STATEMENT OF

GOVERNOR J. L. ROBERTSON

ON BEHALF OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BEFORE THE SENATE BANKING AND CURRENCY COMMITTEE

REGARDING COMMITTEE PRINT OF BILL TO

REVISE THE BANKING LAWS

February 12, 1957

Mr. Chairman:

The Board of Governors is in full accord with the Committee's objective of streamlining the present banking laws; and the Committee Print which is the subject of these hearings is an admirable step in that direction. For the most part, its effect would be to rearrange provisions of existing law in a more orderly manner, eliminate obsolete provisions, correct technical defects, and clarify ambiguous provisions. At the same time, it would also make a number of substantive changes, and it is to be expected that there may be differences of opinion as to the desirability of some of these changes.

Most of the provisions of the Committee Print relate to matters which are beyond the Board's jurisdiction and have no direct effect upon the Federal Reserve System. The Board's comments, therefore, are limited primarily to the provisions of Title II of the bill revising the Federal Reserve Act and to certain provisions of other Titles of the bill which directly affect the System or are of interest to the Board.

Title II (Federal Reserve Act)

Title II of the Committee Print would make numerous technical and clarifying changes in the Federal Reserve Act that are obviously desirable and appear to require no special comment.

Most of the changes of substance are in general accord with the legislative recommendations made by the Board to the Committee last October and during the Committee's hearings in November. These changes include restoration of a requirement for payment of a franchise tax by the Federal Reserve Banks to the United States; removal of the present statutory dollar limitation on the cost of Federal Reserve Bank branch buildings; provision for rotation in office of Federal Reserve Bank directors and of members of the Federal Advisory Council; authority for the requirement of reports from State member banks on a sample basis; a requirement that Federal Reserve Bank directors reside within the Federal Reserve district or within a radius of 50 miles of the Reserve Bank; authority for the temporary acquisition of bank stock by a member bank in connection with the absorption of another bank; a liberalization of restrictions on loans by member banks to their executive officers; and a limited extension of the authority of foreign branches of national banks to enable them to compete on more equal terms with banks in foreign countries. All of these changes are desirable, in the Board's opinion, as tending to improve and facilitate the operational activities of the Federal Reserve System and its member banks.

The bill contains a new provision which would require annual audits of the accounts of the Board of Governors by a firm of certified public accountants. Another provision would require the Board to take measures to assure that examinations of the Federal Reserve Banks meet the highest standards of commercial audits, and the Board would be authorized to arrange for review by certified public accountants of the procedures followed in the examination of the Reserve Banks. All such audits of the Board and reports of examinations of the Reserve Banks would be required to be transmitted to the Banking and Currency Committees of Congress. As indicated at the hearings held by the Committee last November, the Board would favor the enactment of these provisions of the bill.

The bill contains some additional substantive changes in Federal Reserve law which have not been suggested by the Board. To certain of these changes the Board would have no objection; as to others it would have reservations.

The bill would require every State member bank to keep, and transmit to the Board on demand, a full list of its shareholders, and to notify the Board of any purchase or sale of its shares involving 10 per cent or more of the number outstanding. The Board believes that these requirements have merit and would not be unduly burdensome.

Investments in bank premises by a State member bank would, under the bill, require the Board's approval only if they should exceed 100 per cent of the bank's capital stock or 50 per cent of the bank's capital and surplus, whichever might be greater, whereas present law requires Board approval in all cases in which the investment would exceed 100 per cent of capital stock. The Board would have no objection to this change.

The bill would have the effect of repealing the present authority of the Reserve Banks under section 13b of the Federal Reserve Act to make working capital loans and commitments to business enterprises. The repeal of this authority, which has been utilized very little in recent years, would be in accord with the position heretofore taken by the Board in this matter.

The bill would transfer to the Comptroller of the Currency the present authority of the Board to grant trust powers to national banks and to regulate the exercise of such powers. As indicated at the Committee hearings last November, the Board would have no objection to the transfer of that authority to the Comptroller of the Currency.

