

**Report of the Committee**  
**on**  
**FINANCIAL INSTITUTIONS**  
**to the**  
**PRESIDENT OF THE UNITED STATES**

**April 1963**



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(II)

THE WHITE HOUSE,  
*Washington, April 19, 1963.*

MEMORANDUM FOR MR. WALTER W. HELLER, Chairman, Council of  
Economic Advisers.

Subject: Report of the Committee on Financial Institutions.

I should like to express my appreciation to you, as Chairman, and to the members of the Committee on Financial Institutions, for the valuable analysis you have made of the changes in Government policy toward private financial institutions, which could contribute to economic stability, growth, and efficiency. It is heartening that the eleven agencies represented, all of them intimately involved in the formulation and execution of Federal policies affecting such institutions, both recognize the need for improvements and agree on the steps which should be taken.

The conclusions of the Committee are couched in terms of principles and goals. As the Report states, many of the needed revisions in law and policy identified by the Committee are not so urgent as to command the highest priority. However, in my judgment, they will provide a sound basis for policy and constructive guidance in considering specific proposals for legislative action.

It is important that we begin to take the actions necessary to strengthen and make more effective our private financial system. For instance, Federal insurance for bank deposits and savings and loan share accounts has long proved its value. The problem of additional coverage is now before the Congress. The report concludes, and I agree, that in increasing the coverage of deposit and share insurance certain related issues should be satisfactorily resolved. I am requesting that draft legislation resolving these issues be prepared as soon as possible.





THE CHAIRMAN OF THE  
COUNCIL OF ECONOMIC ADVISERS,  
*Washington, D.C., April 9, 1963.*

DEAR MR. PRESIDENT: I submit herewith the Report of the Committee on Financial Institutions, established in response to your memorandum of March 28, 1962. The members of the Committee are listed in the letter of transmittal which follows.

This report is the product of an immense amount of effort by members of the Committee and their staffs. The Committee held 39 formal meetings, at which it considered a broad range of issues, many of them controversial. It had the benefit of close to 100 working papers prepared by the various departments and agencies; numerous studies and memoranda prepared by trade associations, financial institutions, and individuals; and the report and studies of the Commission on Money and Credit.

James Tobin, member of the Council of Economic Advisers, acted as Chairman pro tem of the Committee until July. Since that time, Gardner Ackley, Mr. Tobin's successor on the Council, has served in this capacity. The Committee is extremely grateful to Robert Solomon of the staff of the Board of Governors of the Federal Reserve System, who ably served as its Secretary and as the principal draftsman of its report, as well as to Chairman Martin for making Mr. Solomon's services available to the Committee.

Your charge to the Committee was that it "consider what changes, if any, in Government policy toward private financial institutions could contribute to economic stability, growth, and efficiency." While the Committee has not attempted to formulate specific legislative recommendations, its findings point to a number of significant changes in legislation and in administrative rules and arrangements that would enable private financial institutions to play a more effective role in our market economy.

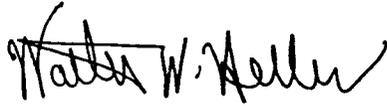
Although numerous improvements are suggested, the report as a whole offers reassurance that our financial system, for the most part, functions soundly and efficiently to promote the growth and stability of our economy and effective employment of our Nation's savings; and that Federal supervision and regulation advance these ends. The Nation is therefore in a position to proceed with improvements after

due deliberation rather than, as has so often been true in the past, under the pressure of financial crisis.

All members approached these difficult and controversial issues in a spirit of cooperation and with a sincere desire to obtain the maximum possible degree of consensus. As a result, a majority of the Committee's specific conclusions were reached by unanimous vote. On the others, there were one or more dissents. Even where there were no dissents, however, the conclusions frequently represent a "common denominator" of somewhat differing shades of opinion.

The Committee unanimously recommends that this report be released for publication. In addition to the guidance which the report may provide for the executive and legislative branches of the Federal Government, we believe that the report's analysis of issues and its findings can contribute to a better understanding of these complex questions in the financial community and in the public generally.

Respectfully,

A handwritten signature in black ink, appearing to read "Walter W. Heller". The signature is written in a cursive style with a horizontal line striking through the middle of the name.

WALTER W. HELLER, *Chairman.*

LETTER OF TRANSMITTAL

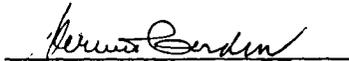
APRIL 10, 1963.

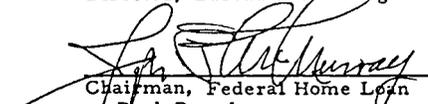
DEAR MR. PRESIDENT: Attached is the report of your Committee on Financial Institutions, which you appointed on March 28, 1962, "to review legislation and administrative practices relating to the operations of financial intermediaries," and "to consider what changes, if any, in government policy toward private financial institutions could contribute to economic stability, growth, and efficiency."

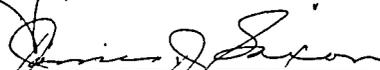
Faithfully yours,

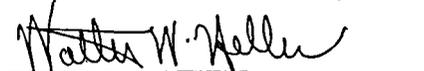
  
Secretary of the Treasury

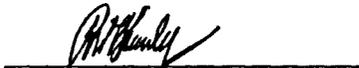
  
Secretary of Agriculture

  
Director, Bureau of the Budget

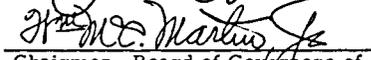
  
Chairman, Federal Home Loan  
Bank Board

  
The Comptroller of the Currency

  
Chairman, Council of Economic  
Advisers, Chairman of the Committee

  
The Attorney General

  
Secretary of Health, Education,  
and Welfare

  
Chairman, Board of Governors of  
the Federal Reserve System

  
Administrator, Housing and Home  
Finance Agency

  
Chairman, Federal Deposit  
Insurance Corporation



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(IX)



# REPORT ON FINANCIAL INSTITUTIONS

## Chapter I

### INTRODUCTION

The general task of the Committee on Financial Institutions was, according to the President's memorandum establishing the Committee, "to consider what changes, if any, in governmental policy toward private financial institutions could contribute to economic stability, growth, and efficiency."

Private financial institutions serve a vital function in the economic process. They gather funds of economic units with surpluses and lend funds to economic units with deficits. In addition, commercial banks, the largest group of private financial institutions, create the bulk of the economy's medium of exchange and administer its payments mechanism, and are the main channel through which monetary and credit policy is implemented. These institutions as a group are closely involved in financing capital expenditures and in creating liquid assets for businesses and consumers. As a result, the activities of financial institutions have an important bearing on economic growth and on fluctuations in economic activity. As lenders of capital, financial institutions also influence the allocation of resources and therefore the efficiency with which the economy operates. Although the financial system by itself cannot assure that the economy will enjoy steady, stable, and efficient growth, a well-functioning financial system is a necessary condition for stability, growth, and efficiency.

Only on a few occasions in our history has the Government undertaken a broad examination of the financial structure in the absence of a crisis that made such an examination imperative. During the Civil War, after the financial panic of 1907, and during the Great Depression, the need for reexamination and action with respect to the financial structure was unmistakable.

The occasion for the present study was quite different. It was triggered not by a crisis, nor by the presence of acute problems. Rather, it represented a recognition that substantial changes had occurred in our economy and in the financial structure since the mid-1930's. In the decade of the Great Depression, numerous innovations had been introduced into the relationship between Government and private

financial institutions. Many of these changes were designed either to prevent a repetition of the financial catastrophe of the early 1930's or to encourage recovery from severe depression.

Since World War II, the economy has grown and the environment in which financial institutions operate, and which they help to create has altered appreciably. The question naturally arose whether these changes called for new approaches or revisions in Federal regulation in the financial area.

In the interim, there were a number of congressional investigations in the area of financial institutions. Subcommittees of the Joint Economic Committee under Senator Douglas (1950) and Representative Patman (1952) made intensive studies of monetary, fiscal, and debt management policies and in 1956-57 the Senate Banking and Currency Committee under Senator Robertson reviewed Federal laws applicable to financial institutions.

More recently, the Commission on Money and Credit, a private group, undertook an extensive study and in 1961 presented a set of recommendations calling for, among other things, reform and improvement of the financial structure.

The present Committee's assigned task was to take the recommendations of the Commission on Money and Credit as a point of departure and to determine what changes, if any, are desirable in the Federal Government's approach to private financial institutions in order to contribute to economic growth and stability, remove apparent inconsistencies, inequities, and impediments in the financial structure, and assure that other public purposes are being served effectively.

