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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 16, 1938

To Chairman Eccles

From Mr. Wyatt, General Counsel

Subject: Treasury report on Bulkley Bill S. 3874 re Federal Savings and Loan Associations

Through the courtesy of the General Counsel of the American Bankers Association, I am handing you herewith for your information a copy of a letter addressed to the Chairman of the Senate Banking and Currency Committee by the Secretary of the Treasury under date of May 12, 1938, which contains a very valuable report on the Bulkley Bill, S. 3874.

Respectfully,

Walter Wyatt

Walter Wyatt,
General Counsel.

Attachment

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C O P Y

TREASURY DEPARTMENT

WASHINGTON

May 12, 1938

My dear Mr. Chairman:

Reference is made to your letter of April 21, 1938, requesting my opinion as to the merits of proposed legislation incorporated in Bill S. 3874, "To amend the Federal Home Loan Bank Act, the Home Owners' Loan Act of 1933, the Federal Reserve Act, and the National Housing Act, and for other purposes".

Before discussing the proposed legislation, I want to emphasize that the comments of the Treasury Department are not intended to indicate a negative position on the part of the Department toward the objective of the Federal Home Loan Bank System. The legislation creating that System and subsequently expanding it through provision for the chartering of Federal savings and loan associations and for insurance of the solvency of building and loan associations was designed to strengthen the facilities for home financing in the interest of home ownership. With that objective, this Department is in complete accord. The discussion of the proposed amendments, however, serves to raise the underlying problem of a clear definition of that objective and of modifications in the system to carry it out in a manner consistent with the proper coordination of the financial economy as a whole.

The Bill goes far beyond technical or clarifying amendments to the Acts referred to in its title, and would fundamentally alter the place in our financial structure of the institutions supervised by the Federal Home Loan Bank Board, change materially the character of the business of these institutions, as well as open new and wide avenues of tax exemption. Because of the far-reaching character of the proposed legislation and because, in my opinion, most of the proposed changes would constitute precedents for further changes of similar character, I have thought it best to discuss briefly the broad issues involved before commenting more particularly upon the various sections of the Bill.

First, the assumption seems to underlie the proposed legislation that shares in building and loan associations ought to have a degree of liquidity comparable to that of bank deposits. The Bill consequently provides for substantially supplementing the ability of the Federal home loan banks to make the advances to their members which would be necessary in order to permit them to maintain, in times of stress, the status of their shares as quasi-demand deposits. The objective of providing liquidity for these shares would also be furthered

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by revising the insurance settlement of the Federal Savings and Loan Insurance Corporation so that shareholders in defaulted building and loan associations may be paid off in cash or in interest-bearing debentures rather than being asked to wait for a substantial period without interest, as is the case at present.

Shares in building and loan associations have been generally understood to be means for the investment of long-term savings and not liquid instruments. The assets of the associations, consisting almost entirely of mortgages and derivative real estate, are of a character suitable to this concept of their shares and provide no means for furnishing any considerable degree of liquidity.

If this concept is to be changed and shares in building and loan associations made liquid instruments, such shares will become, for practical purposes, indistinguishable from bank deposits; and building and loan associations and banks may be expected to compete actively for all funds now held in banks where the checking privilege is not essential. If, in making their adjustment to such a situation, building and loan associations endeavor to maintain liquid assets comparable in extent and character to those customarily maintained by banks, the effect of the tendency strongly evident in the proposed legislation will be to transform them into a competing form of banks -- operating, however, under different supervisory authorities and under different fundamental statutes from the existing banking institutions. In the more likely case that building and loan associations fail to build up their proportion of liquid assets, notwithstanding the changed character of their shares, they would still constitute a competing system of banks except that in this case their liquidity would be furnished almost entirely at the expense of the Government -- whereas, existing banking institutions supply their own liquidity under all ordinary circumstances.

