basic law reads:

Any Federal reserve bank may discount acceptances of the kinds hereinafter described, which have a maturity at the time of discount of not more than ninety days' sight, exclusive of days of grace, and which are indorsed by at least one bank: Provided, That such acceptances if drawn for an agricultural purpose and secured at the time of acceptance by warehouse receipts or other such documents conveying or securing title covering readily marketable staples may be discounted with a majority at the time of discount of not more than six months' sight exclusive of days of grace.

Eligible bankers' acceptance maturities thus cannot exceed 90 days, with the exception of those financing some agricultural products.

The Federal Reserve establishes eligibility requirements in Regulation C:

1. Acceptances arising from the importation or exportation of goods to or from the United States

---


2. Acceptances arising from shipment of goods within the United States
3. Acceptances arising from the storage of readily marketable staples in the United States or in any foreign country when the acceptance is accompanied by a warehouse receipt or other document conveying or securing title to the goods.

Bankers' acceptances used to finance the export, import, movement, or storage of goods are eligible for discount at the Federal Reserve under prescribed legislation. Dollar exchange acceptances are not eligible for discount because they do not rise out of a specific foreign trade transaction.

The Federal Reserve imposes certain aggregate limitations upon commercial bank acceptance financing. The total acceptance credit per customer may not exceed 10 per cent of a commercial bank's net capital (i.e., stockholders' equity). For example, if the second National Bank has net capital of $1,000,000, the bank may not extend acceptance credit in excess of $100,000 to any one customer. For larger commercial banks the per-bank limitation would not be a constraining factor. Additionally, the total outstanding credit per bank may not exceed 100 per cent of a commercial bank's net capital. For example, if the Second National Bank has net capital of $1,000,000, the bank may not extend total acceptance credit in excess of $1,000,000.

A bankers' acceptance crunch occurred in July, 1979, when the major money center banks became fully loaned up with acceptances.\textsuperscript{60} Suggestions were made to sell part interests in acceptances during the acceptance crunch,\textsuperscript{61} a subject discussed in detail in Chapter VI.


\textsuperscript{61}\textit{Ibid.}
CHAPTER V

THE STRUCTURE AND FUNCTIONING OF THE
BANKERS' ACCEPTANCE MARKET

The purpose of this chapter is to examine the structure and functioning of the bankers' acceptance market. First, the structure of the market is surveyed, i.e., the types of dealers, the location of the market, and the primary investors. Second, the functioning of the market is analyzed, i.e., spreads in the bankers' acceptance market and pricing of bankers' acceptances. Third, the special relationship between dealers and the Federal Reserve is examined.

The Structure of the Bankers' Acceptance Market

The market for bankers' acceptances is an over-the-counter market composed of ten to fifteen firms. Most of the dealer firms are general dealers in that they maintain an inventory of a number of marketable obligations. There are dealer firms which trade solely in bankers' acceptances. One such firm trading solely in bankers' acceptances is

Bankers Discount Corp., a firm founded in 1932 and located in San Francisco. While there is no known instance of a principal loss to any investor in a banker's acceptance, a dealer firm specializing in bankers' acceptances (M & T Discount Corp.) was forced to leave the acceptance business in 1974 because of narrowing spreads and the high cost of carrying inventory. The bankers' acceptance market today consists primarily of dealer firms maintaining inventories of a number of types of marketable obligations.

The major dealers in bankers' acceptances are located in New York City. As explained in Chapter II, the bankers' acceptance market gravitated to New York City prior to 1920 because of the city's close relationship to foreign trade and activities of the Federal Reserve Bank of New York. Other dealers in bankers' acceptances are located in the major West Coast cities and regional inland financial centers.

---


5Helfrich, p. 55.
The market for bankers' acceptances exceeds forty billion dollars. As a result, there are numerous investors in the secondary market. The major investors in the secondary market for bankers' acceptances are:

1. The Federal Reserve System.
2. The Federal Home Loan Bank Board.
3. Municipal and state treasuries.
5. Savings and loan associations.
7. Foreign banks.
8. Domestic corporations.
10. Insurance companies.
11. Benefit funds and foundations.
12. Union funds.
13. Pension funds.

The ability of state and municipal treasuries to invest in bankers' acceptances is determined by state statutory law. For example, local treasurers in Oregon are limited to a list of certain eligible investments; bankers' acceptances are not among the investments provided for in

ORS 294.035 and bankers' acceptances are thus not eligible for surplus municipal funds.⁷

Some other interesting rules apply to investors. The Internal Revenue Code sets forth a definition of a savings and loan association for federal income tax purposes in Section 7701(a)(19) and includes certain asset tests which must be met for the taxpayer to qualify as a domestic savings and loan association.⁸ The Code provides that not more than 18 per cent of total assets may consist of certain categories of assets. Cash may be held in unlimited quantities. The banker's acceptance is not among the assets qualifying for the 18 per cent test and a specific ruling states that the banker's acceptance is not to be considered as cash for the test.⁹ A savings and loan association is discouraged from buying bankers' acceptances if it is seeking to meet the 18 per cent test to qualify as an association. These are specialized rules concerning the banker's acceptance. The growing use of the banker's acceptance is reflected in its increasing appearance in administrative law and administrative rulings. The growth

⁷"County and Municipal Financial Administration," Oregon Revised Statutes, Section 294.035.

⁸Internal Revenue Code, Section 7701(a)(19).

of the market is also reflected in the list of investors who now participate in the acceptance market.

Pricing and Trading in the Bankers' Acceptance Market

The bankers' acceptance market was characterized by posted rates of dealers until the latter part of 1969. Major acceptance dealers quoted bid and asked rates for selected maturities and stood ready to buy and sell prime bankers' acceptances at the posted rates. This practice reflected a relatively stable market through 1969. The market for bankers' acceptances became more volatile, the practice was altered, and "... it has become generally understood that trading is done on a negotiated basis."

A recent quotation in *The Wall Street Journal* is without bid and asked quotations and reads: "9 3/4%, 30 days; 9 3/4%, 60 days; 9.65%, 90 days; 9.60%, 120 days; 9 1/2%, 150 days; 9 1/2%, 180 days." The absence of bid and asked quotations reflects the fact that negotiated rates are the order of the day.

The dealer's profit is determined by the difference in rate between what the dealer pays for acceptances and what he sells them for, the spread on the cost of financing.

---

10 Helfrich, pp. 55-56.  
his position, and the turnover of his inventory of securities. The normal dealer spread between buying and selling rates for a banker's acceptance is 1/8 to 1/4 per cent; however, the spread can exceed 1 per cent in a volatile market.\textsuperscript{13}

Dealer quotations are an important source of information for accepting banks. Accepting banks employ dealer quotations in establishing a discount rate for customer acceptance financing, customarily adding the acceptance fee of 1 1/2 per cent per annum to the dealer bid rate.\textsuperscript{14}

There are also "odd-lot" discounts in the bankers' acceptance market. As per correspondence with Michael Gabriel in the Money Market Division of the First National Bank of Boston, acceptances aggregating $500,000 are generally the most marketable.\textsuperscript{15} Some investors require that acceptances be in one million dollar blocks. Odd-lot acceptances, those acceptances of less than $500,000, trade in the acceptance market at discounts anywhere from 5 to 15 basis points higher than the round lot acceptances of $500,000.\textsuperscript{16} An odd-lot discount is present in the bankers' acceptance market.

\textsuperscript{13}Helfrich, p. 56.

\textsuperscript{14}Survey questionnaire received from Michael Gabriel, Money Market Division, First National Bank of Boston, on August 13, 1977.

\textsuperscript{15}Ibid.

\textsuperscript{16}Ibid.
Market tiering is also in evidence in the bankers' acceptance market. Mr. Gabriel of the First National Bank of Boston writes that the secondary market is very much tiered.\textsuperscript{17} The bankers' acceptances of BankAmerica, Citicorp, Manufacturers Hanover Trust, Bankers Trust, and Morgan Guaranty trade the lowest discount rates in the secondary market. In a stable market the bankers' acceptances of Mellon and Continental Illinois command similar bids. "If the market is in disarray, the 'tiering' is more pronounced. United California Bank, Marine Midland, and First Pennsylvania can be tough names to sell despite the fact that they are in the 'Top 20.'"\textsuperscript{18} Market tiering in the bankers' acceptance market in the Northeast is on a "name" basis.

Market tiering is also in evidence on the West Coast. Frederick Walker, Vice-President of Bankers Discount Corporation, the largest dealer specializing exclusively in bankers' acceptances, writes from San Francisco:\textsuperscript{19}

There are many investors who restrict their investments in banker's acceptances to those of the:

\textsuperscript{17}Survey questionnaire received from Michael Gabriel, Money Market Division, First National Bank of Boston, on March 30, 1979.

\textsuperscript{18}Ibid.

\textsuperscript{19}Letter from Frederick Walker, Jr., Vice-President of Bankers Discount Corporation of California, dated June 7, 1979.
(1) top 10 U.S. banks  
(2) top 25 U.S. banks  
(3) top 50/100 U.S. banks  
(4) other U.S. banks  
Obviously the market becomes more restrictive as we proceed down the list to  
(5) Edge Act subsidiaries  
(6) ineligible acceptances of U.S. banks  
(7) eligible acceptances of U.S. branches and agencies of foreign banks  

He discusses the differentials attendant with the eight categories:  

The price differentials offered between each of these seven categories has been about 5 to 7 basis points in a stable market and 10 to 125 basis points in a less stable market. In other words the differential between the rates available to an investor on the acceptances of the largest U.S. bank and the 51st largest may range anywhere from 20 to 40 basis points. While the normal differential between top domestic and the eligible acceptances of U.S. agencies of Japanese banks is about 25 basis points. We saw that differential widen to 75 to 100 points during unstable market periods in 1978.  