The Committee was established at the end of March 1962. The large number of issues requiring examination in the period since then precluded any sizable amount of new research. The Committee's analyses have been based largely upon existing information and studies (including those done for the Commission on Money and Credit) and the experience of its members and staff, together with written submissions from interested groups and individuals outside the Federal Government.

On this basis, the Committee has weighed the various issues within its terms of reference and has arrived at conclusions, not always unanimous, regarding goals and objectives of Federal policy with respect to private financial institutions. The Committee has generally refrained from formulating specific legislative recommendations. Its conclusions are generally stated in broad terms rather than in the form of detailed proposals.

Implementation of many of the conclusions in this report would require transitional arrangements. The Committee has not attempted

to spell out the details of such arrangements, which would depend on the circumstances at the time of implementation.

Our study points to needed improvements in the financial structure. If implemented by legislation, these reforms would contribute in various ways to a better functioning economy. The indicated changes are not so compelling as to command the highest priority in the President's legislative program. But it is of the essence of good government to attempt to anticipate problems before they become acute. In the financial area particularly, where public confidence is crucial to the continued effectiveness of the financial system, and indeed to economic stability generally, it would be unfortunate to confuse lack of urgency with lack of importance. Problems should be dealt with as they become evident in order to avoid the need for urgent action to meet a crisis situation. Furthermore, insofar as unwise policies, inconsistencies, and inequities creep into the financial system, they are more difficult to remove the longer they are tolerated, either because groups come to depend on them for their livelihood or because some policies are not reversible.

### *Scope of Study*

The Committee's terms of reference, as set out in the President's memorandum of March 28, 1962, cover Federal laws and regulations pertaining mainly to private institutions that accept deposits and shares. The Federal Government is involved with these institutions in numerous capacities: as monetary authority seeking to encourage economic growth and stability, as chartering authority, as insuring authority, as lending authority, and as general supervisory authority concerned with financial soundness, preservation of competition, and provision of adequate services to the public. These governmental functions naturally impinge upon each other and overlap in various ways. As a result, judgments regarding Federal policies with respect to private financial institutions must rest on a balancing among several criteria, which sometimes point in different directions.

In conducting its study and formulating its judgments, the Committee has been guided by five basic criteria. Not necessarily in order of importance, these are as follows:

1. *Strengthening the effectiveness of Government stabilization policies in the financial area.* Nearly every issue to which the Committee addressed itself had implications for monetary policy.

2. *Increasing the effectiveness of lending institutions in contributing to efficient resource allocation and promoting economic growth.* Governmental regulations and restrictions need to be examined from time to time to assure that they enhance rather than limit the ability of

private financial institutions to respond to the needs of a growing and changing economy.

3. *Improving equity and efficiency in the regulatory or statutory treatment of financial institutions.* Governmental supervision and regulation can impose competitive advantages or disadvantages on one or another group of private financial institutions. Equally possible is the development of inconsistent or inefficient supervisory actions and policies. It was an objective of the Committee to examine existing regulations and, where appropriate, to recommend elimination of apparent inequities or inefficiencies.

4. *Preserving the solvency and liquidity of private financial institutions so as to protect the savings of the public.* Although it was alert to the need for flexibility and improvement in the financial system, the Committee was continuously conscious of the importance of traditional safeguards over the solvency and liquidity of financial institutions.

5. *Strengthening competition among financial institutions.* Government supervision involves limitations on the scope of competition among financial institutions, because unrestricted competition in the financial area can lead to failures which have wide repercussions, well beyond the welfare of those who own or manage the individual institutions involved. Nevertheless, competition is relied upon to promote efficiency and to protect the public. The Committee was concerned with promoting competition among financial institutions where consistent with other important objectives.

## Chapter II

### SCOPE AND STRUCTURE OF RESERVE REQUIREMENTS

Reserve requirements were originally regarded as a means of assuring that banks maintain sufficient liquidity to meet possible withdrawals of deposits. In present circumstances, it is generally agreed that required reserves serve only a marginal liquidity function; for example, with a 15-percent reserve requirement, a bank would have to meet 85 percent of a deposit withdrawal by reducing assets other than its required reserves. The major function of required reserves, it has come to be recognized, is to facilitate monetary policy. Required reserves perform this function by providing a firm base or fulcrum by means of which actions of the central bank to expand or contract commercial bank reserves are transmitted so as to bring about multiple increases or decreases in bank credit and deposits.

Although their primary function is to serve as a fulcrum for monetary policy, reserve requirements have other effects which are pertinent to policy judgments about the structure and level of requirements. Reserve requirements affect the earning power of banks (or other financial institutions subject to reserve requirements), since these requirements determine the proportion of bank assets that must be held in the form of cash.

A closely related effect of reserve requirements is on the competitive relationships among different types of financial institutions and on their relative rates of growth. The ability to offer terms attractive to savers is influenced by the amount and form of reserves, if any, that financial institutions are required to maintain. This consideration arises most directly in connection with the reserve requirement on commercial bank time and savings deposits, which are closely competitive with savings accounts available at mutual savings banks, savings and loan associations, and credit unions; it may also affect the ability of individual banks to attract and hold demand deposits.

Also related to the influence of reserve requirements on bank earnings is an effect on net interest payments by the Federal Government. The level of reserve requirements influences the distribution of holdings of Government securities between the Federal Reserve and the public. If, for example, reserve requirements are relatively high, the Federal Reserve will necessarily purchase in the open market larger

amounts of U.S. Government securities to provide for a desired increase in the volume of deposits and bank credit. Thus the Federal Reserve, whose earnings revert largely to the U.S. Treasury, will tend to hold a larger proportion, and the public, including commercial banks, will hold a smaller proportion of outstanding United States Government securities.

*Major problems concerning reserve requirements.*—The questions to which the Committee addressed itself include (1) whether any or all commercial banks should be required to be members of the Federal Reserve System, (2) whether all commercial banks should be subject to the reserve requirements of the Federal Reserve, (3) whether the structure of reserve requirements on demand deposits could be improved, (4) whether reserve requirements on commercial bank time and savings deposits should be retained, and (5), if so, whether a similar requirement should be applied to savings accounts at other financial institutions.

### ***Federal Reserve Membership and/or Reserves***

Under existing law, membership of commercial banks in the Federal Reserve System is mandatory for national banks and voluntary for State-chartered banks. National banks comprise one-third of all commercial banks and hold somewhat more than half of all commercial bank deposits. About 18 percent of State-chartered banks presently choose to belong to the Federal Reserve System. They account for about two-thirds of the deposits of all State banks.

Taking all commercial banks together, more than 7,000 (55 percent of the total) are not members of the Federal Reserve System. But they hold only about 16 percent of deposits at all commercial banks.

*History of problem.*—Whether or not all commercial banks should be members of the Federal Reserve System or subject to its reserve requirements has been the object of numerous studies and recommendations over the years.

The principle of voluntary membership for State-chartered banks was first called into question by the Banking Act of 1933, which provided that, in order to enjoy the benefits of deposit insurance, State banks would have to become members of the Federal Reserve System by July 1, 1936. The Banking Act of 1935 exempted banks with deposits of less than \$1 million from this provision. The deadline was postponed from time to time, and in 1939 the provision was repealed.

In the postwar period, both the Douglas (1950) and Patman (1952) committees (subcommittees of the Joint Economic Committee making studies of monetary and credit policies) recommended that all commercial banks be made subject to the reserve requirements of the Fed-

eral Reserve and that all banks be given access to loans at the Federal Reserve banks.

Most recently, the Commission on Money and Credit recommended that all insured commercial banks be required to become members of the Federal Reserve System.

*Principal issues.*—The case for and against compulsory membership of commercial banks in the Federal Reserve System rests on the questions of (1) the effectiveness of monetary policy and (2) equitable treatment of competing banks. In both questions, the compulsory reserve requirement involved in Federal Reserve membership is the primary issue.

*Effective monetary management.*—As noted, it is now generally recognized that the major purpose of legally required reserves is to serve as a fulcrum for monetary policy. Member bank reserves function as a fulcrum for monetary policy for two reasons: (1) for each member bank, deposits may not exceed a given multiple of its reserves, and (2) the total supply of these reserves is under the control of the Federal Reserve System. Thus even in the absence of changes in the required ratio of reserves to deposits, alterations in the supply of reserves made available to member banks by the Federal Reserve, for example by open market operations, normally lead to more or less predictable alterations in the aggregate deposits and assets of member banks. In addition, the Federal Reserve can affect bank deposits and assets by changing the required ratio of reserves to deposits.