Second, the proposed legislation would expand the types of business in which Federal savings and loan associations may engage and would likewise expand the types of collateral eligible for securing advances from Federal home loan banks. These changes pertain to the percentage of total assets of Federal savings and loan associations which may be employed without regard to statutory restrictions limiting loans to "home" mortgages of a stipulated maximum amount and within fifty miles of the home office of the association. The liberalization of eligibility requirements applies to the number of families housed per dwelling, the restriction to mortgages on homes, the restriction to collateral specifically itemized in the statute, and the restriction limiting the size of home mortgages. These changes would tend to rob building and loan associations of their character as "local, mutual, thrift, and home-financing institutions".

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Third, the proposed legislation extends sweeping tax-exempt privileges to Federal savings and loan associations. These associations are already exempt from all Federal corporation taxation, and dividends on their shares are exempt from the normal income tax of the Federal Government. It is now proposed that they also be exempted from all State and local taxation, except real property taxes, and that their shares and the income thereon also be exempted from all State and local taxation (except surtaxes, estate, inheritance, and gift taxes). It is also proposed that the wording of the exemption privilege be so sweeping as to include within its scope indirect as well as direct taxation.

The Treasury is deeply concerned by the increasing demands for tax-exemption privileges constantly being urged for various classes of enterprises, and feels that this request for additional tax exemption upon the part of a class of institution already specially favored in this respect is most untimely in view of the program of the President for the elimination of tax-exemption privileges generally. Tax exemptions are concealed subsidies, particularly undesirable in that their cost is not annually brought to the attention of the appropriating authorities and the public, as is the case with outright subsidies. The proper occasion for a consideration of the granting of exemptions from taxation ought to be in connection with general tax legislation rather than in connection with legislation relating to specific classes of institutions.

Turning to more detailed comments on the provisions of S. 3874, Section 1 would amend subsection (6) of Section 2 of the Federal Home Loan Bank Act, as amended, to permit the Federal Home Loan Bank Board to broaden the eligibility requirements on real estate collateral for loans of the Federal home loan banks to include mortgages on dwellings housing more than four families. The effect of this provision would be to permit member institutions to obtain loans from the banks with collateral consisting of mortgages on large-scale housing projects, thus encouraging building and loan associations to make such mortgage loans. This practice would appear to be an unwise extension of the operations of building and loan associations, inasmuch as such loans might represent an undue concentration of assets, and would tend to rob the associations of their character as local, mutual, thrift, and home-financing institutions.

Section 2 of the proposed bill would amend subsection (a) of Section 10 of the Federal Home Loan Bank Act, as amended, to extend the list of eligible collateral for advances of the Federal home loan banks to include obligations of the banks and of the Federal Savings and Loan Insurance Corporation and other obligations approved by the Board. In addition, mortgages eligible for advances under this subsection would not be restricted to "home mortgages" as now provided. Section 3 would amend paragraph (3) of subsection (a) of Section 10 of the Federal Home Loan Bank Act, as amended, to remove the "home mortgage" restriction

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from mortgages eligible for advances under this paragraph. The effect of these changes would be to increase greatly the list of eligible collateral for bank advances, since mortgages on structures other than homes would be eligible, as well as "other obligations" approved by the Board. As a result, the banks might duplicate in part the existing discount facilities of the Federal Reserve banks.

Section 4 would amend subsection (b) of Section 10 of the Federal Home Loan Bank Act, as amended, to liberalize acceptable collateral for security for bank advances by extending the maximum maturity for permissible home mortgages from 20 to 25 years; and by increasing the maximum size of permissible home mortgages from $20,000 to $30,000, or such greater amount as may be fixed by the Board. The latter proposal would appear to be subject to the same criticisms cited with respect to Section 1, namely, that an undue concentration of assets might result and that the associations would tend to be robbed of their character as local, mutual, thrift, and home-financing institutions.