Market tiering in the bankers' acceptance market on the West Coast is quite pronounced. The eight categories of bankers' acceptances also indicate the level of sophistication of investors in the secondary market.  

Trading spreads between securities are followed closely by participants in the money market. The most comprehensive examination of trading spreads involving bankers' acceptances is Salomon Brothers' An Analytical Record of Yields and Yield Spreads.\(^{20}\) The study examines  

161 different yield series and 181 trading spreads on a monthly basis from January, 1945, through November, 1977, for one-, three-, and six-month bankers' acceptances, Federal Agency issues, commercial paper, finance paper, certificates of deposit, and Europolars. All trading spreads are in basis points from Treasury bill yields. Thus, the importance attached to trading spreads by the market is apparent.

The quarterly trading spread between 90-day prime bankers' acceptances and three-month U.S. Treasury bills from the first quarter of 1973 through the first quarter of 1979 is shown in tabular form in Table IX and in graphical form in Figure 9. The period selected represents twenty-five quarters of data and establishes the recent pattern of trading spreads between bankers' acceptances and Treasury bills. As may be seen from the table, the minimum trading spread occurred in the first quarter of 1976, when acceptance yields exceeded bill yields by only 13 basis points, whereas the maximum trading spread occurred in the third quarter of 1974, when acceptance yields exceeded bill yields by 339 basis points or 3.39 per cent. As the graphical analysis (Figure 9) indicates, the trading spread was quite wide in 1974 and has narrowed considerably in recent years.
<table>
<thead>
<tr>
<th>Quarter</th>
<th>A--90-Day Prime Bankers' Acceptance Yield (%)</th>
<th>B--3-Month Treasury Bill Yield (%)</th>
<th>A-B Trading Spread (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>6.19</td>
<td>5.64</td>
<td>.55</td>
</tr>
<tr>
<td>Quarter II</td>
<td>7.37</td>
<td>6.61</td>
<td>.76</td>
</tr>
<tr>
<td>Quarter III</td>
<td>9.85</td>
<td>8.39</td>
<td>1.46</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>8.91</td>
<td>7.84</td>
<td>1.07</td>
</tr>
<tr>
<td>1974</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>8.33</td>
<td>7.60</td>
<td>.73</td>
</tr>
<tr>
<td>Quarter II</td>
<td>10.36</td>
<td>8.27</td>
<td>2.09</td>
</tr>
<tr>
<td>Quarter III</td>
<td>11.67</td>
<td>8.28</td>
<td>3.39</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>9.19</td>
<td>7.34</td>
<td>1.85</td>
</tr>
<tr>
<td>1975</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>6.70</td>
<td>5.87</td>
<td>.83</td>
</tr>
<tr>
<td>Quarter II</td>
<td>5.87</td>
<td>5.40</td>
<td>.47</td>
</tr>
<tr>
<td>Quarter III</td>
<td>6.66</td>
<td>6.33</td>
<td>.33</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>5.93</td>
<td>5.68</td>
<td>.25</td>
</tr>
<tr>
<td>1976</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>5.08</td>
<td>4.95</td>
<td>.13</td>
</tr>
<tr>
<td>Quarter II</td>
<td>5.44</td>
<td>5.17</td>
<td>.27</td>
</tr>
<tr>
<td>Quarter III</td>
<td>5.37</td>
<td>5.17</td>
<td>.20</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>4.86</td>
<td>5.70</td>
<td>.16</td>
</tr>
<tr>
<td>1977</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>4.81</td>
<td>4.62</td>
<td>.19</td>
</tr>
<tr>
<td>Quarter II</td>
<td>5.17</td>
<td>4.83</td>
<td>.34</td>
</tr>
<tr>
<td>Quarter III</td>
<td>5.82</td>
<td>5.47</td>
<td>.35</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>6.58</td>
<td>6.14</td>
<td>.44</td>
</tr>
<tr>
<td>1978</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>6.82</td>
<td>6.41</td>
<td>.41</td>
</tr>
<tr>
<td>Quarter II</td>
<td>7.33</td>
<td>6.48</td>
<td>.85</td>
</tr>
<tr>
<td>Quarter III</td>
<td>8.18</td>
<td>7.32</td>
<td>.86</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>10.13</td>
<td>8.68</td>
<td>1.45</td>
</tr>
<tr>
<td>1979</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>10.08</td>
<td>9.36</td>
<td>.72</td>
</tr>
</tbody>
</table>

*Source: Survey of Current Business.*
Fig. 9--Quarterly trading spreads between 90-day prime bankers' acceptances and three-month Treasury bills, 1973-1979
The size of the trading spread is determined by the relative movement of bankers' acceptance yields vis-à-vis Treasury bill yields. To compete in the money market for investor funds the banker's acceptance must provide an attractive yield relative to other money market instruments. The banker's acceptance trades on the perceived strength of the accepting bank, whereas the Treasury bill trades on the full faith and credit of the United States government. The resources of the U.S. Treasury exceed the resources of the Bank of America, and therefore the yield of a Treasury bill is less than the yield of a Bank of America acceptance. Investor perceptions of the relative attractiveness of Treasury bills and bankers' acceptances help to explain the size of the trading spreads between the two instruments.

As credit tightened in the second quarter of 1974, interest rates began to rise. Double digit yields on bankers' acceptances occurred, reflecting the general tightening of credit. The tightening of credit during this period reflected a rationing of credit, i.e., bankers' acceptances were required to yield more than Treasury bills in order to obtain relatively scarcer investor funds. It should also be pointed out that the use of bankers' acceptances increased explosively in late 1974 as other credit sources tightened. The substantial spread in the third quarter of 1974 reflects not only an increase in relative
risk position of bankers' acceptances, but also the fact that the volume of bankers' acceptances to be "funded" had greatly increased. Increased trading spreads, then, are characteristic of periods of credit scarcity.

The quarterly trading spread between 90-day prime bankers' acceptances and four- to six-month commercial paper from the first quarter of 1973 through the first quarter of 1979 is shown in tabular form in Table X and in graphical form in Figure 10. The period selected represents twenty-five quarters of data and establishes the recent pattern of trading spreads between bankers' acceptances and commercial paper. As may be seen from the table, the minimum trading spread occurred in the first quarter of 1977 (i.e., there was no trading spread), whereas the maximum trading spread occurred in the fourth quarter of 1978 when bankers' acceptance yields exceeded commercial paper yields by 23 basis points. As the graphical analysis (Figure 10) indicates, the trading spread between bankers' acceptances and commercial paper is rather narrow, never exceeding 25 basis points.

The spread between bankers' acceptance yields and commercial paper yields may be explained by investor perceptions of particular instruments. Prime bankers' acceptances have the guarantee of a recognized commercial bank. Commercial paper has the guarantee of a recognized
<table>
<thead>
<tr>
<th>Quarter</th>
<th>A--90-Day Prime Bankers' Acceptance Yield (%)</th>
<th>B--4-6 Month Com. Paper Yield (%)</th>
<th>A-B Trading Spread (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>6.19</td>
<td>6.28</td>
<td>(.09)</td>
</tr>
<tr>
<td>Quarter II</td>
<td>7.37</td>
<td>7.47</td>
<td>(.10)</td>
</tr>
<tr>
<td>Quarter III</td>
<td>9.85</td>
<td>9.87</td>
<td>(.02)</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>8.91</td>
<td>8.98</td>
<td>(.07)</td>
</tr>
<tr>
<td>1974</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>8.33</td>
<td>8.30</td>
<td>.03</td>
</tr>
<tr>
<td>Quarter II</td>
<td>10.36</td>
<td>10.46</td>
<td>(.10)</td>
</tr>
<tr>
<td>Quarter III</td>
<td>11.67</td>
<td>11.53</td>
<td>.14</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>9.19</td>
<td>9.05</td>
<td>.14</td>
</tr>
<tr>
<td>1975</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>6.70</td>
<td>6.56</td>
<td>.14</td>
</tr>
<tr>
<td>Quarter II</td>
<td>5.87</td>
<td>5.92</td>
<td>(.05)</td>
</tr>
<tr>
<td>Quarter III</td>
<td>6.66</td>
<td>6.67</td>
<td>(.01)</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>5.93</td>
<td>6.12</td>
<td>(.19)</td>
</tr>
<tr>
<td>1976</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>5.09</td>
<td>5.29</td>
<td>(.20)</td>
</tr>
<tr>
<td>Quarter II</td>
<td>5.44</td>
<td>5.57</td>
<td>(.13)</td>
</tr>
<tr>
<td>Quarter III</td>
<td>5.37</td>
<td>5.53</td>
<td>(.16)</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>4.86</td>
<td>4.99</td>
<td>(.13)</td>
</tr>
<tr>
<td>1977</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>4.81</td>
<td>4.81</td>
<td></td>
</tr>
<tr>
<td>Quarter II</td>
<td>5.17</td>
<td>5.24</td>
<td>(.07)</td>
</tr>
<tr>
<td>Quarter III</td>
<td>5.82</td>
<td>5.81</td>
<td>.01</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>6.58</td>
<td>6.59</td>
<td>(.01)</td>
</tr>
<tr>
<td>1978</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>6.82</td>
<td>6.80</td>
<td>.02</td>
</tr>
<tr>
<td>Quarter II</td>
<td>7.33</td>
<td>7.20</td>
<td>.13</td>
</tr>
<tr>
<td>Quarter III</td>
<td>8.18</td>
<td>8.08</td>
<td>.10</td>
</tr>
<tr>
<td>Quarter IV</td>
<td>10.13</td>
<td>9.90</td>
<td>.23</td>
</tr>
<tr>
<td>1979</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quarter I</td>
<td>10.08</td>
<td>10.10</td>
<td>(.02)</td>
</tr>
</tbody>
</table>