In present circumstances, nonmember banks are subject to a variety of State laws regarding legal reserves. These reserves may consist of deposits in other commercial banks, or, in some States, approved types of securities, as well as vault cash. Thus, the position of nonmember banks differs from that of member banks in that neither their reserve ratio nor the supply of reserves on which they draw is uniquely determined by the Federal Reserve.

The result is that Federal Reserve directly influences only that portion of the money supply held in member banks. Yet deposits in nonmember banks are no less a part of the money supply of the United States. As a result, there is some possibility of slippage in the effectiveness of monetary policy.

The Committee believes that, in current circumstances, monetary policy is not significantly weakened by the fact that commercial banks now holding 16 percent of total deposits are outside the direct influence of the Federal Reserve. Important short-run disparities in deposit expansion have not occurred nor are they likely to occur so long as nonmember banks account for a relatively small fraction of deposits. Attempts by nonmember banks to expand credit at a faster

pace than they can attract funds from depositors would promptly result in an unsustainable cash drain, and their ability to attract deposits depends on their overall competitive position which is not likely to change significantly over different phases of the business cycle. Over longer periods, however, there is some evidence that the rate of growth of deposits has been larger in nonmember than in member banks. Their lighter burden of required reserves could permit nonmember banks to offer more attractive terms to depositors and thus to outgrow member banks.

Potentially, a more important consideration bearing on the effectiveness of monetary policy is that the option open to State banks to withdraw from the Federal Reserve System can at times constitute a constraint on actions by the Federal Reserve. In the early post-World War II years, when increases in reserve requirements were being used to restrain inflationary pressures, the possibility that banks would withdraw from membership was a factor inhibiting policy decisions. It is easy to imagine the recurrence of situations in which it would be appropriate to raise reserve requirements but willingness to adopt this measure might be affected by the threat of withdrawal of banks from the System. If all commercial banks were subject to the reserve requirements of the Federal Reserve, this type of inhibition on monetary policy would not arise.

Against these considerations, it has been argued that neither compulsory membership nor compulsory reserves are essential to the conduct of monetary policy, on the grounds that most medium-sized and larger banks would voluntarily retain membership and that Federal Reserve open market operations and discount policy would have their effect even in the absence of required reserves. But most members of the Committee believe that monetary policy would be strengthened if all commercial banks were required to maintain reserves in the amounts and form specified for member banks.

*Equity and competitive advantage.*—Reserve requirements imposed by the States, and therefore applicable to nonmember banks, tend to be less onerous than those applicable to member banks of the Federal Reserve System. In some States, the level of requirements is lower. More important, the form in which reserves may be held is more favorable to nonmember banks. In a number of States, reserves may be held partly in the form of securities, and therefore may earn interest. Furthermore, correspondent balances, which nonmembers would maintain in some amount even in the absence of reserve requirements and from which they derive benefits, serve to satisfy part or all of State reserve requirements. In States where reserve requirements are at the

same level or even higher than those for member banks, the form of reserves is favorable to nonmembers.

These differences in reserve treatment tend to confer a competitive advantage on nonmember banks by permitting them to offer more attractive terms to borrowers and depositors or to earn higher profits than member banks in similar circumstances. But, under present conditions, the only escape from this inequity for member banks is withdrawal from the System, and this also means escape from the reserve base directly under the control of the Federal Reserve. National banks can escape from this inequity only by giving up their national charters.

*Compulsory membership.*—The principal advantages of universal membership by commercial banks in the Federal Reserve System would be achieved if all commercial banks were subject to the reserve requirements of the Federal Reserve and membership for State-chartered banks remained voluntary.

Once the principle of compulsory reserves is accepted, a major remaining deterrent to full membership is the requirement that member banks remit at par for checks drawn upon them. The fact that some nonmember banks, concentrated in a few areas, still maintain the practice of making a charge against the payee for remitting on checks against them is an impediment in the payments mechanism of the United States. In addition, the problem of sorting out checks on these institutions and charging back in an equitable way these so-called “exchange” charges to the persons who have accepted checks at face value for amounts owed to them is costly and time consuming. The Committee favors par clearance in principle. But it recognizes that elimination of the impediment in the payments system would materially affect the 1,600 banks (with 1,900 offices) that do not now remit at par.

If full membership remains compulsory for national banks while other commercial banks are required to adhere only to the reserve requirements of the Federal Reserve, another class of relationship between banks and the Federal Reserve will result. A majority of the Committee sees no reason to change the existing requirement that national banks be full members of the System. At the same time, to require that State-chartered banks become full members would provoke needless controversy; as noted, the major advantages of full membership would be achieved if all commercial banks were brought under the reserve base of the Federal Reserve.

*Conclusion 1.*—*The Committee, with one member dissenting, concludes that all commercial banks ought to be subject to the reserve re-*

*quirements specified by the Federal Reserve, and ought to have access to Federal Reserve discounts and advances. Membership in the Federal Reserve System would continue to be voluntary for State-chartered banks.*

### ***The Structure of Reserve Requirements on Demand Deposits***

Member banks of the Federal Reserve System are required to hold reserves in the form of either deposits at Federal Reserve Banks or vault cash. The present reserve requirement against net demand deposits is 12 percent for banks classified as "country" banks and 16½ percent for "reserve city" banks. Under existing law, the Federal Reserve Board has discretion to set these reserve requirements between 7 and 14 percent for country banks and between 10 and 22 percent for reserve city banks.

The geographical classification between "city" and "country" banks, with differential reserve requirements, dates back to the National Bank Act (1863), under which "reserve city" banks served as reserve depositories for country banks and in turn maintained reserves with "central reserve city" banks. Differential reserve requirements were viewed as necessary in that system as a means of protecting the liquidity of the banking system.

The ineffectiveness of required reserves as a means of ensuring bank liquidity was demonstrated forcefully by the prevalence of financial panics. Indeed it was these difficulties, resulting from the lack of a dependable source of liquidity, that led in 1913 to the establishment of the Federal Reserve System, which has come to be the ultimate provider of liquidity in our monetary system. Nevertheless the three-way geographical classification of banks was carried over from the National Banking System. It was only in 1959 that the three classifications were reduced to two by a consolidation of the two city-bank categories.

Other shortcomings of the existing structure of reserve requirements have become evident. In the past, large banks, which were located mainly in central cities, were concerned principally with serving the needs of industry and commerce and of out-of-town banks. In recent years, consumers have become increasingly important as depositors and borrowers at large city banks. Moreover sizable concentrations of population and business outside the limits of reserve cities, especially in the suburbs, have led to wider branching and substantial growth of many banks in these areas. The result has been that the distinction in size and function between "country" and "city" banks has become blurred. In these circumstances, banks of comparable size and similar activity are more likely than in the past to have different

reserve requirements, depending on where they are located. Furthermore, the question whether or not a city should be classified as a reserve city, with the consequence that its banks would have a higher reserve requirement, is a difficult one and inevitably leads to arbitrary distinctions.

Recognition of these problems has stimulated numerous proposals in recent years for revision of the system of reserve requirements. One such proposal is for identical percentage requirements at all banks. The American Bankers Association is on record in favor of this proposal. Most recently, the Commission on Money and Credit recommended uniform reserve requirements.

The case for uniform requirements is usually based on two arguments: (1) that monetary policy would become a more precise instrument if all banks had the same requirements, since potential credit and monetary expansion would no longer vary with changes in the distribution of demand deposits among banks in different locations, and (2) that the present differential is arbitrary and imposes inequitable treatment on many banks.

The Committee recognizes the logic of the argument, presented by the Commission on Money and Credit and others, that completely uniform requirements would enhance the precision of monetary policy. At the same time, it is aware that, as a practical matter, the difference in reserve requirements between city and country member banks introduces only a minor imprecision into the management of bank reserves by the Federal Reserve. Greater imprecision results from the fact that small banks maintain sizable excess reserves and, in contrast to larger banks, adjust their loans and investments only with a lag when their reserves change. For this reason, required reserves would be affected when deposits shift between city and country banks even if reserve requirements were uniform.

A system of differential reserve requirements is defended on the grounds (1) that smaller banks find it necessary, in order to obtain certain services from their city correspondents, to hold a large proportion of their assets in the form of non-interest-bearing balances at other banks and (2) that smaller banks are necessarily higher cost banks, in view of their lesser ability to take advantage of economies of scale (such as avoiding excess reserves, making large individual loans and investments, and using automatic accounting equipment and other specialized facilities); a lower level of reserve requirements may serve to offset these disadvantages of smaller banks, thus helping to preserve a system of independent unit banks.