Section 5 provides, inter alia, that the Board shall have power to examine and audit State-chartered members, the accounts of which are not insured by the Federal Savings and Loan Insurance Corporation, if such members are not subject to State examination and supervision or if in the judgment of the Board State examination is inadequate for the protection by the Board of the Federal home loan banks, other members, and the public. This Department has had long experience in the field of bank examinations, and with the problems arising as a result of the operations of parallel supervisory authorities. It is virtually impossible to obtain examinations of uniform quality from different supervisory authorities whose interests, powers and objectives are bound to vary. The interests of sound organizations and operation of financial institutions in each field demand supervision which is consistent and uniform. The present proposal to accept the examinations of other supervisory authorities must be viewed as unsound and as a step backward in the public regulation of financial institutions.

Section 7 would amend subsection (n) of Section 4 of the Home Owners' Loan Act of 1933, as amended, to authorize the Home Owners' Loan Corporation to purchase up to $250 millions of Federal home loan bank debentures and obligations of the Federal Savings and Loan Insurance Corporation, the authorization to constitute a revolving fund. This would be in addition to the present authorization of $300 millions made available for the purchase of obligations of the Federal home loan banks and for investment in building and loan associations. The Home Owners' Loan Corporation was organized as an emergency agency to do one particular job -- make mortgage loans to financially distressed home owners -- while the Federal home loan banks and the Federal Savings and Loan Insurance Corporation were set up as permanent agencies to aid in the financing of building and loan associations. It seems quite

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illogical to use the facilities of a temporary agency to aid in financing permanent agencies in this manner.

Section 8 would amend subsection (a) of Section 5 of the Home Owners' Loan Act of 1933, as amended, to insert the word "safely" before the phrase "invest their funds" in the sentence authorizing the Federal Home Loan Bank Board to charter Federal savings and loan associations, "In order to provide local, mutual, thrift, institutions in which people may invest their funds . . ." This Section would also permit Federal savings and loan associations to be known as "Federal savings associations" if the Federal Home Loan Bank Board so determines.

The present term, Federal savings and loan associations, aptly describes the type of business which these organizations conduct, while the proposed name might well result in a misunderstanding of the nature of the organizations. The terms "building and loan association" and "savings and loan association" have long served to describe the class of organization to which Federal savings and loan associations clearly belong and the present name therefore conveys to the public the idea of a financial organization making mainly long-term home mortgage loans, and accepting savings for this purpose. The proposed name, however, would more likely give the impression of an organization like a mutual savings bank. Such banks are fundamentally different from savings and loan associations in the character of their relationship to the investor. The investor in a mutual savings bank is a depositor, and if his claim for withdrawal is denied, the bank is deemed insolvent. The investor in a Federal savings and loan association, on the other hand, is a part owner, and if his claim for withdrawal is denied he must wait until such time as the association may have sufficient funds to repurchase his shares.

The proposal to insert the word "safely" in the statute with respect to the making of investments in Federal associations seems unwise, since it might be interpreted as implying that the Government guarantees such investments. The Federal Savings and Loan Insurance Corporation insures the share accounts of these associations to a limited extent, but the Federal Government as such has extended no guarantee of the solvency of either the insurance corporation or the associations.

Section 9 would amend subsection (c) of Section 5 of the Home Owners' Loan Act of 1933, as amended, to increase from 15 to 30, the percentage of total assets of Federal savings and loan associations which may be employed without regard to the limitations (1) restricting the size of mortgages, (2) restricting loaning activity to a 50-mile radius of the home office, and (3) restricting loans to those on homes or combination homes and business property. This proposal appears to be subject to the same criticism cited above in connection with Sections 1 and 4, namely, that an undue concentration of assets might result and that the associations would tend to be robbed of their character as

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local, mutual, thrift, and home-financing institutions.