*Source: Survey of Current Business.*
Fig. 10—Quarterly trading spreads between 90-day prime bankers' acceptances and four- to six-month commercial paper, 1973-1979
corporation. Both are usually short-term. A bank failure should cause investor concern in the acceptance market and thus higher acceptance yields. Frederick Walker of Bankers Discount Corporation observes in private correspondence with the author:21 "Since the Franklin, U.S. National Bank of San Diego, Herstatt failures and other near misses, investors have become quality conscious and the market place reflects this by interrelated methods which manifests [sic] tiering, exclusion, or pricing." A failure of a major corporation such as the Penn Central should cause investor concern in the commercial paper market and thus higher commercial paper yields. Bankers' acceptances and commercial paper are theoretically comparable when the credit guarantor is examined, e.g., General Motors and Citicorp are both financially strong. The spread between bankers' acceptances and commercial paper then becomes a matter of investor perceptions regarding the relative strength of the banking community vis-à-vis the industrial community.

Dealer Trading Relationship with the Federal Reserve

A dealer firm must meet certain operational, financial, and managerial criteria in order to establish a trading

21Walker.
relationship with the Federal Reserve. The officers of the dealer firm must satisfactorily answer the following questions before the Federal Reserve trades with the firm:

1. Is the firm actively engaged on a daily basis in trading bankers' acceptances?
2. Is the firm's trading activity of sufficient volume and diversification to satisfy the Federal Reserve's requirements that the dealer be a significant market participant?
3. Does the firm maintain a portfolio of satisfactory size, particularly relative to the other firms with which the Desk transacts business?
4. Is the firm reputable and financially sound?
5. Will the Federal Reserve's open market operations benefit from recognition of the dealer, i.e., from the firm's ability to make markets and its ability to contribute to the development of a broader market?
6. Are the management and staff competent?

The Federal Reserve will trade with the dealer firm if all questions can be answered in the affirmative. Those dealer firms which trade with the Federal Reserve have met selected qualitative criteria.

\[\text{Helfrich, p. 56.}\]
CHAPTER VI

A PROPOSED FRAMEWORK FOR THE IMPROVED MARKETABILITY OF THE BANKER'S ACCEPTANCE

The purpose of this chapter is to examine some of the principal features which reduce the marketability of the banker's acceptance and to suggest a remedy. Among the disadvantages of the banker's acceptance are small principal amount and lack of familiarity with the instrument by some investors. After examining the results of the survey of the twenty largest commercial banking companies regarding the perceived characteristics of the banker's acceptance and the bankers' acceptance market, this chapter will present a recommended clearinghouse technique for combining or pooling diverse bankers' acceptances into a single, even instrument of defined maturity that could be very marketable in the New York money market. This instrument would be called a Banker's Acceptance Participation Certificate and would be the money market equivalent of the Ginnie Mae Participation Certificate, the latter now being used to provide a secondary market for home mortgage loans. This chapter is thus suggesting the creation of a new money market instrument.
The Survey of Commercial Banks

A survey was made of the twenty largest U.S. commercial banks in order to determine certain perceived characteristics of the banker's acceptance instrument and the bankers' acceptance market. The twenty largest commercial banking companies are ranked by Fortune and are shown in Table XI. As may be seen from the table, the survey sample ranges from BankAmerica Corp. ($82 billion in assets) to First Pennsylvania Corp. ($8.7 billion in assets), with the twenty largest banks holding $523.7 billion in assets. These twenty banks represent the major commercial banking institutions in New York, Chicago, the West Coast, and the regional inland financial centers. A copy of the survey questionnaire is presented in Appendix A. As may be seen from the survey questionnaire, the respondent is presented with a list of disadvantages of the banker's acceptance and is then asked to comment on the disadvantages as perceived by his or her bank. The respondent is then presented with three questions regarding the potential for pooling bankers' acceptances and the concept of utilizing a clearinghouse for such a pooling technique. The twenty largest commercial banking companies were selected as the sample because they should represent the heart of the bankers' acceptance market conducted by non-dealers in the United States.
TABLE XI
THE TWENTY LARGEST COMMERCIAL BANK COMPANIES*

<table>
<thead>
<tr>
<th>Bank</th>
<th>Assets $</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. BankAmerica Corp. (San Francisco)</td>
<td>82.0†</td>
</tr>
<tr>
<td>2. Citicorp (New York)</td>
<td>77.1†</td>
</tr>
<tr>
<td>3. Chase Manhattan Corp. (New York)</td>
<td>53.2†</td>
</tr>
<tr>
<td>4. Manufacturers Hanover Corp. (New York)</td>
<td>35.8</td>
</tr>
<tr>
<td>5. J. P. Morgan &amp; Co. (New York)</td>
<td>31.7</td>
</tr>
<tr>
<td>6. Chemical New York Corp.</td>
<td>30.7†</td>
</tr>
<tr>
<td>7. Continental Illinois Corp. (Chicago)</td>
<td>25.8†</td>
</tr>
<tr>
<td>8. Bankers Trust New York Corp.</td>
<td>23.5†</td>
</tr>
<tr>
<td>9. First Chicago Corp.</td>
<td>22.6</td>
</tr>
<tr>
<td>10. Western Bancorp. (Los Angeles)</td>
<td>22.5†</td>
</tr>
<tr>
<td>11. Security Pacific Corp. (Los Angeles)</td>
<td>18.7†</td>
</tr>
<tr>
<td>12. Wells Fargo &amp; Co. (San Francisco)</td>
<td>15.4†</td>
</tr>
<tr>
<td>13. Charter New York Corp.</td>
<td>12.6</td>
</tr>
<tr>
<td>14. Crocker National Corp. (San Francisco)</td>
<td>12.4†</td>
</tr>
<tr>
<td>15. Marine Midland Banks, Inc. (Buffalo)</td>
<td>12.1†</td>
</tr>
<tr>
<td>16. First National Boston Corp.</td>
<td>10.3†</td>
</tr>
<tr>
<td>17. Mellon National Corp. (Pittsburgh)</td>
<td>9.9†</td>
</tr>
<tr>
<td>18. Northwest Bancorp. (Minneapolis)</td>
<td>9.5†</td>
</tr>
<tr>
<td>19. First Bank System, Inc. (Minneapolis)</td>
<td>9.2†</td>
</tr>
<tr>
<td>20. First Pennsylvania Corp. (Philadelphia)</td>
<td>8.7</td>
</tr>
</tbody>
</table>

Total Assets: $523.7

†In billions.
Response received.

An Evaluation of the Results of the Survey

The response rate to the questionnaire was 76 per cent (16 written responses from 21 questionnaires). It should be noted that the respondents included the largest commercial banking company in the United States, the two dominant banks in New York City, the largest bank in Chicago, and the two largest banks on the West Coast. In terms of
relative size, the respondents held $412 billion in total assets or about 78 per cent of the total assets of the twenty largest commercial banking companies.

Some very interesting responses emerged from the survey. Most respondents agreed that the competitive disadvantages of the banker's acceptance are its relatively small principal amount, high administrative/processing costs, uneven principal amount, and lack of familiarity by many investors. To this list the respondent at the Mellon National Bank in Pittsburgh added: "The time lag in settlement for non-New York City banks." The respondent at Chicago's Continental Bank expanded upon this point:

High administrative/processing cost, inhibit same day delivery outside of New York. Centralized marketing effort requires drafts being delivered to head office. This delays the time in which a draft can reach the marketplace. Risk of loss is eminent as a result.

The pooling of bankers' acceptances proposed in this research is designed to centralize the marketing effort and overcome the disadvantage that non-New York City banks have.

Two of the respondents carefully differentiated the acceptance market between odd-lot acceptances and acceptances aggregating $500,000 or more. This reply came from the First National Bank in Boston:

Acceptances of $500,000 face amount are the most marketable. Most often the minimum investors want is $1,000,000 (2 x $500,000). (Investors refers to corporations, government agencies, and local governments.) When markets for acceptances are quoted,
the rates are good for $500,000 blocks. Acceptances in amounts other than $500,000 do not trade in this market—they do trade anywhere from 5-15 points higher than the $500,000 drafts. These "odd lot" drafts do not experience good turnover despite the premium in rate.

Thus there would appear to be a two-tier market, one for acceptances in amounts of $500,000 and one for odd-lot acceptances. This was confirmed by a respondent at the opposite end of the country, United California Bank in Los Angeles:

These questions are based on the erroneous assumption that most acceptances are in small, odd amounts. In fact, a high percentage of the larger banks' acceptances originate from third country refinancing, and are marketed in multiple units of $500,000 at block rates.