As it considered these arguments, the Committee was aware of the practical difficulty of implementing the two recommendations of the

Commission on Money and Credit that all (insured) commercial banks should be required to become members of the Federal Reserve system *and* that reserve requirements should be identical for all member banks. Nonmember banks are predominantly small banks. Among the 7,000 banks that are not members of the Federal Reserve system, more than three-fourths have total deposits of less than \$5 million. If these banks were required to adhere to member bank reserve requirements and if requirements were made uniform at anything like present levels (somewhere between 12 and 16½ percent), a strain would be imposed on many of the small nonmember banks. To implement the two recommendations therefore, it would probably be necessary to lower the present average level of reserve requirements on member banks, perhaps to less than 10 percent.

Although reserve requirements serve mainly as a vehicle for monetary policy, there is, within broad limits, little basis for judging that in the long run one level is preferable to another in terms of facilitating monetary policy. Inevitably therefore the other effects of reserve requirements—on bank earnings, on competitive relationships with other institutions, and on net interest payments by the Government—become relevant in evaluating the advisability of a change in the average level of requirements. It is clear that a substantial reduction in requirements—to 10 percent or less—would, at least in the short run, result in a sizable increase in net profits of banks (especially of larger banks in reserve cities now subject to a requirement of 16½ percent) and a corresponding reduction in net receipts by the U.S. Government, taking into account payments by the Federal Reserve to the Treasury.

The Committee has examined other means of altering the structure of reserve requirements, in a way that might represent an improvement over the present arrangement for member banks, and might also accommodate small nonmember banks if they were required to maintain reserves as specified by the Federal Reserve Board, while causing a minimum of transitional disturbance.

The Committee has analyzed in specific terms a possible graduated system of reserve requirements, and a large majority was convinced that, under present circumstances, an approach along these lines was the most practical. Under such a system, every bank would maintain a low reserve against the first few million of its net demand deposits, a higher reserve against its deposits above this minimum amount and up to a substantial figure, and a still higher reserve against net demand deposits, if any, above the latter amount. By way of illustration, banks, at least initially, might be required to keep a 7-percent reserve requirement against the first \$5 million of net demand de-

posits; a 12-percent requirement (the present country bank level) against the next \$95 million, and a 16½-percent requirement (the present city bank level) against net demand deposits above \$100 million. As at present, ranges within which the Federal Reserve could vary the required percentages would be specified for each bracket—ranges which probably should overlap, at least for the two higher brackets.

A system of this type would represent an improvement over the present system, whether or not all commercial banks were subject to the reserve requirements of the Federal Reserve. It would bring some of the advantages of uniform reserve requirements, since banks of the same size (with respect to demand deposits) would be subject to identical requirements regardless of location. The sharp differential between classes in the present two-way classification would be replaced by a smoothly graduated system. As a bank grew and passed into another reserve bracket, the higher requirement would apply only to its marginal demand deposits. The character of the present reserve requirement structure could be preserved to the extent deemed desirable, by continuing to place higher marginal requirements on larger banks. Similarly, a graduated system would facilitate a transition to greater uniformity—or, to full uniformity—if and when desired.

*Conclusion 2.—The Committee, with one member dissenting, concludes that a system of graduated reserve requirements for demand deposits would eliminate many of the inequities and administrative difficulties in the present system of reserve requirements and would facilitate a decision to bring all commercial banks under the reserve jurisdiction of the Federal Reserve.*

### **Reserves on Time Accounts**

The present reserve requirement against time (and savings) deposits at member banks of the Federal Reserve System is 4 percent and the range within which it can be varied under existing law is between 3 and 6 percent. From the time of establishment of the Federal Reserve System, the reserve requirement against time deposits has been identical at all banks, although the legal authority exists for differential ratios at different classes of banks.

Under the National Bank Act (1863), reserve requirements on time deposits were at the same level as on demand deposits. Provision for a lower requirement on time than on demand deposits in the original Federal Reserve Act (1913) reflected a belief that time deposits are less volatile and require less liquidity backing than demand deposits.

As noted earlier, commercial bank reserve requirements are now regarded as providing only a minor degree of liquidity. Their major function is to facilitate central banking actions designed to affect bank credit and deposits.

*Recommendation of Commission on Money and Credit.*—The Commission recommended repeal of statutory reserve requirements on time and savings deposits. It stated that the principal justification for such requirements “is to impress upon financial management the need for making provision for liquidity” but “management and supervisory authorities are able to see to it that such liquidity as may be necessary with respect to such deposits is maintained.”

The discussion in the Commission’s *Report* stated further that if “it is deemed wise to continue statutory reserves against savings and share accounts,” the requirement “should be designed to minimize any differential effect on the earning capacity of various institutions competing for savings.” The Commission suggested that this could be accomplished by permitting “liquidity reserves to be held in cash or short-term Government securities.”

*Reserves on time accounts and monetary policy.*—In view of the primary function of required reserves—to serve as a fulcrum for monetary policy—the question may properly be asked whether required reserves on time deposits and shares are a necessary part of the fulcrum. Could monetary policy be effectively conducted without reserve requirements on commercial bank time deposits? Are reserves on accounts at other savings depositories needed as a means of strengthening monetary policy?

These are questions to which neither economic theory nor central banking experience gives clear answers. Those who regard the money supply, narrowly defined to include only currency and demand deposits, as the major variable through which monetary action influences economic activity are likely to believe that reserve requirements on time and savings deposits are unnecessary, either at commercial banks or at other institutions.

Those who prefer a definition of the money supply that includes time deposits at commercial banks (as well as those who regard commercial bank loans and investments as the major variable) view reserve requirements on time deposits as an important adjunct of monetary policy. In fact this view has led some observers to the proposition that there should be little if any differential between requirements on time and on demand deposits.

Another widely accepted view stresses the belief that time deposits at commercial banks and savings accounts at other financial institutions are close although imperfect substitutes for demand deposits.

Shifts between demand deposits and savings accounts are said to be responsive to changes in interest rates and are reflected in the rate of turnover (or velocity) of demand deposits. In periods of monetary restraint, for example, rising interest rates are said to attract funds from demand deposits to time, savings, and share accounts. Because of the difference in reserve requirements (and their absence at some institutions) this permits an expansion of credit at the institutions whose deposits or shares increase, without a corresponding contraction in demand deposits and credit at commercial banks, unless the Federal Reserve takes action to absorb reserves. Some have concluded, on this basis, that monetary policy is blunted by the existence of a difference in reserve requirements as between money proper and money-substitutes such as deposits and shares in savings institutions, and would be further weakened if there were zero reserve requirements against time deposits at commercial banks. They call for a measure of control by the central bank over the reserves of all institutions whose liabilities are close substitutes for money.

These differences in approach and their implications for policy have been widely discussed and analyzed in recent years, not only in the economic literature and the financial press in the United States but also in many other countries; a notable example is the Radcliffe Report (1959) in the United Kingdom, which in general adopted the third approach noted above.

The Committee does not pretend to have resolved the issues raised in this wide-ranging and many-faceted discussion. It observes, however, that the empirical evidence for the United States does not offer strong support for the proposition that, in practice, the operations of nonbank financial intermediaries have offset or seriously weakened countercyclical monetary policy. On the contrary, experience to date has shown that the nonbank institutions tend to grow faster when monetary policy is encouraging expansion of commercial bank assets and liabilities and to grow less rapidly in periods of monetary restraint. Time deposits at commercial banks have tended to behave in a similar manner, although interpretation of this experience is clouded by the two postwar increases (in 1957 and 1962) in maximum permissible rates payable on commercial bank time and savings deposits.

The evidence also shows that since the end of World War II, the nonbank savings institutions have grown faster than commercial banks. This in turn may help to account for the upward trend in monetary velocity experienced over this period. Yet, many other influences were at work, including the substitution of short-term securities for demand deposits, as market interest rates rose from the low levels of the early postwar period.

At the present time therefore, the Committee believes that it is difficult, on grounds of essentiality to effective monetary policy, to support either maintaining the existing requirement on time deposits or extending direct central bank controls to nonbank financial institutions. In fact, the Committee noted that extension of reserve requirements to nonbank institutions—with the reserves taking the form of deposits with the Federal Reserve—might at times complicate rather than simplify the task of monetary management. For example, under present circumstances, a decision by the public to transfer funds out of securities and into nonbank savings institutions has no effect on member bank required reserves (and little, if any, effect on the economy). If, however, all savings institutions were required to maintain reserves at the Federal Reserve, a switch from securities to savings accounts, or *vice versa*, would increase or decrease required reserves. If these restraining or stimulating effects were to be avoided, offsetting Federal Reserve operations would be necessary.