This Section would also provide that any portion of the assets of Federal savings and loan associations may be invested "in obligations of, or guaranteed as to principal and interest by, the United States, the stock or obligations issued pursuant to the Federal Home Loan Bank Act or in other securities approved by the Board." With respect to direct and guaranteed obligations of the United States, the present authority of the associations is to invest "in obligations of the United States." This Department has had occasion to consider the provisions of the present law in a case where an association had invested most of its assets in bonds of the Home Owners' Loan Corporation guaranteed as to principal and interest, and inferentially at least, interpreted the words "obligations of the United States" as used in this Section (Section 5(c) of the Home Owners' Loan Act of 1933, as amended) to include obligations which were fully guaranteed as to principal and interest by the United States. I understand that the General Counsel for the Federal Home Loan Bank Board rendered an opinion in which the same conclusion was reached. I see no objection to inserting the suggested language in section 19, but I think it would be desirable for the Committee Report on the Bill to contain an explanation of the section to the effect that the addition of the phrase "or guaranteed as to principal and interest by" is a clarifying provision rather than specific new legislation.

The expansion of the authorized investments of Federal savings and loan associations to include "other securities approved by the Board" might result in a tendency for Federal savings and loan associations to alter materially the character of their business.

Section 10 would amend subsection (h) of Section 5 of the Home Owners' Loan Act of 1933, as amended, to provide complete tax exemption for Federal savings and loan associations except from real property taxes. Present law provides complete exemption only with respect to Federal taxes, while State taxes are applicable to Federal associations to the same extent as they are applicable to State-chartered associations. This Section would also make shares of Federal savings and loan associations exempt, both as to value and income, from State and local taxes (except surtaxes, estate, inheritance, and gift taxes). The same exemption is already given with respect to Federal taxes.

Such tax exemptions would constitute hidden subsidies and would be undesirable forms of financial assistance inasmuch as they would escape the scrutiny and safeguards generally present in connection with ordinary expenditures entering into the budget of a political unit. It would appear to make no difference whether the activity being assisted by a hidden subsidy is worthy or unworthy; the important point is that the assistance to be provided would take place without ever being recorded as an expenditure.

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In addition to this general criticism of the proposed tax exemptions, these particular proposals are undesirable for two specific reasons. In the first place, the Federal Government would be granting exemptions from taxes levied by State and local governments, and granting such exemptions to private institutions and their shares. This would seem to be an unwise extension of the sphere of reciprocal tax exemption which would result in the introduction of new tax conflicts between the Federal and State and local governments, at the very time when the program of the President is to eliminate reciprocal tax exemptions generally.

In the second place, the granting of the tax exemptions proposed would give an unfair competitive advantage to Federal associations. National banks (which are also Federally chartered) and their shares, receive no tax exemption, either as to Federal or State and local taxes; and as a matter of fact, the statute specifies that national banks shall be subject to State and local taxes, but only to the same extent as State-chartered banks. Federal credit unions are exempt from Federal corporation income taxes, but their shares and dividends received thereon are subject to full taxation in the hands of the recipient. If State-chartered building and loan associations and their shares are not now granted exemption from State and local taxation, this proposal would favor Federal associations; and if State-chartered institutions are now given special tax treatment, Federal associations automatically receive the same treatment. In the final analysis, therefore, it seems to me that this proposal would conflict with the intention implied in the legislative history with respect to Federal savings and loan associations, that the competitive situation with respect to State-chartered institutions should not be disturbed.

This Section also incorporates the words "and the burden thereof" in connection with the specified tax-exemption provisions, apparently in an effort to include the incidence from indirect taxation. If, in fact, this language is used in an attempt to include the incidence from indirect taxation, such action would give Federal savings and loan associations greater exemption from taxes than is now accorded any other Federally-chartered organization. If, on the other hand, the intention is merely to spell out with greater particularization the legal effect of tax exemption, I fear that the long-standing construction given to similar tax-exemption provisions without the new language might thereby be prejudiced.