Section 29 of Title II would make certain changes in the provisions now contained in section 30 of the Banking Act of 1933 regarding the removal from office of directors and officers of member banks. A new provision would require that hearings under this section be held in accordance with the Administrative Procedure Act and be subject to review as therein provided and that review by the court shall be upon the "weight of the evidence". Since any such hearings would be subject to the Administrative Procedure Act without this provision, the Board sees no need for its inclusion. Moreover, the provision for judicial review on the weight of the evidence would be a departure from the general rule, as stated in the Administrative Procedure Act, that the reviewing court may set aside agency action if it is "unsupported by substantial evidence"; and the Board would not favor this departure from the general rule.

Section 33 of Title II would permit a holding company affiliate to use the reserve of readily marketable assets required by present law for the purpose of making additions to the capital of its affiliated banks as well as for replacement of capital. This reserve was intended to enable a holding company affiliate to come to the aid of its subsidiary banks in times of stress or emergency. If it could be used in normal times for additions to capital in order to enable expansion and growth, the reserve fund might be depleted and not be available at the very time when it would be needed to maintain the sound condition of the subsidiary banks.

The same section contains a new provision which, in a situation in which there are several holding company affiliates with respect to the same bank or group of banks, would permit the statutory reserve to be maintained by only one of such companies to be designated by the Board. The Board would have no objection to this provision if, in order to prevent possible evasions of the law, a proviso were included to the effect that, of the holding company affiliates involved, only the designated holding company affiliate shall own stock of the subsidiary banks in the group.

Finally, as far as Title II of the Committee Print is concerned, the Board would not favor, at least in its present form, the new provision in section 38(i) prohibiting employees and former employees of the Board or the Federal Reserve Banks from accepting employment in member banks except pursuant to regulations of the Board. This provision, which carries heavy criminal penalties, would place an unduly severe restriction on individuals who may have been employees of the Board or the Reserve Banks many years ago. If this provision should be enacted, it would undoubtedly increase the difficulty of recruiting qualified new employees. Moreover, we know of no abuses within the Federal Reserve System; and furthermore an appropriate path for employees between banks and the supervisory agencies would, on the whole, be beneficial rather than injurious to the public service and the banking system. The Board sees no need for such a "conflict of interests" provision, but it would not object to the provision if it were made inapplicable to any former employee after a specified period, such as two years. At a later point, comment will be made on the even more severe provisions of section 803 of the bill affecting the employment by banks of former employees of the Federal supervisory agencies.

It is noted that the Committee Print's revision of the Federal Reserve Act does not include provisions to carry out a few of the Board's recommendations. Some of the more important omissions may be mentioned.

For many years, the Federal Reserve Banks in connection with their open market operations have utilized repurchase agreements as a convenient and flexible means of helping to smooth out temporary irregularities in the money market. These agreements are in the form of a purchase and sale and they are used only to implement open market policies under regulations of the Federal Open Market Committee. However, they have some of the attributes of a loan and the law now contains no specific reference to such transactions. Accordingly, the Board recommended an amendment specifically authorizing such repurchase agreements; and we continue to believe that such a clarifying amendment would be desirable.

Another of the Board's recommendations omitted from the Committee Print was that the activities of the Federal Reserve Banks as fiscal agents of the United States and of various agencies of the Government should be made specifically subject to supervision and regulation by the Board. Such activities have increased substantially in recent years. More than 3,300 of the System's employees are engaged in fiscal agency activities for more than 25 governmental agencies in approximately 50 different capacities. It has become more and more evident that, in addition to the general authority of the Board to supervise the Federal Reserve Banks, there should be some more specific authority for the over-all coordination of the fiscal agency operations of the Reserve Banks. Such authority would help to prevent Government departments and agencies from requiring the Reserve Banks to perform functions which may be inconsistent with their over-all purposes and unduly burdensome.

Finally, the Committee Print does not carry out the recommendations made by the Board on the subject of payment of interest on deposits by member and nonmember insured banks. The bill would make only one change in present law in this respect. At present, the Federal Deposit Insurance Act provides that "the Board of Directors shall by regulation prohibit the payment of interest on demand deposits in insured nonmember banks and for such purpose it may define the term 'demand deposits'." Section 26 of Title III of the Committee Print would change this language to read: "No insured bank shall, directly or indirectly, by any device whatsoever, pay any interest on any deposit which is payable on demand and for such purpose the Administrator may define the term 'demand deposits'."