Nevertheless, the Committee recognizes that reserve requirements on nonbank institutions, even if not kept at the Federal Reserve, could at times serve as a supplement to the existing instruments of monetary policy. Furthermore, there are reasons other than the need for quantitative credit and monetary controls that justify applying cash reserve requirements to nonbank depository institutions.

*Liquidity, equity, and supervisory considerations.*—The Committee is aware that some savings institutions need to make additional provision for liquidity. The liabilities of savings and loan associations, mutual savings banks, and credit unions are widely regarded by the general public as being withdrawable on demand. Whatever the legal considerations applicable to such savings accounts, institutions must in practice be prepared to meet demands for withdrawals promptly. Yet the assets of these institutions are concentrated in instruments, primarily mortgages, which are inherently illiquid.

It is true that monthly repayments provide a steady cash inflow which contributes significantly to day-to-day liquidity needs. It is also true that the ultimate liquidity of the economy can be provided only by an effective central bank. Yet, within this framework, individual institutions, and all other economic units, should manage their portfolios so that, in ordinary circumstances, they can meet their own liquidity needs.

It has traditionally been a function of supervisory agencies to ensure that financial institutions maintain an adequate degree of liquidity and remain solvent. The Committee takes the view that it is necessary and desirable to strengthen the authority of the existing supervisory agencies, in particular the Federal Home Loan Bank

Board in its relationship to member savings and loan associations. This relationship involves surveillance and influence over the practices of savings institutions, including the extent to which institutions make provision for liquidity in order to be in a position to meet withdrawals. The Committee believes that if the associations were required to maintain a cash reserve at the Federal home loan banks the relationship between the supervisory agency and the supervised institutions would be strengthened in the public interest. The influence of the supervisors would be enhanced by the existence of the cash requirement and the power to change it. The institutions in turn would become more acutely conscious of the role of the Federal Home Loan Bank System as a governmental institution operating in the public interest.

Two additional considerations support the proposal for cash reserve requirements at all savings depository institutions. First, it would eliminate the existing inequity wherein commercial banks must maintain cash reserves against time deposits but competing savings institutions have no such requirement. The alternative way to remove this inequity—namely, eliminating the requirement at commercial banks—would have the disadvantage of increasing the incentive of banks to induce depositors to hold in the form of time deposits what are in fact demand deposits. Second, such a cash requirement, even if it were not kept at the Federal Reserve as an instrument of monetary policy, could be used at times as a supplement to monetary policy. Increases in the reserve requirement would serve to limit the lending power of savings institutions and reductions would increase their lending power.

The Committee has noted the relationship of a proposal for a cash reserve requirement on savings institutions both to the policy of the Federal Home Loan Bank System with regard to advances to member institutions and to the earnings of the home loan banks. It is expected that the System's advances policy would not become any more liberal because of the cash reserve requirement.

The substantial amount of funds that would accrue to Federal home loan banks when the proposed cash reserve requirement became effective should in ordinary circumstances be reinvested in U.S. Government securities. Only at times of substantial and widespread withdrawals of funds from member institutions should the Federal Home Loan Bank System be expected to use for advances the funds accruing to it as a result of the cash reserve requirement. In addition, as in the case of Federal Reserve banks, dividends to member associations should be limited to 6 percent, and net earnings of Federal home loan

banks, after additions to reserves and payment of dividends, should be paid over to the Treasury.

A similar cash reserve requirement is desirable in the case of mutual savings banks. Which Federal agency would hold the required reserve balances will presumably depend on what action if any is taken on the question of Federal charters for mutual savings banks.

The Committee also considered whether such a requirement is necessary and desirable for credit unions. No such recommendation is made at this time. The reasons for this conclusion are discussed more fully in chapter VI in connection with the subject of Federal insurance of credit union shares.

*Conclusion 3.—The Committee, with one member dissenting, favors the continuation of reserve requirements on time and savings deposits at commercial banks and the introduction of a similar reserve requirement for shares at savings and loan associations and deposits at mutual savings banks. In addition, Federal agencies that supervise financial institutions should be endowed with sufficient authority to assure that the institutions maintain adequate liquidity over and above cash reserve requirements.*

## Chapter III

### INTEREST RATE REGULATION

The Federal Government regulates rates of interest paid on deposits at commercial banks. In particular, payment of interest on demand deposits is prohibited and rates paid on time and savings deposits are subject to ceilings determined by the Federal Reserve Board and the Federal Deposit Insurance Corporation.

These controls were introduced into Federal legislation by the Banking Acts of 1933 and 1935. Prior to that time there had been no direct Federal control over interest paid on deposits.

The major reason for enactment of the prohibition of interest on demand deposits in 1933 was apparently to prevent a recurrence of certain developments that were thought to have contributed to the financial debacle of 1929-33. The stock market boom of the late 1920's had involved financing through the call loan market at high rates of interest. This market was fed in part by New York and other large city banks, which invested deposit balances of interior banks that were drawn to the large city banks by the payment of attractive interest rates. The major purpose of the prohibition was to limit the drawing of funds from interior banks to money centers for speculative purposes.

The authority to regulate maximum rates paid on time and savings deposits had a somewhat different purpose. It was designed to limit interest rate competition among banks, on the grounds that such competition had tended to drive up interest rates on time and savings deposits and thereby induced banks to acquire high-yielding but unsound assets. There was a widespread feeling that such motivations had contributed to many bank failures, even before the depression. In the years 1921-29, more than 5,000 commercial banks were forced to close their doors because of financial difficulties. Concern over the soundness of bank assets may also have been a factor in the decision to prohibit interest on demand deposits.

*Major questions.*—The Committee weighed the question whether the prohibition of interest on demand deposits remains justified under present-day conditions. With respect to regulation of maximum rates on time and savings deposits, the Committee considered the alternatives of (1) maintaining the *status quo*, (2) converting the control

to a standby basis, (3) and eliminating the control; related to these alternatives is the question of extending regulation, if any, to other financial institutions that accept time and savings accounts.

*Recommendations of Commission on Money and Credit.*—The Commission recommended that the prohibition of interest on demand deposits be continued. In the case of time and savings deposits, it recommended that the present authority be converted to a standby basis and be extended, under the appropriate Federal agencies, to mutual savings banks and savings and loan associations.

The Commission noted that commercial banks must compete for time and savings deposits with other financial institutions whose rates are presently unregulated, and its recommendation for suspension of the regulation of maximum rates on time and savings deposits was apparently based in good part on a wish to eliminate this competitive disadvantage under which commercial banks are forced to operate.

### *Interest on Demand Deposits*

Some of the important considerations that apparently motivated enactment of the prohibition in 1933 have little force today. The call loan market is of minor importance. Stock market credit is regulated by Federal Reserve margin requirements. Consequently, there is little likelihood of a repetition of the experience of the 1920's when stock market speculation attracted funds, including interbank deposits, from the interior of the country to New York.

Payment of interest on demand deposits could, however, give rise to related problems. If the prohibition were eliminated, it has been argued, banks in financial centers would compete more actively for demand deposits of businesses and institutions and would succeed in attracting deposits away from banks in smaller communities. This in turn might have undesirable effects on the availability of bank credit in smaller communities. Competitive bidding for demand deposits might also induce banks to reach out for unsound assets in order to increase earnings. These considerations are regarded by some members of the Committee as the present-day counterpart of the dangers that promoted acceptance of the prohibition in 1933.

Another consideration favoring the prohibition of interest on demand deposits is that it helps to preserve the fundamental distinction between the payments medium and liquid savings—a distinction that underlies the existing arrangements for monetary control.

Those who favor elimination of the prohibition argue that the holding of demand deposits is made unnecessarily costly to the depositor. The cost is measured by the interest foregone when demand deposits are held instead of interest-earning liquid assets. In order to minimize

this cost, the public has an incentive to undertake frequent financial transactions designed to avoid loss of interest on what would otherwise be idle demand deposits—transactions that serve no economic purpose. The extent to which such transactions would be reduced in volume, if interest on demand deposits were permitted, was questioned by others, who also suggested that the costs involved are of minor significance.

A second consideration in favor of restoring interest payment on demand deposits is that it would tend to reduce cyclical fluctuations in monetary velocity and would therefore ease the task of the monetary authorities. It is argued that as interest rates vary over the business cycle, while the interest rate on demand deposits remains fixed at zero, there is a corresponding cycle in the incentive presented to the public to substitute interest-earning assets for demand deposits; this incentive is said to grow stronger in periods of high interest rates and weaker in periods of low interest rates and is reflected in a cyclical variation in the velocity of money. If interest payment were permitted, the rate paid on demand deposits would presumably move cyclically with other interest rates and the incentive to hold demand deposits would vary less over the business cycle, thereby dampening the extent to which movements in velocity tend to offset counter-cyclical monetary policy.