This Section would also make shares in Federal savings and loan associations lawful investments for, and acceptable as security for, all fiduciary, trust, and public funds, the investment or deposit of which is under the authority or control of the United States or any officer or officers thereof. A major anomaly of this provision is that it would make shares in Federal savings and loan associations eligible as security

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for deposits of public funds in national and other banks. (In connection with Section 13, the Treasury disapproves the proposal to allow national banks to invest in shares of Federal associations and other associations insured by the Federal Savings and Loan Insurance Corporation.) Deposits in these banks are roughly analogous to shares in savings and loan associations, except that deposits in commercial banks have the added protection of the stockholders' equity and are much more liquid. Since collateral is required as security for deposits of public funds in banks, it would seem reasonable to require collateral to be posted likewise if public funds are invested in the shares of Federal savings and loan associations. Furthermore, inasmuch as an assignment of a deposit in one bank is not considered acceptable collateral to secure the deposit of public funds in another, it would seem likewise that shares in Federal savings and loan associations should not be eligible as collateral either to secure the deposit of public funds in banks or the investment of public funds in other savings and loan associations.

With respect to the further provision of this Section that shares in Federal savings and loan associations should themselves be acceptable investments for fiduciary, trust and public funds, it appears obvious that they should not be acceptable for any funds with respect to which an important degree of liquidity is desired.

The last sentence of this Section would provide that:

> "All taxation and the burden thereof now and hereafter imposed by the United States, any Territory, dependency, or possession thereof or the District of Columbia upon any building and loan, savings and loan, or homestead association or cooperative bank or the shares, deposits or certificates of indebtedness issued by them, or the income therefrom shall be on the same basis as that prescribed for Federal savings and loan associations."

This Department is not inclined to favor any such extension of Federal tax exemptions for reasons hereinbefore indicated, and particularly in view of the program of the President with respect to the elimination of reciprocal tax exemptions.

Section 13 would amend the seventh paragraph of Section 5136 of the Revised Statutes, as amended, to liberalize the present restriction prohibiting national banking associations from purchasing stock of corporations, to allow them to invest in shares of Federal savings and loan associations and other institutions insured by the Federal Savings and Loan Insurance Corporation, waiving the restrictions respecting investment securities. It would appear that this proposal is unsound for two

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reasons. In the first place, the field of proper investments for banks is a matter which should be determined in connection with general banking legislation, and not in connection with legislation pertaining to other classes of institutions. Second, it has been the policy of the Government to separate banks from other businesses, while this proposal would permit them to set up affiliates to operate as building and loan associations.

Section 15 would amend subsection (a) of Section 402 of the National Housing Act, as amended, to change the name of the Federal Savings and Loan Insurance Corporation to Federal Savings Insurance Corporation. This proposal would be subject to objections similar to those which I have discussed in connection with the proposal in Section 8 to change the name of Federal savings and loan associations.

Section 16 would amend subsection (b) of Section 402 of the National Housing Act, as amended, to provide for repeal of the cumulative feature of dividends of the Federal Savings and Loan Insurance Corporation. Dividends would not be paid until a reserve is accumulated equal to 5 percent of insured accounts and creditor obligations of all insured institutions. The dividend rate would also be changed from the rate being received on the Corporation's Home Owners' Loan Corporation bonds to the rate "paid by the Government on its last issued bonds having a maturity of 10 years or more." Strictly speaking, the Home Owners' Loan Corporation should not be called upon to grant subsidies to the Federal Savings and Loan Insurance Corporation which is what the present proposal would amount to. Moreover, under the proposed amendment, it is not clear what disposition would be made of the accumulation of dividends to which the Home Owners' Loan Corporation is already entitled under the provisions of the present law. As to the dividend rate, I see no reason to make the proposed change, since the rate paid by the Government on its bonds seems to be irrelevant in establishing a dividend rate for the Federal Savings and Loan Insurance Corporation. The present arrangement of basing the rate on the interest received on the Home Owners' Loan Corporation bonds held by the Insurance Corporation seems much more logical. In the end, this arrangement, viewed in conjunction with the proposal to withhold dividends until a 5 percent reserve is accumulated, would merely mean that the investment of the Home Owners' Loan Corporation in the Insurance Corporation would be costless to the former, once the reserve has been set up and is currently maintained.