The West Coast respondent is probably referring to block trading in Asian acceptances. And finally the respondent at the Marine Midland Bank added another disadvantage, i.e., that it was especially difficult to obtain maturity dates desired by investors.

The Chase Manhattan Bank is employing an interesting technique to market bankers' acceptances. As described in a conversation with the bankers' acceptance manager, the Chase sells "participations" in acceptances already in the loan portfolio. For example, if the bank has a one million dollar acceptance with a maturity of twenty-four days and a corporate customer wished to buy an acceptance with a twenty-four day maturity in the amount of $615,000,
the Chase would allow the customer to participate in the amount of $615,000 and the Chase would retain the remainder, $385,000, in the loan portfolio. Such a technique is limited to a portfolio of large denomination acceptances of acceptable maturities. This is the opposite concept of the proposed Banker's Acceptance Participation Certificate, i.e., rather than assembling acceptances for sale in the impersonal money market, the Chase divides existing large denomination acceptances for existing customers. The Chase is the only commercial bank indicating the use of such a marketing technique.

In addition to the twenty largest commercial banking companies, the questionnaire was sent to Ralph Helfrich of the Federal Reserve Bank of New York. He responded to the list of competitive disadvantages of the banker's acceptance with the following reply: "As a central banker I would prefer to be positive; however, I am obliged to agree with the above." Regarding the practicality of a clearinghouse for bankers' acceptances, he responded with no observation; however, he answered affirmatively to the questions of whether acceptances could be pooled and whether a commercial bank might issue a certificate representing an undivided interest in a pool of prime bankers' acceptances.
The tabulated results of the survey of the twenty largest commercial banking companies are presented in Table XII. As may be seen from the survey form which appears in Appendix A, the first survey question presented the respondent with a list of disadvantages that characterize the banker's acceptance in the money market. The responses to this question have just been discussed. The remaining questions on the survey questionnaire, questions two through four, requested the respondent to indicate his perceptions regarding the potential for pooling acceptances. He was asked to respond by checking the appropriate space marked "Yes," "No," or "No Observation."

The second survey question in the survey questionnaire asked the respondent to indicate whether he felt prime bankers' acceptances could be pooled to make them more marketable. To this 88 per cent replied in the affirmative and the remainder replied in the negative. The purpose of this question was to determine whether it was conceptually possible to combine bankers' acceptances in order to overcome some of the major disadvantages of the instrument, i.e., an often relatively small principal amount, high administrative/processing costs, and an often uneven principal amount. As evidenced by the response rate, surveyed market participants believed combining acceptances to be a feasible concept.
TABLE XII

A TABULATION OF THE RESULTS OF THE SURVEY OF THE BANKERS' ACCEPTANCE MARKET*

<table>
<thead>
<tr>
<th>Survey Question</th>
<th>Yes</th>
<th>No</th>
<th>Observation</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Could prime bankers' acceptances be pooled or combined to make them more marketable?</td>
<td>88</td>
<td>12</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>3. Would a clearinghouse technique be a practical approach to pooling prime bankers' acceptances to achieve a large, even principal amount?</td>
<td>12</td>
<td>44</td>
<td>44</td>
<td>100</td>
</tr>
<tr>
<td>4. Could a major commercial bank issue a certificate or instrument evidencing an undivided interest in a pool of prime bankers' acceptances of comparable maturity?</td>
<td>75</td>
<td>13</td>
<td>12</td>
<td>100</td>
</tr>
</tbody>
</table>

*Source: Survey questionnaire prepared for this study (see Appendix A).

The third survey question in the survey questionnaire asked the respondent to indicate whether a clearinghouse technique would be practical in pooling bankers' acceptances. The results were 12 per cent in the affirmative,
44 per cent in the negative, and 44 per cent without opinion. The purpose of this question was to determine whether bank data processing techniques such as Magnetic Ink Characteristic Recognition or MICR numbers would be adaptable to pooled bankers' acceptances. The negative and neutral response may be explained by the fact that the survey was sent to respondents in the money market departments rather than the operating areas of the respective commercial banks. Respondents in the money market departments would be more familiar with the marketing aspects of bankers' acceptances, but less familiar with the operational aspects of bankers' acceptances.

The fourth survey question asked the respondent whether a commercial bank could issue a certificate or instrument representing an undivided interest in a pool of prime bankers' acceptances of comparable maturity. To this 75 per cent responded in the affirmative, 13 per cent responded in the negative, and 12 per cent responded with no opinion. The purpose of this question was to determine whether a new money market instrument issued by a commercial bank evidencing a pool of acceptances could be issued. Thus the respondents believed that bankers' acceptances could be pooled and a new instrument created, but they were skeptical of the use of a bankers' acceptance clearinghouse.
The results of the survey were best summarized by an especially well thought out response by the respondent at the Continental Bank in Chicago:

In summary, creation of bankers acceptances is sporadic. A bankers acceptance serves two functions, a lending function and a credit function. These functions must be understood by the marketplace so that the nature of the instrument being purchased is understood. Given a proper educational program bankers acceptances may continue to grow as an investment alternative in the money market arena.

The Banker's Acceptance Participation Certificate is just the instrument to allow the banker's acceptance to achieve its place in the sun in the money market.

The Conceptual Framework for Pooling or Combining Bankers' Acceptances

Because the primary disadvantages of the banker's acceptance are those of small principal denomination, uneven principal amount, and near-term maturity, the marketability of the banker's acceptance could be enhanced by combining numerous acceptances into a single new instrument. This could be accomplished by a clearinghouse operation to combine bankers' acceptances of similar maturities into a single, new certificate to be issued with the guarantee and as the liability of the clearinghouse. The proposed clearinghouse technique is shown in Figure 11. As may be seen from the figure, the result is a new instrument representing an undivided interest in a pool of prime bankers' acceptances.
Fig. 11--A proposed clearinghouse technique for bankers' acceptances
The accepting commercial banks represent the principal source of supply of acceptances to the proposed clearinghouse. Probably the most difficult aspect of the technique for the accepting commercial bank is finding acceptances of comparable maturity dates. Given the considerable recent growth in the dollar volume of the bankers' acceptance market, a single clearinghouse in New York City might satisfy the requirement of aggregating numerous, diverse individual acceptances, since the bulk of bank acceptance financing passes through the New York banks.\(^1\) Indeed, of the five largest commercial banking companies listed in *Fortune*, four are located in New York City.\(^2\) Were the accepting bank to encode its own bankers' acceptances with Magnetic Ink Character Recognition Numbers upon initial acceptance, computer processing by the clearinghouse would be greatly facilitated.\(^3\) Adapting the concept of reference digits now in use on checks, the sequence of digits for a banker's acceptance might indicate the following: a number identifying the proposed bankers' acceptance clearinghouse,

---


a number identifying the accepting bank, a number indicating the maturity date, and a series of numbers indicating the principal amount. The computer at the clearinghouse could then match or aggregate acceptances into a single, even amount, such as $500,000. The clearinghouse or even a lead commercial bank could then issue a new money market certificate evidencing an undivided interest in a pool of prime bankers' acceptances.

The new money market instrument issued by the clearinghouse or lead commercial bank would be highly marketable for the following reasons:

1. It would have the guarantee of the clearinghouse or lead commercial bank.

2. Each banker's acceptance in the underlying pool would have the guarantee of the prime accepting commercial bank.

3. Each banker's acceptance in the underlying pool would represent a specific foreign trade transaction of a short-term, self-liquidating nature.

Thus the instrument representing pooled bankers' acceptances would be guaranteed on the first two tiers by commercial banks (or a commercial bank and the clearinghouse) and on the third tier by the underlying foreign trade transaction. Efficiency in combining diverse bankers'
acceptances would be greatly enhanced by use of the proposed clearinghouse technique.

But marketability of the banker's acceptance would also be increased. While the supply of bankers' acceptances is shown on the right side of Figure 11, the demand for bankers' acceptances is shown on the left side of the figure. For example, if a corporate treasurer were presented with the opportunity to purchase an instrument evidencing a pool of thirty-, sixty-, or ninety-day bankers' acceptances, he would be purchasing an instrument providing liquidity, yield, and safety. By selecting the maturity of the instrument, say sixty days, he secures the prerequisite liquidity. Because the banker's acceptance traditionally yields more than the Treasury bill, he obtains a certain yield and yield advantage. And because the instrument is an obligation of the clearinghouse or lead commercial bank and the accepting commercial bank, the corporate treasurer achieves the desired safety of principal as well. The marketing advantages, as illustrated with our corporate treasurer, are thus threefold: liquidity in the instrument, yield from the instrument, and safety of principal with the instrument.