The practical significance of this point was questioned by a majority of the Committee on the grounds that even if interest on demand deposits were permitted, the rate is likely to remain low and inflexible. The rate on demand deposits would probably not be highly responsive to short-run market forces. As a result, the incentive to economize demand deposits would continue to vary directly with the cyclical movement in interest yields on short-term securities.

It is recognized both by those who favor and those who oppose a change in the present law that various practices exist by which interest is paid implicitly on demand deposits. In order to attract and keep demand deposits while adhering to the prohibition on explicit interest payment, banks may compensate some customers with more liberal loan terms and the provision of various free services; furthermore, service charges may be graduated or waived entirely.

Many Committee members believe that the banks and the public have by now adjusted to the substitution of implicit for explicit payment of interest on demand deposits; a reversion to explicit interest payment would therefore have very little beneficial effect and might be harmful for the reasons previously cited. Some feel, however, that if implicit interest were replaced by explicit interest, together with a requirement that interest rate schedules be published, treatment of depositors would be more uniform and equitable.

In balancing these considerations, some members of the Committee favor repeal of the prohibition of interest payments on demand deposits and its replacement with standby authority to prohibit interest or establish a maximum rate if the possible dangers cited by the majority turned out to be realized. In addition to the considerations outlined earlier, this view is based on the thought that demand deposits and other types of deposits and shares are sufficiently similar and substitutable to merit similar regulatory treatment. A majority of the Committee believes that this differential treatment is justified, on the grounds that demand deposits constitute the fundamental medium of exchange in our economy and as such should be subject to unique restrictions, which are not necessary in the case of financial assets serving only as a store of value but not as a medium of exchange.

*Conclusion 4.—The Committee, with three members dissenting, concludes that the prohibition of interest payments on demand deposits should be continued.*

### ***Interest on Time and Savings Accounts***

The Federal Reserve Board and the Federal Deposit Insurance Corporation are presently required by law to establish maximum rates on time and savings deposits.<sup>1</sup> Between 1936 and 1957, the regulations specified a maximum rate of 2½ percent. This was raised to 3 percent as of January 1, 1957, and to 4 percent as of January 1, 1962. At the present time, the maximum rates are as follows:

Savings deposits held for:	Percent
1 year or more.....	4
Less than 1 year.....	3½
Time deposits payable in:	
1 year or more.....	4
6 months to 1 year.....	3½
90 days to 6 months.....	2½
Less than 90 days.....	1

The case for ending Federal regulation of interest rates on time and savings deposits rests mainly on the presumption that, in the absence of strong evidence to the contrary in particular cases, the public interest will best be served if the forces of supply and demand are permitted to reflect themselves in prices, including interest rates. In particular, the presumption is that both equity as between buyers and sellers (or lenders and borrowers) and the allocation of resources will be more satisfactory when prices and interest rates are free to reflect market forces.

<sup>1</sup> An Act of Congress approved on Oct. 15, 1962, provided that, for a period of 3 years, deposits of foreign governments and certain foreign official institutions were exempt from interest ceilings.

An analogy with governmental regulation of prices charged by public utilities is sometimes suggested. In view of the fact that public utilities are inherently in a monopolistic position, price regulation is designed to prevent monopolistic pricing while other regulations are designed to assure adequate service to the public. Although Government regulation limits competition in the field of banking—in part by restrictions on the establishment of new banks—existing interest rate regulation is not at all comparable to price regulation in the public utilities field. If deposit interest rate regulation were analogous to price regulation over public utilities—that is, if it were designed to protect the public from monopolistic pricing—the regulation would impose a floor, not a ceiling, on interest rates.

When originally enacted, the objective of this regulation was to help assure sound banking. The Committee takes the view that improvements in bank supervision and examination in recent decades make continuous regulation of interest rates unnecessary as a means of preventing acquisition of unsound assets. In addition, the pervasive use of amortized and of Government-backed mortgages today, in contrast with the 1920's, lessens the danger of serious losses by banks in the investment of time deposits.

Another consideration is that the present regulation applies only to commercial banks and not to other institutions with which they compete for funds. This difference in regulatory treatment results in a competitive disadvantage for commercial banks.

Consideration was also given to the possibility that under certain conditions competitive bidding up of rates paid on time and savings accounts might produce undesirable repercussions, particularly in the mortgage market.

On balance, the Committee believes that the case for continuous regulation has less force today than in 1933. Nevertheless, recognizing the possibility of a recurrence of the need for maximum rates, the Committee does not propose that interest rate regulation be completely abandoned. Rather, it should be placed on a standby basis and extended to other depository-type institutions. The very existence of such standby authority would help to prevent excessive increases in rates paid.

The Committee envisages that such standby authority would be invoked by the responsible supervisory agencies only when they deem it necessary either to prevent institutional practices in the payment of interest and extension of credit that were inconsistent with the safety and liquidity of a significant number of institutions or to supplement other governmental policies to promote the objectives of the Employment Act of 1946.

In either case, the Committee believes that the supervisory agencies should be given wide discretion in invoking the standby authority. This discretion should include the authority to impose different rates on different kinds of deposits, classified by type of holder, maturity, location, or other characteristics, and to apply a maximum rate only to some types of deposits. The Committee believes, for example, that the reconciliation of domestic aims with balance of payments considerations might at times justify different ceilings on domestic and foreign deposits, or perhaps limitations on rates of one of these groups but not the other. Rate ceilings on some or all domestic accounts might under unusual circumstances be useful in exerting a marginal influence on the flow of funds and terms available for certain types of credit, such as mortgages, although the Committee does not feel that interest rate regulations should ordinarily be used as a means of affecting the allocation of credit.

In these circumstances coordination among the supervisory agencies would be especially important. This matter is discussed in Chapter IX.

The Committee is aware of an administrative difficulty that would arise if ceiling rates on time deposits were eliminated while the prohibition on demand deposits were retained. One of the problems faced by the Federal Reserve and the FDIC even under the present legislation is to prevent demand deposits from earning interest in the guise of short-maturity time deposits. This problem has been met in the past by establishing a relatively low maximum rate on short-term time deposits. If continuous regulation were eliminated, policing the prohibition of interest payment on demand deposits would become more difficult. The broad authority suggested above would make it easier to deal with this problem.

*Conclusion 5.—The Committee believes that the purpose served by continuous regulation of interest rates on time and savings deposits would be served equally well by standby authority to impose maximum rates, and that this regulation should apply as well to nonbank financial institutions that accept deposits or shares. The standby authority might be invoked either to help assure the continued safety of the institutions or to promote the stability of the economy. In exercising this authority, the supervisory agencies should be permitted to establish, at their discretion, different maximum rates for different accounts according to type, holder, maturity, or other characteristics.<sup>2</sup>*

<sup>2</sup> One member of the Committee dissents from the last sentence of this conclusion.

## Chapter IV

### PORTFOLIO REGULATION

Financial institutions are subject to restrictions, both qualitative and quantitative, on the assets they may acquire. The Federal Government imposes restrictions on the lending and investing activities of federally chartered institutions (national banks, Federal savings and loan associations, and Federal credit unions) while portfolio restrictions on State-chartered institutions are, for the most part, a matter of State laws. There are, however, some exceptions to this generalization—that is, cases in which Federal statutes limit the lending and investing activity of State-chartered institutions; these exceptions apply mainly to State-chartered member banks of the Federal Reserve System. There are virtually no specific portfolio limitations imposed on State-chartered institutions by the Federal Government in its capacity as insuring authority, but Federal insurance agencies have responsibility for examination of the quality of assets and the adequacy of capital at State-chartered institutions.

Portfolio restrictions are to a large extent the historical product of periodic waves of failures of banks and other institutions with consequent losses to depositors (or other claimants) and disruption to the economic life of the communities involved. Much of the restrictive legislation has been added in a piecemeal manner, in response to specific problems. Similarly, exceptions and exemptions, both general and specific, to these restrictions, have been enacted at various times, in response either to pressures from regulated institutions for less burdensome restrictions or to a desire by government to encourage or discourage particular lending activities.

The trend in recent decades has been toward less stringent restrictions. For example, since 1927 national banks have been permitted to acquire mortgages of progressively longer maturity than the 1-year maximum of that time. Similarly the authority for Federal savings and loan associations to acquire assets other than mortgages on single-family dwelling units has been repeatedly broadened.