In the Board's opinion, this change would not only be inadequate to meet the problems and inequities which have arisen in this particular field, but would actually multiply the existing difficulties because, while it may not have been intended, the new language would authorize the Federal Deposit Insurance Corporation to define "demand deposits" for all insured banks. In order to avoid any misunderstanding, we should like to restate and attempt to clarify the two objectives of the Board's recommendations on this subject.

In the first place, it has become clear over a period of many years that the present law on this subject is completely unworkable. This has been due to the difficulty of determining whether various services offered by banks to their depositors, such as free parking facilities, special printing of checks, etc., constitute indirect payments of interest under the broad language of the statute. Accordingly, the Board recommended that the words "directly or indirectly, by any device whatsoever", be deleted from the statute and that a "payment of interest" be defined as including only cash payments made, or credits given, by a bank for the account or benefit of a depositor. The Board believes that such a change would carry out the basic purpose of the statute and at the same time make it more workable.

The second objective of the Board's proposal on this subject is to make clear that the same rules as to what constitutes a payment of interest on deposits should apply, as Congress obviously intended, to member banks and nonmember insured banks alike. In applying the present law, the Board has ruled that absorption of exchange charges by member banks is a payment of interest, whereas the Federal Deposit Insurance Corporation has taken the opposite position with respect to nonmember insured banks. As a result, member banks in some sections of the country have been placed at a serious competitive disadvantage with respect to nonmember insured banks, and the check collection process has been slowed up by the unnecessary circuitous routing of checks drawn on nonpar banks. If the law were amended as suggested by the Board to define interest as including only cash payments or credits, the Board believes that absorption of exchange would come within that definition. However, in order to remove any doubt on this question, the Board recommended last fall, and continues to recommend, that the law be amended either by including an explicit statement with respect to absorption of exchange charges by both member and nonmember insured banks, or by authorizing the Board or the Federal Deposit Insurance Corporation to define "interest" for both classes of banks.

In this connection, the Board wishes to make clear that its proposal on this subject is not intended to force "par clearance" upon those banks that now charge exchange. The Board's proposal relates not to the making of exchange charges but to the absorption of such charges as a means of paying interest on deposits; and the purpose of the Board's proposal is simply to make the same rules applicable to all insured banks and to preclude situations in which nonmember insured banks are permitted to absorb exchange while competing State and national member banks are not allowed to do so.

Title I (National Bank Act)

Turning now to Title I of the Committee Print relating to national banks, the Board recognizes that the changes in law which would be made by that Title are matters primarily within the jurisdiction of the Comptroller of the Currency. Certain of these changes, however, are of concern to the Board because of their possible effect upon the soundness of the banking system.

Sections 20 and 21 of Title I would permit national banks to issue preferred stock and capital notes and debentures under certain restrictions. In the past, the issuance of preferred stock and capital notes and debentures has been authorized only as an emergency measure. The Board questions the desirability, without further study, of authorizing national banks to issue such stock except in emergencies. It has even greater reservations as to the proposed authority for non-equity capital notes and debentures, since, although they may be subordinated to deposits, they are difficult to distinguish from deposits on which interest is limited by law. The Board suggests that this authority should be stricken from the bill, along with the reference thereto contained in section 37(h). In any event, if this should not be done, the authority should be limited to emergency situations.

Section 26(c) of Title I would have the effect of eliminating the present mandatory requirement for cumulative voting in elections of directors of national banks, but would permit cumulative voting if so provided in the bank's articles of association. Cumulative voting is based on the principle of permitting due representation of minority shareholders on the board of directors; and the principle has been applied to elections of national bank directors since 1933. The Board believes the principle is sound and questions whether the proposed change should be made unless Congress is satisfied that cumulative voting has produced undesirable results so great as to outweigh the obvious justice of giving proper representation to minority interests.