The demand side represents, in addition to corporate treasurers and similar investors, the Federal Reserve System. Magnetically encoded bankers' acceptances might
be especially useful with repurchase agreements in which the Fed purchases acceptances for periods of one to seven days.\footnote{Helfrich, p. 53.} From all bankers' acceptances in the clearinghouse inventory, those with one to seven or longer day maturities could be quickly established. Timing in such a situation is critical and the clearinghouse could be most responsive to this need. The Federal Reserve System also limits its purchase of acceptances from any one accepting bank to a percentage of the total outstanding acceptances of that bank.\footnote{Ibid., pp. 52-53.} If all the accepting bank's acceptances were listed with the clearinghouse, the purchase limitation could be rapidly determined and the acceptances of the accepting bank not eligible for purchase could be readily ascertained. The magnetically encoded banker's acceptance processed through the clearinghouse would also be useful to the Federal Reserve when it purchases acceptances for customer accounts, chiefly other foreign central banks, where the maturity range and the accepting bank name are specified by the customer.\footnote{Ibid., p. 53.} From the pool of clearinghouse acceptances, a group could be readily formed consisting of the same maturity date and a selection of specific accepting banks.
Dealers in bankers' acceptances might find the clearinghouse technique valuable. Because the normal dealer spread between buying and selling rates is 1/8 to 1/4 percent in a normal market, clerical costs could be minimized with the use of data processing techniques offered by a clearinghouse. The ability to ascertain an inventory of diverse bankers' acceptances rapidly and efficiently is the hallmark of the system conceptualized in Figure 10. The dealer who knew the composition and level of his inventory at all times, especially in a volatile market that caused his inventory to turn over rapidly, would be especially responsive to the market with a resulting increase in profitability.

Summary and Conclusions

The purpose of this study is to recommend a conceptual framework for the pooling or combining of bankers' acceptances. The pooling of similar securities may very well be a trend of the future. Ginnie Mae, the Government National Mortgage Association, pioneered the pooling of VA and FHA mortgages by issuing mortgage participation certificates in 1971. First Federal Savings and Loan of

7 Ibid., p. 56.

Rochester, New York made the first private placement of mortgage-backed bonds in April, 1974, while California Federal Savings and Loan made the first public placement of mortgage-backed bonds in September, 1975. The Bank of America was the first commercial bank to issue mortgage-backed pass-through certificates in September, 1977, while First Federal Savings and Loan of Chicago was the first thrift institution to issue mortgage-backed pass-through certificates in October, 1977 (mortgage-backed bonds are the direct liability of the issuer, while mortgage-backed pass-through certificates are not). The pooling or combining of a relatively unmarketable money market instrument would be the logical extension of this trend.

The net result of the clearinghouse technique proposed in this study is to assemble a group of diverse bankers' acceptances and to combine them into a new, single


Ibid.


instrument which would be readily marketable in the U.S. money market. The proposed instrument, to be called the Banker's Acceptance Participation Certificate, would provide a source of funds for the rapidly burgeoning foreign trade market. The dramatic increase in bankers' acceptances since 1956 reflects this growth in foreign trade.\textsuperscript{13} The new money market instrument would represent an undivided interest in a group of bankers' acceptances, each representing the financing of a specific foreign trade transaction that would be of a self-liquidating nature. The Banker's Acceptance Participation Certificate or BAPC would have a three-tier set of guarantees: on the first tier, the guarantee of the clearinghouse (or possibly lead commercial bank); on the second tier, the guarantee of the accepting bank for the individual acceptance; on the third tier, the self-liquidating feature of the underlying foreign trade transaction. By means of the Banker's Acceptance Participation Certificate our New York bankers' acceptance clearinghouse becomes a financial intermediary between the New York money market and a corporate treasurer or buyer. The net result is a more marketable banker's acceptance.

CHAPTER VII

SUMMARY AND CONCLUSIONS

The purpose of this chapter is to summarize and analyze the main findings of the preceding chapters, presenting the past, present, and future of the banker's acceptance. The banker's acceptance was created in England in the 1820s--this is its past. The volume of bankers' acceptance financing at the end of 1979 approximated 40 billion--this is its present. The pooling of diverse bankers' acceptances into a single money market instrument as suggested in Chapter VI would enhance marketability of the instrument--this is its future.

The essence of a banker's acceptance is credit substitution. The credit of a well-known bank is substituted for the credit of a less well-known debtor. The credit reputation of Citibank is well-known; the credit reputation of XYZ Import Co. is less well known (if at all). When Citibank accepts XYZ Import's draft, that acceptance may trade in the money market. Citibank has substituted its credit for that of the importer. Major commercial banks may substitute their credit as long as money market investors perceive that the accepting commercial banks will honor the banker's acceptance as it matures. The basis
for such credit substitution is essentially twofold: (1) the commercial bank's evaluation of the customer-drawee, and (2) money market investor perceptions regarding the accepting commercial bank. The commercial bank's favorable evaluation of a customer-drawee application results in a letter of credit and ultimate acceptance of the draft. The money market investor's favorable evaluation of a banker's acceptance results in the investor purchasing the acceptance.

The risks associated with and attendant to a banker's acceptance may be minimized if the commercial bank carefully confirms the existence of the underlying trade transaction and examines the credit history of its customer. A money market investor turns to the accepting bank for payment on the banker's acceptance when it matures. The accepting bank turns to the customer for payment on the banker's acceptance. The customer has the self-liquidating foreign trade merchandise with which to pay the accepting bank. Thus the underlying foreign trade transaction is the major underpinning upon which the instrument is built. There then exists a multiple set of guarantees to reduce risk in a banker's acceptance. As long as a self-liquidating foreign trade transaction is being financed, credit substitution through the banker's acceptance would appear sound. And for this reason, there is no known
instance of a principal default in the bankers' acceptance market to date. In summary, there exists a multiple set of guarantees based upon a foreign trade transaction.

History of the Banker's Acceptance

The historical evolution of the banker's acceptance begins with the bill of exchange, a practical instrument of foreign trade born of necessity in the Middle Ages. The bill of exchange of the late fifteenth century had four parties: the drawer, the payer, the payee, and the initial creditor (the initial creditor has disappeared from the modern acceptance). The bill of exchange developed in the Middle Ages because it represented a viable means of paying a distant claimant without an immediate physical transfer of funds across unsecure distances. The bill of exchange was thus a marvelous commercial invention: funds were transmitted by letter evidencing book entries, i.e., actual money transfers across frontiers were minimized in what was an uncertain political environment at best. Mutuality of confidence became the cornerstone of transacting business. The negotiability of the bill of exchange was limited only by the ability of the parties to honor the debt: the greater the financial reputation of the parties, the greater the negotiability of the draft. The modern banker's acceptance is the descendant of the medieval bill of exchange.
In the nineteenth century England was the major world trade power. The banking system consisted of well-known London agent banks and country banks. London agent banks began accepting bills of exchange on behalf of the country banks. Thus was born the modern banker's acceptance.

The banker's acceptance developed because the country banks needed funds with which to finance England's foreign trade. London banks soon began accepting drafts in non-British trade and the financing of world trade gravitated to the London money market. The banker's acceptance was thus created in nineteenth-century England as a result of credit substitution, i.e., the credit of the famous London banks was substituted for the credit of less well-known entities.

The Banker's Acceptance Today

The volume of bankers' acceptances outstanding at the end of 1979 approximated $40 billion. The development and present state of the bankers' acceptance market may be explained by examining the relative advantages of the instrument itself.

Nine advantages of bankers' acceptance financing to the accepting bank, to the foreign trader, and to the investor may be identified. The following advantages to the accepting bank help explain the growth of the bankers' acceptance market. First, the accepting bank lends its name rather than money. The accepting bank collects the
principal amount of the banker's acceptance prior to paying the money market investor; thus there is no net cash outlay on the part of the accepting bank. **Second**, the accepting commercial bank may pass loan demand pressures to the money market. An accepting bank may retain the acceptance as part of its loan portfolio or sell the acceptance in the money market.

The following advantages to foreign traders help explain the growth of the bankers' acceptance market. **Third**, commercial banks reconcile credit histories of divergent foreign trade companies. **Fourth**, no compensating balances are required in acceptance financing. A compensating balance increases the cost of a bank loan.

The following advantages to investors in bankers' acceptances help explain the growth of the bankers' acceptance market. **Fifth**, only well-known commercial banks have access to the bankers' acceptance market. Accepting banks are the recognized financial institutions in the U.S. **Sixth**, the bankers' acceptance market approximates $40 billion. There is a substantial pool of investments from which an investor may draw. **Seventh**, there is no known instance of principal default in the bankers' acceptance market. The safety of principal in the bankers' acceptance market is excellent. **Eighth**, each banker's acceptance has a multiple set of guarantees. Safety of
principal is further enhanced by the guarantee of the commercial bank and the presumably self-liquidating character of the underlying foreign trade transaction. Ninth, bankers' acceptances have a yield advantage over Treasury bills. The investor in a banker's acceptance obtains a yield advantage over Treasury bills.

The development and state of the bankers' acceptance market may be explained in part by the relative advantages listed above.

The Banker's Acceptance Tomorrow

The banker's acceptance is a unique money market instrument that has experienced rapid growth in this century. The present state of the bankers' acceptance market is limited because of certain disadvantages of the instrument.

Eight disadvantages of the banker's acceptance to the investor and to the accepting bank may be identified. The following disadvantages to the investor help explain limitations to the bankers' acceptance market. First, bankers' acceptances are frequently in uneven principal amounts. Many investors prefer instruments in even principal amounts. Second, bankers' acceptances are frequently in small denominations. Many investors, especially institutional investors, prefer instruments in large principal amounts. Third, there is lack of familiarity with
bankers' acceptances on the part of institutional investors. Bankers' acceptances are not as well-known as other money market instruments. Fourth, bankers' acceptances usually bear unusual maturity dates reflecting the terms of the underlying foreign trade transaction. This is in contrast with Treasury bills which bear standard maturity dates.