At the same time, the attitudes and practices of financial institutions have changed. The traditional view of commercial banks as short-term lenders to business has been modified as banks have placed a significant proportion of their assets in longer term instruments (such

as term loans and mortgages) and have attempted to meet both the short- and long-term financing needs of consumers (in the form of consumer instalment credit and residential mortgage credit).

*Purposes of portfolio regulation.*—Restraints on the lending and investing activity of financial institutions have two broad purposes: to safeguard their solvency and liquidity and to maintain a degree of specialization in their functions.

Portfolio restrictions, along with other governmental policies, such as limitations on the establishment of new financial institutions, are designed to insure the solvency and liquidity of financial institutions responsible for maintaining the money supply and for handling the liquid savings of individuals and businesses. The Nation as a whole has an overriding interest in assuring universal acceptability of the means of payment and in preventing the disruption to individual communities and to the economy generally of failures of financial institutions. While these purposes are now served in part by deposit and share insurance, the Federal Government has a direct interest in preventing insolvency in its incipient stages.

Portfolio regulation is also related to the specialized nature of financial institutions. Specialization is most marked in the case of credit unions and savings and loan associations. It is less evident in mutual savings banks and still less in commercial banks. To some extent, the enforcement of specialization by means of portfolio restrictions can be traced to a desire to confine institutions to types of lending activity most appropriate either to their management structure or to the nature of their liabilities. Portfolio regulation is also designed to promote national policies, notably encouragement of home ownership, through specialized institutions.

*Major issues.*—The Committee considered the following questions concerning portfolio regulation: (1) To what extent, if any, should regulation continue to impose a degree of specialization among financial institutions? (2) In what ways consistent with other objectives might regulatory policy better promote competition between institutions, mobility of funds (geographically or among sectors of the economy), or risk taking? (3) Does the multiplicity of regulations and supervisory authorities introduce serious inequities or inconsistencies in the availability of loans and investments?

*Recommendations of Commission on Money and Credit.*—The Commission recommended “that the regulatory authorities be authorized to permit greater flexibility to savings banks and savings and loan associations to acquire a wider range of suitable long-term debt instruments. Commercial banks should be allowed the same flexibility in investing their time and savings deposits. Financial institutions

should be permitted to change their investment practices but they would not be obliged to do so." It recommended further that investment in equities continue to be restricted, but called for equal treatment, at the least burdensome level of mutual savings banks, savings and loan associations, and commercial banks in the investment of time and savings deposits. The Commission also recommended a liberalization of restrictions on the geographical area over which institutions may lend.

The background discussion of these and related recommendations in the *Report* of the Commission states that they were designed to encourage the safety of the financial system, on the one hand, and to provide greater flexibility for portfolio investment, increased mobility of funds, and increased alternatives for savers and borrowers as a means to stimulate economic growth, on the other. These recommendations would, according to the *Report*, "enable the financial institutions to become less specialized in investment, if they so desired. The recommendations are not intended to alter the specialized powers of the institutions to offer the forms of financial assets and the services which they now provide."

### ***Considerations Regarding Specialization***

The Committee recognizes the disadvantages of excessive specialization among financial institutions. By inhibiting adequate diversification of loans among industries and sectors of the economy, specialization could make financial institutions more vulnerable to insolvency arising from adversity in the particular industries or sectors in which their lending is perforce concentrated. A related danger is that a restricted choice of lending power may induce institutions to reach out for unduly risky loans of the permitted type in an effort to invest funds fully when credit demands in the specialized area are declining.

If specialization is overdone, the resulting restrictions on the mobility of funds may have harmful effects on resource allocation. Unless loan funds of institutions can shift with reasonable facility from one use or one locality to another in response to changing needs, important market distortions are likely to persist, with adverse consequences for growth and efficiency. If savings institutions are overly specialized, such shifts are likely to be slow and cumbersome, since they must await shifts of funds by depositors or savers from one institution to another. Excessive specialization may also restrict competition among lenders, to the detriment of borrowers, especially those outside of urban centers who may have access to relatively few institutions of each type.

On the other hand, a degree of specialization can contribute to both solvency and efficiency in a setting characterized by many small institutions. Management is induced to concentrate in relatively limited sectors of the credit market, and the ability to appraise basic values and risk may be enhanced. Concentration on certain sectors, when the supply of managerial talent and size of institutions is limited, can also help promote more efficient techniques and economies of scale.

Moreover, specialization in the lending activities of at least some types of institutions provides to Government a vehicle for stimulating or, if need be, restraining lending activity in particular sectors in accordance with broad social objectives. This can be done through central reserve institutions or special treatment in other respects. Even more broadly, specialization provides some assurance that certain types of borrowers with needs deemed important from the standpoint of the public interest and the efficient performance of the economy can be assured access to a set of institutions particularly attuned to, and sympathetic with, their special problems and requirements. In addition, specialization serves to prevent large and sudden shifts of funds from one sector of the economy to another in response to short-run deviations in rates of return—shifts which could, when real resources cannot be shifted with equal speed, seriously affect particular industries and complicate the task of achieving economic stability.

In balancing these considerations, the Committee is inclined toward the view that there is merit in continuing to charter institutions somewhat specialized in their lending activities. But this approach would not preclude some broadening in the lending powers of specialized institutions. In general, the greater assurance which national policies and institutions now provide against severe economic and financial collapse should permit some redirection of portfolio regulation, consistent with the objectives of solvency and liquidity, toward greater mobility of funds, freer competition, and further flexibility for innovation.

### ***Portfolio Policy for Commercial Banks***

By tradition, commercial banks tend to give priority to the short- and intermediate-term borrowing needs of business. Through their handling of demand deposits, commercial banks are already closely attuned to the needs and circumstances of their local business communities. This orientation helps to assure a flow of credit to smaller and more localized businesses which lack ready access to the broader money and capital markets. The Committee believes that this basic orientation has much to commend it.

Commercial banks have, however, developed diversified lending activities beyond business loans, and it is appropriate that they continue to do so. Commercial banks are the most widely dispersed geographically of all lending institutions; they attract funds of individuals as well as businesses; they are necessarily in close contact with all elements in a community; and they are sometimes the only institution conveniently available to local borrowers. Moreover, diversification in the lending activities of commercial banks helps to assure that specialization among other types of institutions will not endanger either the mobility of credit between sectors or effective competition.

Because of the primary orientation of banks toward business lending, and because of the volatility of some of their liabilities, retention of some aggregate limitation on the size of their home mortgage portfolios appears consistent with a desirable degree of diversification. The existing limitation for national banks was recently raised by Congress from 60 to 70 percent of their volume of time and savings deposits.

Limitations on the volume of funds advanced to one borrower are felt to remain an appropriate means of enforcing diversification. However, the current limit of 10 percent of capital and surplus applied to national banks might usefully be reviewed to determine whether, consistent with adequate diversification, some liberalization is desirable to permit banks more effectively to serve the needs of their larger customers, and whether the existing network of exceptions to the loan limit is beneficial.

The Committee believes that some detailed portfolio restrictions might better be determined by supervisory authorities on the basis of general statutory guidelines. This would facilitate timely adjustments to basic changes in lending conditions and economic circumstances. Discretionary authority of this nature exists in the case of regulations on the investment powers of commercial banks, with generally satisfactory results.

### ***Portfolio Policy for Savings and Loan Associations***

If Congress feels that the desirability of encouraging housing continues to justify special attention to the availability of residential mortgage credit, savings and loan associations might appropriately continue to concentrate their major efforts in that field. This will help to assure the continuation of widely dispersed facilities for mortgage loans to individuals through savings associations that have developed expertise and special interest in providing mortgage credit and handling individual savings.

While favoring the concept of some specialization of lending activity between groups of institutions, the Committee has been mindful, as

noted, of the problems that might arise when such specialization is carried to the point that competition between institutions is stifled, and institutions are unable to shift any significant proportion of their funds to other sectors of the economy in response to changes in underlying economic conditions. Thus, authority for savings and loan associations to acquire mortgages on other than single-family residences, rather than being treated as exceptions to a general rule as at present, might be made more positive; and existing geographical limitations on lending might reasonably be liberalized. A majority of the Committee believes that consideration should also be given to providing statutory authority for savings and loan associations to engage in shorter term lending directly related to improving the "livability" of real estate through the purchase of major household durable goods; on the other hand, several members feel that further expansion into the field of consumer credit would be too much of a departure from the specialized function of mortgage lending.

Federal savings and loan associations must now confine their earning assets, apart from loans based on real estate or savings passbooks, to U.S. Government securities. It would be consistent with the regulatory principles here recommended to permit them to invest in high-quality State and local government bonds.