Section 31 of Title I contains a provision which would authorize national banks to grant stock purchase options to their employees. The Board recognizes the advantages which stock option plans might have in enabling national banks to recruit and maintain high-caliber personnel. The requirement of the bill for approval by the Comptroller of the Currency of the terms and conditions of such options would help to prevent possible abuses, although it is possible that the last sentence of the new provision might authorize a bank's directors to override any terms or conditions prescribed by the Comptroller of the Currency with respect to the consideration for the issuance of such options. The Board suggests that, at least with respect to some banks, the application of the proposed authority would not be compatible with the public interest. Some banks might be encouraged by this authority to develop unduly profit-minded, expansion-minded managements. Even though employees' stock option authorizations may be appropriate for other types of corporations, the Board questions whether they are appropriate in the case of commercial banks which are quasi-public institutions entrusted with other peoples' money. At any rate the Board believes that the statute should include more specific limitations on the terms and conditions under which the options may be granted. We suggest that the provision should be dropped from this bill and made the subject of separate legislation after a period sufficient to permit careful study of both the merits of such an authorization and the limitations which should be placed on its use.

Section 36 of Title I would permit a national bank to make real estate loans in a total amount up to 20 per cent of its demand deposits if that amount were greater than its capital and surplus or 60 per cent of its time and savings deposits, the alternative limits provided by present law. Since 1913, the aggregate limitation on real estate loans has been increased on two occasions, once in 1927, and again by the Banking Act of 1935; but Congress has consistently considered it advisable to relate these limitations to the amount of the "permanent" capital structure of national banks or the amount of their time deposits. It has always been felt that demand deposits are an unsuitable basis for real estate loans, and that the aggregate amount of such loans should be based either on the magnitude of the equity cushion in the bank (i.e., capital and surplus) or on the amount of its time deposits which are less likely than demand deposits to be withdrawn suddenly in large volume. The Board does not believe there has been such a substantial change in banking conditions as to justify using demand deposits as a basis for long-term real estate loans, and therefore would oppose the proposed change.

Section 37 would increase the maximum limit on a national bank's total indebtedness from 100 per cent of its capital stock to 100 per cent of its capital stock <u>and surplus</u>. The Advisory Committee recommended that the debt limit be increased to make it less restrictive with respect to borrowings from correspondent banks. However, the increased limit provided by the bill (which, for national banks in the aggregate, would be a dollar amount two and one-half times the present limit) would apply to all types of borrowings that do not fall within one of the several excepted types enumerated in the statute. In the Board's opinion, such a considerable expansion in the borrowing ability of national banks would be unnecessary and undesirable.

Borrowing by banks occasionally is necessary and desirable in limited amounts and for limited periods in order to avoid asset liquidation that might otherwise be necessary. It is not, however, a practice that should be encouraged, because it tends to dilute the cushion of protection provided depositors by bank capital and surplus.

Banks should follow a practice of maintaining holdings of liquid assets adequate to meet ordinary needs. Enlargement of borrowing limits as proposed in this bill might encourage banks to hold smaller amounts of liquid assets and rely upon borrowing for needed adjustments. In an emergency requiring large-scale and extended borrowing the discount facilities of the Reserve Banks are readily available. To enlarge the ability of national banks to borrow outside the Reserve Banks would diminish the restraining influence that the Reserve Banks are directed by law to exert upon borrowing banks which are making undue use of bank credit for speculative purposes.

Section 50 of Title I would make reports of examinations of national banks and related correspondence confidential documents privileged against disclosure without the Comptroller's consent.

The Board concurs in this proposal but believes that it would be highly desirable to include in Title II a comparable provision regarding the confidentiality of examination reports of State member banks.

Title III (Federal Deposit Insurance Act)

Section 23 of Title III would expand provisions of existing law relating to bank mergers so as to require prior approval by the appropriate Federal bank supervisory agency for every merger or consolidation involving insured banks, with a specific requirement that the Comptroller, the Board, or the Federal Deposit Insurance Corporation, as the case may be, shall consider not only the usual banking factors but also whether the proposed transaction would unduly lessen competition or tend unduly to create a monopoly. The supervisory agency would be required to consult the other two Federal banking agencies on the question of competition and would be authorized to request the opinion of the Attorney General with respect to that question. In the Board's opinion, such an amendment would fill a gap in provisions of present law and would serve to insure consideration on a substantially uniform basis of the impact of bank mergers upon competition in the banking field. As the Committee is aware, a bill along these lines which was passed by the Senate last year received the endorsement of all three of the Federal bank supervisory agencies.