The following disadvantages to the accepting bank help explain limitations to the bankers' acceptance market. Fifth, high administrative costs to accepting banks are associated with bankers' acceptances. Sixth, a centralized marketing effort for bankers' acceptances is required. Acceptances reflect diverse foreign trade transactions and they must be combined or aggregated to make them more marketable. Seventh, there is a time-lag settlement for acceptances of non-New York City banks. The acceptance market is centered in New York City and commercial banks outside of this market are at a competitive disadvantage, as explained in Chapter V.

A survey was made of the twenty largest U.S. commercial banks in order to determine certain perceived characteristics of the bankers' acceptance market and the banker's acceptance instrument. The listing of the twenty largest commercial banks was derived from Fortune magazine. The survey sample ranges from BankAmerica
($82 billion in assets) to First Pennsylvania Corp. ($8.7 billion in assets) and also includes the Federal Reserve Bank of New York. The response rate to the survey questionnaire was 76 per cent (16 written responses from 21 questionnaires).

The first question on the survey questionnaire asked the respondent for his perceptions regarding the competitive disadvantages surrounding the instrument. The listed disadvantages were relatively small principal amount, uneven principal amount, high administrative and processing costs, and lack of familiarity by some investors. The respondents generally agreed with the list provided. Their comments are discussed at length in Chapter VI.

The second question on the survey questionnaire asked the respondent to indicate whether he perceived prime bankers' acceptances could be pooled to make them more marketable. To this question 88 per cent replied in the affirmative and the remainder replied in the negative. As evidenced by the response rate, surveyed market participants believed combining acceptances to be a feasible concept.

The third question on the survey questionnaire asked the respondent to indicate whether he perceived a clearing-house technique would be practical in pooling bankers' acceptances. The purpose of this question was to determine
whether bank data processing techniques such as Magnetic Ink Character Recognition or MICR numbers would be adaptable to pooled bankers' acceptances. The results were 12 per cent answering in the affirmative, 44 per cent answering in the negative, and 44 per cent answering with no opinion. The negative and neutral response may be explained by the fact that the survey questionnaire was sent to respondents in the money market departments rather than to respondents in the operating departments of the respective banks.

The fourth question on the survey questionnaire asked the respondent whether he perceived a commercial bank could issue a certificate or instrument representing an undivided interest in a pool of prime bankers' acceptances of comparable maturity. The purpose of this question was to determine whether a new money market instrument could be issued by a commercial bank evidencing a pool of acceptances. To this 75 per cent responded in the affirmative, 13 per cent responded in the negative, and 12 per cent responded with no opinion. Thus, the respondents believed that bankers' acceptances could be pooled and a new money market instrument created.

Because the primary disadvantages of the banker's acceptance are small principal amount, uneven principal amount, and near-term maturity, the marketability of the
banker's acceptance could be enhanced by combining numerous acceptances into a single, new instrument. This could be accomplished by a clearinghouse to combine bankers' acceptances of similar maturity into a single, new certificate to be issued with the guarantee and as a liability of the clearinghouse.

The pooling of bankers' acceptances would help improve the present market mechanism. A special problem of the present system involves the mechanics of presentation and delivery. Pooled acceptances using MICR numbers and an acceptance clearinghouse mechanism would alleviate the time-lag settlement for non-New York City banks. Trading in pooled acceptances could take place by book entry and not by cumbersome physical delivery.

The number of market makers in bankers' acceptances (refer to Appendix C) appears adequate. There were at least sixteen market makers in bankers' acceptances as of June, 1979. The market makers included the nation's two largest banks, Bank of America and Citibank, and the nation's largest brokerage firm, Merrill Lynch. Trading spreads among the market makers have fluctuated based upon the realities of the marketplace as discussed in Chapter V. There is sufficient profit in bankers' acceptances as evidenced by the fact that Bankers Discount has exclusively brokered bankers' acceptances since 1931.
Acceptance fees are presently 1.5 per cent per annum. This would appear a reasonable fee. If the typical banker's acceptance has a maturity of ninety days, the acceptance fee is a mere .375 per cent (.015 x 90/360). The bank lends its name; the foreign trade firm obtains the credit of the commercial bank. Present acceptance fees, therefore, are reasonable to both borrower and lender.

Presently there is no formal system of ratings for bankers' acceptances. A system of ratings seems unnecessary because a banker's acceptance has a multiple set of guarantees: the guarantee of the self-liquidating nature of the underlying foreign trade transaction and the guarantee of the accepting bank. A system of ratings would necessarily rate the accepting bank and not the important underlying foreign trade transaction. Because the specific foreign trade transaction could not realistically be assessed by the rating agency, a system of ratings for bankers' acceptances seems unnecessary.

Bankers' acceptances will probably not play a larger role in financing U.S. inland trade. Credit histories in the United States are well developed. The banker's acceptance is especially suited for situations where credit histories between buyer and seller are unknown. Bankers' acceptances also require extensive documentation. Financing
an open account is more practical for domestic trade. For these reasons bankers' acceptances will probably not enjoy a significant role in financing U.S. inland trade.

Federal Reserve aggregate limitations on bankers' acceptances do pose a limitation on acceptance financing. The total acceptance credit per customer may not exceed 10 per cent of a commercial bank's stockholders' equity. And the total outstanding credit per bank may not exceed 100 per cent of a commercial bank's stockholders' equity. Even though the accepting bank sells its accepted bills in the money market, Federal Reserve aggregate limitations continue to apply. Thus the 100-per-cent-of-equity rule sets an inflexible limit on the amount of financing a commercial bank can do.¹

The banker's acceptance has gradually changed character over time. Its role in inland commercial trade has become relatively unimportant. Its role in dollar exchange creation, principally in Latin America, continues. But the banker's acceptance plays its most important role in the area of foreign trade. This role may be expected to continue as exports and imports grow in relation to U.S. gross national product.

The Federal Reserve is not presently an important factor in the secondary market for bankers' acceptances. Money market volume for bankers' acceptances is presently $40 billion. The money market is presently adequate to accommodate trading and an increased participation by the Fed in the secondary market is not needed.

The banker's acceptance does have a manifest destiny. That destiny lies in the creation of a new money market instrument. The new money market instrument suggested might be called a Banker's Acceptance Participation Certificate and would represent an undivided interest in a group of bankers' acceptances, each underlying acceptance representing the financing of a specific foreign trade transaction that would be of a self-liquidating nature. The Banker's Acceptance Participation Certificate would have a three-tier set of guarantees: on the first tier, the guarantee of the clearinghouse; on the second tier, the guarantee of the accepting bank for each individual acceptance; and on the third tier, the self-liquidating nature of the underlying foreign trade transaction. By means of the Banker's Acceptance Participation Certificate, the New York bankers' acceptance clearinghouse becomes a financial intermediary between the New York money market and the purchaser of a banker's acceptance. The net

---

2Federal Reserve Bulletin, October, 1979, Table A-42.
result would be a more marketable banker's acceptance and a more efficient method of financing foreign trade. This is the manifest destiny of the banker's acceptance.
APPENDIX A

QUESTIONNAIRE ON THE BANKERS' ACCEPTANCE MARKET
1. The banker's acceptance is at a competitive disadvantage with some other money market instruments. Among these disadvantages are:

a. Relatively small principal amount.
b. High administrative/processing costs.
c. Uneven principal amount.
d. Lack of familiarity with the instrument by some investors.

Please list the disadvantages of the banker's acceptance as you see them:

For questions 2 through 4 below, check the appropriate response in the right hand column based upon your observations. Add any additional comments you may wish.

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>No</th>
<th>Observation</th>
</tr>
</thead>
</table>

2. Could prime bankers' acceptances be pooled or combined to make them more marketable? (Has this been tried to your knowledge?)

Comments:

3. Would a clearinghouse technique be a practical approach to pooling prime bankers' acceptances to achieve a large, even principal amount?

Comments:
4. Could a major commercial bank issue a certificate or instrument representing an undivided interest in a pool of prime bankers' acceptances of comparable maturity?

Comments:

Yes  No  No  Observation

(Signed) _____________________________

Title ________________________________

If you have any further comments, please write them on the back of this questionnaire.

Please return this questionnaire to: Hoyet Wilson

201 Adams, Apt. 205

La Grande, OR  97850
APPENDIX B

CORRESPONDENCE WITH THE ACCEPTANCE COMMUNITY
Selected correspondence from the bankers' acceptance community is presented in Appendix B. Four respondents chose to reply by letter rather than by questionnaire (refer to Appendix A).

1. **Continental Bank.** The letter from Continental Bank is valuable in that it presents the perceptions of a portfolio manager as to the feasibility of pooling bankers' acceptances. The respondent concludes:

   In summary, creation of bankers acceptances is sporadic. A bankers acceptance serves two functions, a lending function and a credit extension function. These functions must be understood by the marketplace so that the nature of the instrument being purchased is understood.

The letter was especially well written.

2. **Chase Manhattan Bank.** The letter from Chase Manhattan points out that acceptances are being combined by means of depository receipts. The letter also mentions the interesting court decision *First Department Bank v. Seltzer*, a Supreme Court decision concerning the status of bankers' acceptances.

