December 6, 1944

To: Chairman Eccles Subject: Commercial bank earnings

From: L. M. Piser and D. M. Kennedy

We have studied further the question of commercial bank earnings and submit for your consideration the following observations:

1. The solution to the problem of large commercial bank earnings might be to increase the rate of interest on time deposits, to increase wages and salaries, and to reduce service charges on deposits. An increase in the rate of interest on time deposits from the present low level of 0.9 per cent to 1.8 per cent would reduce member bank earnings in 1945 by 170 million dollars. An increase of 25 per cent in wages and salaries would reduce member bank earnings by 125 million dollars. Bank wages and salaries are low in comparison with the general level of wages and salaries. In addition, service charges on deposits could well be reduced considerably. These changes, which would not seem to be excessive, would reduce member bank earnings by more than 300 million dollars to a level between 5 and 6 per cent of capital funds. It seems to us that these changes would be less disturbing to the banking system than changes in the form of Treasury financing and that they would be desirable changes for reasons other than the position of bank earnings.

2. If measures are taken to reduce bank earnings on Government securities, our preference would be for the Treasury to maintain approximately the present maturity distribution of the debt and to allow the yields on medium-term securities that are eligible for bank purchase to decline. In order to prevent banks from acquiring an excessive amount of medium-term securities and thereby defeating the objective of the proposal, the Treasury would have to eliminate future offerings of medium-term bonds for nonbank subscription. If nonbank investors could not replenish their present holdings of medium-term securities, it is not likely that they would sell an excessive amount of them to commercial banks. Although this program would lower the yields on medium-term securities, it need not have any effect on long-term restricted issues if the Treasury continued to give full allotment to nonbank investors. This program would not be subject to the criticism that it unduly interferes with banks. In addition, it would avoid the administrative problems that would be involved in the issuance to commercial banks of special deposit receipts.

3. Of the proposals involving special issues, the least objectionable is the requirement that all commercial banks hold deposit receipts in an amount equal to some percentage of their demand deposits. The Treasury would issue these deposit receipts in exchange for marketable holdings. One objection to this program, however, arises from the fact that there are wide variations among individual banks in the ratio between their holdings of Government securities and their demand deposits. If the requirement were

placed low enough to cover every bank, it might leave the commercial banking system with a large amount of marketable securities. If it were placed high enough to cover the average ratio, it probably would force many banks to liquidate loans. Since bank loans would be limited by this requirement, it might discourage some banks from making additional loans and thus might weaken the position of the private banking system. It also would involve complicated administrative problems, because the Federal Reserve or the Treasury would need to redeem deposit receipts for banks that were losing deposits and to issue deposit receipts to banks that were gaining deposits.

4. We believe that it would be undesirable to require commercial banks to limit their holdings of marketable issues to a percentage of savings deposits and to force them to exchange their excess holdings of marketable securities for deposit receipts. This procedure, if not illegal, would be unfair to banks, because banks have purchased marketable securities in good faith and with a Treasury contract that these issues will not be called prior to a given date. It also would involve complicated administrative problems.

5. We believe also that it would be undesirable to permit banks to exchange maturing issues for deposit receipts. It would be necessary to couple this proposal with a prohibition against banks increasing their present holdings. This proposal would be more equitable than the previous proposal, because banks would not be forced to exchange their holdings before they are called or mature. On the other hand, banks that were losing deposits would either redeem deposit receipts or sell marketable securities that banks gaining deposits could not purchase. It would, therefore, involve a difficult administrative problem of allocating deposit receipts to banks that were gaining deposits. It also would conflict with credit policy, because the Federal Reserve would find it necessary to purchase marketable securities that were sold by banks losing deposits and that other banks were prohibited from purchasing.

6. We are still opposed to a lengthening of the Treasury debt through refunding of short-term securities. The reasons are the same as previously advanced, namely, that (1) it would increase the interest cost of the debt, (2) it would give less flexibility to the Treasury in managing the debt, (3) it would further increase commercial bank earnings, (4) it would increase the outstanding amount of long-term securities, which are inherently unfair to both the Treasury and investors if interest rates subsequently change, and (5) it would result in a large depreciation in the value of bank holdings in the event of an increase in interest rates.

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