It is noted that under section 6 of Title III a single Administrator would replace the present Board of Directors of the Federal Deposit Insurance Corporation and that section 7 provides for an Advisory Board which would include the Chairman of the Board of Governors or his designee. Since the proper discharge of the important functions of such an Advisory Board would make heavy demands on the time of its members, we doubt the desirability of requiring Government officials to assume this added responsibility; and in any event we seriously question whether it would be desirable or advisable for the Chairman of the Board of Governors or his designee to serve as a member.

Title IV (Federal Home Loan Bank Act)

The provisions of Title IV of the Committee Print have no material relation to the principal functions of the Federal Reserve System. There are two points, however, with respect to which the Board would like to comment briefly.

Section 15 of Title IV would make obligations of Federal Home Loan Banks eligible for purchase by any "agency or instrumentality" of the United States. In the judgment of the Board, it would be undesirable for the Reserve Banks to be authorized to acquire obligations of the Federal Home Loan Banks. The language of the bill could conceivably be construed as authorizing investments in such obligations by the Federal Reserve Banks. It is assumed that this result was not intended by the provision in question; but if there should be any doubt in this respect the Board recommends that the provision be appropriately clarified.

Section 17(c) of Title IV, dealing with the authority of the Federal Home Loan Bank Board over its financial transactions, expenditures, and personnel, provides that it shall have the same powers and authority in this respect as are presently vested in the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation. The existence of such a cross-reference would mean that if the relevant provisions of the Federal Reserve Act or of the Federal Deposit Insurance Act should be changed, it would be necessary to consider whether the provisions of the Federal Home Loan Bank Act should be similarly altered. The Board of Governors believes that any such description of the authority of the Federal Home Loan Bank Board in these matters should be self-contained, without any cross-reference to the Board of Governors of the Federal Reserve System.

Section 803

Finally, the Board wishes to comment specially on section 803 of the Committee Print which would substantially revise and expand sections 217 and 218 of the Criminal Code relating to bank loans and gratuities to examiners. In brief, these provisions would be extended to prohibit (1) gifts by member banks to any officers or employees of the Board of Governors or the Reserve Banks; (2) the making of loans or offers of employment by member banks to any employees of the Board or the Reserve Banks who may have performed any duties in connection with the member bank in the preceding two years; and (3) the making of loans or offers of employment to any other employees of the Board, even though they had performed no duties in connection with the bank, unless the written approval of the Board is first obtained in each case.

Such extremely restrictive provisions are not only unnecessary but, in the Board's opinion, would impose a heavy hardship on employees of the Board and the Reserve Banks and the other Federal supervisory agencies to which they would also apply. They would handicap the operations of the supervisory agencies themselves and, even more than the conflict of interest provisions of the bill already mentioned, would hinder recruitment of new personnel. The mere likelihood of enactment of these provisions might possibly bring about an exodus of present employees. Restrictions on loans and offers of employment by a member bank to employees of the Board who have performed duties in connection with that bank would have particularly harsh results; and the difficulties of determining the application of these restrictions in particular cases are apparent. The Board employee who dictates a letter regarding a particular member bank, the stenographer who types it, the lawyer who passes on its legal effect, members of the Board who approve it, and the file clerk who files it, may all be performing duties in connection with that bank.

About 95 per cent of the employees of the Federal Reserve System are engaged in duties connected with services performed by the System for member banks, such as the collection of checks and the furnishing of coin and currency. All of these employees would be precluded from obtaining loans from, or accepting employment with, member banks.

Equally burdensome and severe would be the restrictions on loans or offers of employment to any employees of the Board regardless of the nature of their duties. Actually, these restrictions as written in the bill, would seem to go so far as to apply to borrowings by a Board employee from a savings and loan association or a Federal credit union. In addition, it seems inconceivable that Congress would wish to impose upon the Board and the other supervisory agencies the administrative burden of passing upon practically all borrowings, including installment purchases, by all of their employees.

For all of the reasons indicated, the Board opposes the proposed revision of sections 217 and 218 of the Criminal Code which would be made by section 803 of the Committee Print.

In conclusion, Mr. Chairman, we would like to reiterate that we are in complete accord with the objectives of the Committee; and, with the relatively few exceptions that have been mentioned, we believe that the Committee Print constitutes a long step toward simplification of the banking laws. The Board and its staff will be glad to give any assistance that may be desired in connection with your Committee's further consideration of this proposed legislation.