Section 17 would amend Section 403 of the National Housing Act by adding a new subsection (e), providing that any insured institution which is regularly and adequately examined at least annually by any public authority, which makes available to the Federal Savings and Loan Insurance Corporation a copy of the report of examination, no additional examination shall be required, except at the expense of the Corporation,

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provided that the Corporation may require special examinations at the expense of an insured institution in cases of defaults or similar circumstances. This proposal is subject to the same weaknesses cited above in connection with Section 5, and in this case, the weaknesses are vastly more important. The Federal Savings and Loan Insurance Corporation assumes a definite and important liability with respect to all insured associations, a liability which the State supervisory authorities do not share. The Federal Savings and Loan Insurance Corporation will naturally be loath to stigmatize the standards of examination of any State authority as "inadequate", yet in the absence of such action the Corporation would have no authority to examine State-chartered insured associations, except at its own expense (and so indirectly at the expense of Federal associations).

If the examinations of State-chartered insured associations now made by the Federal Savings and Loan Insurance Corporation are more thorough than those of the supervisory authorities of many States, the associations will suffer from their discontinuance. If they are less thorough, the only thing which would be saved by their discontinuance would be a minor expense, while a major uncertainty would be introduced with respect to the adequacy of future State examinations, since no standard of comparison would hereafter be available. Upon the basis of the experience of this Department in the examination of banks, it appears that the extension of the principle here proposed with respect to State-chartered insured building and loan associations to State-chartered insured banks would be likely to undermine the Federal insurance of bank deposits.

Section 18 would amend Section 404 of the National Housing Act, as amended, to provide for a reduction in the annual insurance premium rate of the Federal Savings and Loan Insurance Corporation from 1/8 of 1 percent to 1/12 of 1 percent, effective as of January 1, 1938. The Federal Savings and Loan Insurance Corporation was organized in 1934, and an analysis of the reserve it has accumulated since organization does not indicate that the present premium rate is excessive. It is true that the Federal Deposit Insurance Corporation levies a premium of 1/12 of 1 percent in connection with its insurance of bank deposits but in my opinion the risk is substantially less than that encountered by the Federal Savings and Loan Insurance Corporation. In the first place, banks are required by law to carry considerably larger reserves than are customarily carried by building and loan associations. Banks in New York City, for example, must carry reserves of 22-3/4 percent of demand deposits in the form of a deposit with the Federal Reserve bank, and, as in the case of banks generally, customarily carry in addition considerable amounts of nonreserve cash and of liquid securities and hold large portfolios of Government securities. Building and loan associations, on the other hand, seldom maintain substantial reserves in cash and customarily carry only a small amount of liquid securities and a small portfolio of Government securities. In the second place, the premium base

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in the case of insured banks as a class is much higher in relation to the aggregate amount of insurance in force than is the case with building and loan associations. Stated in other words, banks have a much larger proportion of uninsured funds on which they pay premiums than do building and loan associations.

Section 19 would amend subsection (b) of Section 405 of the National Housing Act, as amended, to provide that settlement on insured accounts by the Federal Savings and Loan Insurance Corporation shall consist of "at least", instead of "not to exceed", 10 percent in cash, and that debentures shall bear 2 percent interest instead of being noninterest-bearing. The Corporation would also be empowered to pay settlements in full in cash, in its discretion. Investors in building and loan associations receive a relatively high return because of their willingness to invest in institutions making primarily long-term mortgage loans. Consequently, the insurance of building and loan accounts takes the form of insuring their "solvency" rather than their "liquidity". Furthermore, since assets acquired by the Insurance Corporation in the case of insolvency of an insured association are likely to require a considerable time for their liquidation, settlements by the Insurance Corporation take the form of noninterest-bearing debentures except, presumably for convenience, some portion, not to exceed 10 percent, may be paid in cash. The proposal to increase the percentage paid in cash, even to 100 percent in the discretion of the Corporation, and to pay interest on debentures, is in conflict with the character of building and loan association assets.

Very truly yours,

Secretary of the Treasury.

Hon. Robert F. Wagner,
Chairman, Committee on Banking and Currency
United States Senate.

WL/mb - typed 5/11/38

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