3. **Citibank.** The letter from Citibank also indicates the use of depository receipts in combining bankers' acceptances. The respondent indicates the odd-lot differential for bankers' acceptances is between 15 and 30 basis points.
4. Wells Fargo Bank. The letter from Wells Fargo Bank presents the perceptions of an investment division controller. The respondent indicates West Coast round lot of bankers' acceptances are $500,000, while odd lots are in amounts less than $500,000.

A second questionnaire was prepared. The purpose of the second questionnaire was to present the respondent with three questions concerning the bankers' acceptance market:

1. Are there acceptances deemed less than prime?
2. Is there any evidence of "quality consciousness" in the bankers' acceptance market?
3. How do banks earn the recognition accorded to a prime banker's acceptance?

The letter of Frederick Walker of Bankers Discount Corporation of California addresses these three questions.
October 17, 1977

Mr. Hoyet Wilson  
Division of Business  
Sul Ross State University  
Alpine, Texas  79830

Dear Mr. Wilson:

Here is the response to your questionnaire. I mistakenly sent a copy to your old address apparently it got lost in the mail. Hope these remarks are helpful, please feel free to call me if you have any further questions.

Sincerely,

[Signature]

Nelson T. Bryant  
Portfolio and Money Management  
Telephone: (312) 828-4250
1. The bankers acceptance is at a competitive disadvantage with some other money market instruments because of a:

A) **Lack of familiarity with the instrument by investors.** A bankers acceptance is a time draft, essentially an 'order to pay' a specified sum of money at a specified date, drawn on and 'accepted' by a bank. The accepting bank will secure the goods involved as collateral. The created draft then will be marketable having the bank's name and the secured goods as collateral for this liability. Investors only realize the acceptance as a liability of the bank.

B) **Relatively small principal amounts are inhibiting to the large institutional investor, however, here is where salesmanship becomes a factor.** The marketplace must understand the benefits of the instrument. Small investors can be told of the benefits increasing alternatives for their investment needs.

C) **Uneven principal amounts, this instrument is discounted same as a treasury bill.** Again, the small amounts increase investment opportunities for non-institutional investors. Acceptances can be pieced together for same day maturities or for adjacent day maturities, whatever the needs of the customer. Supply would be the only inhibiting factor.

D) **High administrative/processing cost, inhibit same day delivery outside of New York.** Centralized marketing effort requires drafts being delivered to head office. This delays the time in which a draft can reach the marketplace. Risk of loss is eminent as a result.

2. No. The creation of bankers acceptances wouldn't allow for this in its present format. Holding drafts until matching maturity dates and amounts exist, subject the initial drafts to market risk.

3. No. Your question implies uneven amounts are unmarketable. I contend that it is a lack of understanding on the part of the investor that inhibits marketability. Educate the non-institutional investor or the mutual fund managers as to the benefits inherent in this instrument.

4. Yes they could, however, for reasons espoused in questions 2 and 3 they shouldn't. Creation of the drafts inhibit holding for pooling.

In summary, creation of bankers acceptances is sporadic. A bankers acceptance serves two functions, a lending function and a credit extension function.

These functions must be understood by the marketplace so that the nature of the instrument being purchased is understood. Given a proper educational program bankers acceptances may continue to grow as an investment alternative in the money market arena.
October 17, 1977

Mr. Hoyet Wilson
P.O. Box C-44 SRSU
Alpine, TX 79830

Dear Mr. Wilson

In response to your questionnaire on Banker's Acceptances, Mr. Peraita thought that my input may be of some value to you. I wish to respond to all four questions in as complete description as possible.

The large institutional investors do not see any of the disadvantages you have listed, as severe enough to preclude Banker's Acceptances from use in short term investment policies. The only two disadvantages I feel significant are as follows:

A) Only a limited number of prime issuers are acceptable in size without restrictions based on credit line limitations.

B) Acceptances are not always available in the denominations or maturities desired. This is especially true in periods of limited loan expansion or during statement periods when issuers tend to "hoard" acceptances to show larger loan portfolios.

The money market center banks are by virtue of Fed Regulations (i.e., B.A. creation as a function of paid in capital and surplus) are the largest suppliers of the acceptance market. B.A.'s in small denominations with the same maturity date have been "pooled" and marketed as a "depository receipt". The pool of B.A.'s is held in safekeeping account for the customer and a cover document, which is the depository receipt, is issued with the usual details; total par value of the pool, maturity date and market rate. The bank of issue may maintain a limited secondary market for its customers. This type of security, in my opinion, can not be successfully handled in a clearing house environment.

Another concept, used successfully in marketing Banker's Acceptances is the participations certificate. Opposite in structure to the depository receipt, the P.C. (Participation Certificate) is a large B.A. which is devided for reoffer to small customers. This has been most successful in periods of high interest rates and disintermediation. The large draft is segregated in a safekeeping account and the P.C. is issued to the customer which serves as record of purchase. Similarly, the bank of issue may maintain a limited secondary market for customers. Again, it is my firm belief that the clearing house could not service the P.C.
Given the myriad of credit considerations which are translated into yield spread differentials by the B.A. market participants, the clearing house could not facilitate handling of B.A.'s.

Following the failure of I.B. Herbstadt of West Germany and Franklin National Bank, the B.A. market developed into a multi-tiered market. There were the prime issuers (i.e., Chase, Citibank, Morgan Guaranty and Bank of America), the regional banks (i.e., Continental Illinois National Bank, Mellon National Bank, Girard Trust, Industrial National Bank of Rhode Island, etc.), and non-resident issuers such as Japanese banks and U.S. Agency subsidiaries of Foreign and Domestic Banks. Much emphasis is given to the credit of the issuer. For example, when the oil embargo occurred and oil prices quadrupled, a new investor was born out of the billions of petro-dollars, petro-sterling, etc., which were being accumulated by OPEC. Being counseled by Swiss bankers who are very conscious of credit considerations, the orders for B.A.'s which funneled through the Swiss banking center called for only the top five issuers of acceptances and excluded regional and foreign issuers.

Perhaps, if the issuers were rated by an independent service (i.e., Moody's and S&P), credit differences could be translated into yield spread and a new type of instrument could be developed on the order of the S.D.R. (Special Drawing Rights). Therefore, the credit risk could be spread among the issuers in similar fashion to spreading the currency risk among several national issuers in the S.D.R.

Before closing, I would like to make you aware of a little known Supreme Court decision handed down on July 6, 1931. The case was the First Department Bank of the United States vs. Seltzer. The essence of the decision gives B.A.'s a higher degree of safety as an investment than prime Certificates of Deposit or prime Commercial Paper. The Supreme Court dealt with the failure of the First Department of the U.S. and Seltzer's claim against the bank as a holder of a B.A. issued by the bank. The court decided that the proceeds from the sale of B.A.'s are to be held in an irrevocable trust to insure payment at maturity. Therefore, irrevocable trust guarantees prior lien on assets in a bankruptcy proceeding. I hope I have been of some help to you in responding to your questionnaire. Feel free to communicate with me or Mr. Peralta. I would appreciate a copy of the test upon completion.

Sincerely yours,

Gene M. Ruder, Assistant Treasurer

Lorenzo Peralta, Second Vice President
November 21, 1977

Prof. H. Wilson  
Assistant Professor Department of  
Business Administration and Economics  
Sul Ross State University  
Alpine, Texas 79830  

Dear Professor Wilson:

I have pleasure in responding to your October 25, 1977 questionnaire regarding Bankers' Acceptances. It was not always easy to give a clear-cut yes or no answer to the formulated questions, but I will try and substantiate the answers as concisely as possible:

**Question 1:**

I feel that neither of the listed alternatives would constitute a definite impediment to the further expansion of the Bankers' Acceptances market:

a. The market is broad enough to handle tickets for large amounts, both in terms of single items and in terms of total volume traded

b. whereas administrative costs may be marginally higher than for example line borrowings; I do not think they are really prohibitive

c. trading mainly occurs in even amount lots, but trading in odd lots (or the odd part of an acceptance split in even amounts and an 'odd end') is possible, although it calls for a slightly higher discount rate (currently between 15 and 30 basis points, depending on maturity)

d. those investors who really matter for trading and investing in large volumes apparently all are familiar with the instrument.

**Question 2**

Yes - it actually is done through the use of a fairly recently created instrument called Depository Receipt. DR's are not as marketable as proper BA's, and are not eligible for Federal Reserve Bank rediscount, but usually a bank issuing a DR will add a repurchase commitment to that instrument, so as to enhance its marketability.
Question 3

Yes - this is achieved by the pooling of even lots or, as mentioned above, by pooling odd lots under a Depository Receipt.

Question 4

Yes - same answer as Question 2.

Please let me know whether this addresses your questions properly, and do not hesitate to revert to us in case further clarification is needed.

Yours sincerely,

Lode G. Beckers
Vice President
October 9, 1978

Hoyet Wilson
Division of Business
Eastern Oregon State College
La Grande, Oregon 97850

Dear Mr. Wilson:

Mr. Horn referred your letter and questionnaire of September 20 to my attention, as I am more involved with the operating procedures supporting our banker's acceptance activity.

In response to your questionnaire, let me explain our procedures for handling the acceptances created by our International Division. First, when possible, the acceptance is created as a series of drafts in even increments of $1 million or preferably $500 thousand.

These drafts are forwarded to New York so they can be traded and delivered in the New York market. The "Odd Lots" under $500 thousand, whether it represents the total advanced or is the residual form a large advance which has been broken down into even increments, are held in San Francisco and sold to retail customers who usually maintain a safekeeping account. If requested, they could be delivered. Acceptances under $100 thousand are pooled by "maturity date". Each maturity date represents a separate pool of acceptances from which we sell participants with a minimum of $25 thousand. These are controlled and held in safekeeping and are not deliverable.

The administrative and processing costs are not much different than for any other security. As for the customers' familiarity with the instrument, it too is not much different than their familiarity with other securities.

A clearinghouse technique does not seem practical. If more than one bank were participating in pooling their acceptances, the controls to properly market the instruments, is knowing which are available at
the time of sale to avoid overselling a maturity, as well as the accounting to identify how much of which banks acceptance was sold would necessitate "excessive administrative and processing costs."

I would like to bring special attention to your comment of "comparable maturity" in question #4. The comptroller of the currency has reviewed this "pooling" concept in several banks and suggests that the pool might represent collateral for a deposit account, hence it should be subject to regulations D and Q. This would negate the benefits of this investment opportunity to the small investors who participate in these pools.

Since each of our pools are supported by a definative maturity date, we contend the transaction represents a sale of actual securities and can support it by identifying the specific B/A's. The comptroller has not yet given a final opinion on how to classify these pools, however, they appear more supportive of the pools set up by maturity.

I hope this will answer any questions you have concerning our procedures with B/A's. If I can be of further assistance, do not hesitate to write.

Sincerely,

H. Cebers, Jr.
Investment Division Controller
June 7, 1979

Hoyet Wilson  
Associate Professor  
Eastern Oregon State College  
Le Grande, Oregon  98750

Dear Mr. Wilson:

Enclosed are my responses to your questionnaire. I hope they are helpful to you. I would certainly appreciate receiving copies of your research.

I have also enclosed a copy of a booklet on Bankers Acceptances which we recently published. You may find it interesting.

Sincerely,

[Signature]

Frederick Walker, Jr.  
Vice President
The term "prime" as it relates to Bankers Acceptances is, unfortunately, frequently misunderstood in the marketplace. The adjective does not apply to the issuing Bank, but rather to the characteristics of underlying transaction giving rise to the Bankers Acceptance which qualify it as "eligible" for discount or purchase by the Federal Reserve Bank. In other words, an "eligible" Bankers Acceptance is a "prime" Bankers Acceptance, whether the accepting Bank is Bank of America or a small regional Bank.

The foregoing is a preface to my response to your question. Yes, there is a very significant body of Acceptances which are not "prime" that is, not eligible for either discount or purchase by the Federal Reserve Bank. In addition to those Acceptances which may fail to qualify on technical grounds, (please refer to the Federal Reserve Bank of New York, Monthly Review of February 1976, page 55), there are also Acceptances created for the purpose of providing general "Working Capital" to the drawer - these are now often referred to as "Finance Bills."

There are various types of "ineligible" Acceptances which may be categorized as follows:

(1) Those which fulfill the broad criteria for eligibility but are disqualified for technical reasons, such as, the draft having been drawn subject to a bill of lading date. For a comprehensive discussion of this category please see, Federal Reserve Bank of New York, Monthly Review, February 1976, page 55.

(2) Working Capital Acceptances or "Finance Bills." These Acceptances arise out of drafts drawn simply to provide general working capital to the drawer. There was very active utilization of "Working Caps" or "Finance Bills" during the credit crunches of 1969-70 and 1973-74, since the current market resistance against C/D's did not extend to Bankers Acceptances. Furthermore, the rates at which Banks could sell ineligible Acceptances was better than those at which C/D's could be sold.

(3) Acceptances of Banks whose names are not acceptable at the Federal Reserve. This category is covered comprehensively by Mr. Helfrich on page 55 of his article in the February 1976 issue.
QUESTION # 2

There is very definite evidence of quality consciousness in the Bankers Acceptance market which manifests itself by means of a price "tiering." Up to about 1970, all eligible Bankers Acceptances traded at one price, regardless of name or size. Dealers "posted" bid and offer rates which were stable and available to all interested parties. However, the "credit crunches" of 1969-70 and 1973-74 and the attendant Bank problems changed that. Since the Franklin, U.S. National of San Diego, Herstatt, etc., failures and other near misses, investors have become quality conscious and the market place reflects this by two inter-related methods which manifests tiering, exclusion, or pricing.

There are today many major investors who restrict their investments in Bankers Acceptances to those of the:

(A) Top 10 U.S. Banks or;
(B) Top 25 U.S. Banks or;
(C) Top 50/100 U.S. Banks, etc.
(D) Other U.S. Banks

Obviously, the market becomes more restrictive as we proceed down the list to (E) Edge Act Subsidiaries; (F) Ineligible Acceptances of U.S. Banks; (G) Eligible Acceptances of U.S. Branches and Agencies of Foreign Banks. The price differentials offered between each of these eight categories has been about .05/.07 basis points, (1/2 of 1% or slightly higher) is a stable market and .10/.125 basis points points (1/10 ot 1/8 of 1%) in a less stable market.

In other words the differential between the rates available to an investor on the Acceptances of the largest U.S. Bank and the 51st largest may range anywhere from .20 to .40 basis points, (1/5 to 2/5 of 1%) While the normal differential between top domestic and the eligible Acceptances of U.S. Agencies of Japanese Banks is about .25 basis points (1/4 of 1%). We saw that differential widen to .75 to 100 points during unstable market periods in 1978.
Question #3

I have enclosed a copy of the February 1976 issue of the Monthly Bulletin of the Federal Reserve Bank of New York in which you will find an article entitled, "Trading Bankers Acceptances," page 51, by Ralph Helfrich which responds quite comprehensively to your question regarding attainment of "prime" status.
APPENDIX C

THE PRIMARY DEALERS IN BANKERS' ACCEPTANCES
Correspondence with the acceptance community indicates the primary dealers in bankers' acceptances as of June, 1979, are:

A. G. Becker
Bankers Discount
Bankers Trust
Bank of America

Blyth, Eastman, Dillon
Briggs Schardle
Cantor Fitzgerald
Caroll, McEntee, McGinley

Citibank
Discount Corp.
First Boston
Goldman Sachs

Lombard Wall
Merrill Lynch
Salomon Brothers
Stuart Brothers-New York Hanseatic

The above information was provided by Michael Gabriel, Investment Officer at the First National Bank of Boston, as the result of a special questionnaire received by the author on June 7, 1979.
BIBLIOGRAPHY

Books


Bradford, Frederick, Money and Banking, New York, Longmans, Green and Co., 1936.


**Articles**


Pamphlets

Bankers' Acceptances = Bankers Discount, San Francisco, Bankers Discount Corp., [n.d.].


Court Cases


Hercules Motor Corp., 40 BTA 999.


Statutory Laws, Administrative Rulings, and Interpretations

CCH Standard Federal Tax Reports, Chicago, Commerce Clearing House, various sections.

Internal Revenue Code, various sections.

Internal Revenue Regulations, various sections.

Oregon Revised Statutes, various sections.


Uniform Commercial Code, various sections.


United States Statutes at Large, Vol. XII, 28th Congress, First Session, Chap. 106, Boston, Little, Brown, 1866.

Annual Reports

Fifth Annual Report of the Federal Reserve Board 1918,
Washington, Board of Governors of the Federal Reserve,
1919.

Seventh Annual Report of the Federal Reserve Board 1920,
Washington, Board of Governors of the Federal Reserve,
1921.

Survey Questionnaires

Survey questionnaire from the Financial Manager, First
International Bancshares, received August 6, 1977.

Survey questionnaire from the Vice-President, United
California Bank, received August 6, 1977.

Survey questionnaire from James Bartolero, Bank of America,
received August 6, 1977.

Survey questionnaire from K. Christoforidis, Vice-President,
Marine Midland Bank, received August 8, 1977.

Survey questionnaire from the Assistant Vice-President,
Mellon Bank, received August 8, 1977.

Survey questionnaire from the Acceptance Trader, Security
Pacific National Bank, received August 10, 1977.

Survey questionnaire from Michael Gabriel, First National
Bank of Boston, received August 13, 1977.

Survey questionnaire from Ralph Helfrich, Federal Reserve

Survey questionnaire in letter form from Nelson T. Bryant,
Portfolio and Money Manager, Continental Bank, dated
October 17, 1977.

Survey questionnaire and letter from Gene Ruder, Assistant
Treasurer, and Lorenzo Peraita, Second Vice-President,
Chase Manhattan Bank, dated October 17, 1977.

Survey questionnaire from Frank Jenkins, Assistant Manager,
Citibank, received October 31, 1977.

Survey questionnaire from Thomas F. Dwyer, Vice-President,
Chemical Bank, received November 14, 1977.

Survey questionnaire from Bankers Trust Company, received August 5, 1978.


Survey questionnaire from Mrs. Darryl Early, Crocker National Bank, received October 30, 1978.

Survey questionnaire from Gerald Kraut, Assistant Vice-President, First Bank System, received November 1, 1978.


Survey questionnaire in letter form from Frederick Walker, Jr., Vice-President, Bankers Discount Corporation of California, dated June 7, 1979.

Survey questionnaire from Michael Gabriel, First National Bank of Boston, received June 7, 1979.