In recommending only a relatively modest deviation from the present portfolio regulations of savings and loan associations, the Committee has been influenced by its endorsement of a system of federally chartered mutual savings banks. The existence of such a system would provide an alternative for savings and loan associations that desired to engage in more diversified lending and investing, under appropriate supervision and safeguards.

### ***Portfolio Policy for Mutual Savings Banks***

Mutual savings banks, while generally confined to handling the savings funds of individuals and nonprofit institutions, typically have broader lending and investing authority, under State laws, than savings and loan associations. The Committee sees no serious problems in this area; it feels that this broader authority, such as is now permitted under State laws, is helpful in increasing the mobility of funds and should be retained if Federal charters are provided.

### ***Portfolio Policy for Credit Unions***

Credit unions might reasonably be expected to continue to concentrate on short- and intermediate-term consumer loans to their members. In the case of these institutions, considerations of safety and solvency loom particularly important, since credit unions are

typically managed on a part-time basis by nonprofessionals whose judgment is likely to be most reliable in assessing the credit worthiness of their peers for relatively small consumer loans. Limitation to this kind of lending is also consistent with the special purpose of credit unions—which is, through cooperative action, to help close a possible gap in the availability of small loans to individuals.

### ***The Extension of Federal Portfolio Regulations***

Banking and thrift institutions are subject to portfolio regulations imposed by a multiplicity of authorities, State and Federal. Inevitably, this multiple system of supervision has led in some instances to unequal treatment of institutions in similar circumstances. In the Committee's view, these inconsistencies are not today a serious and immediate threat to the overall health of the financial system, nor do they appear to involve inequities so severe as to create a need at this time for a major overhaul of the regulatory structure.

The Committee does not believe that it is essential, in protecting the legitimate public interest, to extend Federal authority in the area of portfolio regulation to all banking and thrift institutions (or to all insured institutions). It recognizes that some differences in treatment will remain, although in specific instances these differences might legitimately stimulate review by both Federal and State authorities of the validity of their requirements.

There is one area, however, where the ability of Federal authorities to protect their interests should be strengthened. Supervisory and insuring authorities should have adequate powers to assure that all member institutions maintain at all times ample capital in accordance with guidelines established by those agencies. Sanctions short of the complete withdrawal of insurance or expulsion from membership should be available to these Federal authorities.

*Conclusion 6.—The Committee recognizes that there are anomalies in the existing system of portfolio regulation, which are the product of a dual chartering system and of historical evolution. Nevertheless, the Committee sees no need for a drastic overhaul of existing portfolio regulations, nor for extending Federal regulations to State-chartered institutions...*

*Conclusion 7.—Some modification of the existing system is desirable. One aspect is broadening portfolio alternatives while not abandoning the concept of some specialization of financial institutions. In addition, many of the detailed regulations now spelled out in the statutes might well be left to the discretion of supervisory authorities, within statutory guidelines.*

*Conclusion 8.—Federal supervisory and insuring authorities should have adequate powers to assure that all institutions subject to their respective jurisdictions maintain at all times ample capital in accordance with guidelines established by those agencies. These powers should be such that the authorities may enforce adequate provision of capital without the need to resort to expulsion from membership or termination of insurance.<sup>1</sup>*

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<sup>1</sup> The Comptroller of the Currency feels that he now has sufficient power to regulate the capital of national banks.

## Chapter V

### FEDERAL CHARTERS FOR FINANCIAL INSTITUTIONS

Under existing law, both the Federal and State governments provide charters to commercial banks, savings and loan associations, and credit unions. For these three groups of financial institutions, there is a dual system of chartering and supervision.

In recent years, it has been proposed that Federal charters be available also to mutual savings banks. The Commission on Money and Credit supported this proposal and also recommended that Federal charters be available to life insurance companies.

#### *Federal Charters for Mutual Savings Banks*

In broad economic function, mutual savings banks resemble savings and loan associations. There are differences between the two types of institutions in their history, traditions, form of organization, legal nature of liabilities, and investment powers and practices. However, both perform the basic economic function of providing a relatively liquid earning-asset to individual savers and investing in long-term relatively illiquid obligations, mainly residential mortgages. As financial intermediaries, these institutions are more than mere middlemen between savers and borrowers. They hold assets which savers would for the most part be unwilling to hold directly, and their liabilities have a degree of liquidity which individual borrowers would be unable to provide directly.

In attracting funds, mutual savings banks and savings and loan associations compete not only with each other but with commercial banks as savings institutions. But mutual savings banks are concentrated in the northeastern part of the country, whereas savings and loan associations and commercial banks are found in the 50 States. Charters for mutual savings banks are available in only 18 States. Reflecting their historical origins, three-fourths of the savings banks are in three States—New York, Massachusetts, and Connecticut.

The proposal for Federal charters envisages that Federal mutual savings banks might come into existence in three ways: (1) by conversion of existing State-chartered savings banks to the form of Federal mutual savings banks, (2) by conversion of existing savings

and loan associations (Federal or State-chartered), and (3) by the establishment of new institutions.

*Analysis of the proposal.*—Federal charters for mutual savings banks are supported in part on the ground that such charters are now available for competing institutions, and equity calls for similar treatment for savings banks.

It is further argued that if savings banks could spread to other parts of the country, the result would be (1) an increase in saving, (2) a better geographical distribution of saving in relation to investment needs, particularly for home-finance, and (3) more flexible and more competitive financial institutions.<sup>1</sup>

Proponents of Federal chartering have argued that personal saving tends to be higher in communities where mutual savings banks exist than in comparable communities without them. They further argue that Federal charters would contribute to an improved geographical distribution of saving by stimulating greater saving in those areas of the country—especially the West and South—where economic growth has been most rapid but where investment has been financed by savings attracted from capital surplus areas in the north-east.

Whether the evidence on the volume of savings deposits in communities with savings banks can be taken to imply that national or regional saving would increase in relation to national income if savings banks were more widespread is questionable. The spread of such institutions might merely result in a rechanneling of the flow of savings.

The Committee is generally disposed favorably toward measures that would enhance the mobility of savings in response to investment needs, where consistent with other important objectives. Whether the establishment of new Federal mutual savings banks or the conversion of existing institutions to that form would make a major contribution to such mobility is unclear, but it would presumably tend in that direction. To the extent that the availability of Federal charters led to increased competition for savings, the public would benefit from more favorable returns on amounts saved. Moreover, although an excessive multiplication of savings institutions could threaten the solvency of existing and new institutions, this danger seems remote in view of the chartering standards that now exist for other types of institutions and the standards that would presumably be applied in chartering new Federal mutual savings banks.

Mutual savings banks have wider investment powers than savings and loan associations and are in a better position to respond to changes

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<sup>1</sup> National Association of Mutual Savings Banks, *Mutual Savings Banks* (a monograph prepared for the Commission on Money and Credit), 1962, pp. 261-266.

in the composition of investment needs. It is argued that the opportunity to establish additional mutual savings banks, either by the chartering of new, or the conversion of existing, institutions, would provide a desirable safeguard against excessive specialization in mortgage financing by savings institutions. With appropriate statutory standards, a desirable strengthening in the liquidity position of many thrift institutions might also result. Furthermore, savings institutions would be better able to adapt, and less vulnerable, to a relative decline in the demand for residential mortgage funds, for with broader investment powers they could supply funds for other productive uses.

Bills under consideration would best the chartering and supervisory authority for Federal mutual savings banks in the Federal Home Loan Bank Board. This matter is discussed in chapter IX. The Committee's endorsement of Federal charters for mutual savings banks does not imply endorsement of any particular bill in the Congress.<sup>2</sup>

*Conclusion 9.—The Committee concludes that voluntary Federal charters should be available for mutual savings banks, subject to adequate supervisory standards and safeguards.*

### **Federal Charters for Life Insurance Companies**

Life insurance companies are presently chartered in each of the 50 States. Companies that operate across State lines are subject to the regulations of the States in which they sell insurance as well as their home States. In practice, New York has been a key regulatory State by virtue of the fact that companies accounting for three-fourths of all life insurance are licensed to sell insurance in New York.

The Commission on Money and Credit recommended that "over-riding Federal charters be available to life insurance companies," in order "to avoid increasing complications of multiple State jurisdictions \* \* \*"

The Committee has had neither the time nor the resources to undertake an intensive study of the life insurance industry and its regulation. In part because the Federal Government has no supervisory responsibilities over insurance companies, existing knowledge and experience in the Government provide less foundation for judgment on this question than on most of the other issues within the Commit-

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<sup>2</sup>The Committee, while aware of the implications of differing Federal tax treatment of financial institutions (including mutual savings banks) for their growth and relative competitive positions, did not consider this range of problems as directly within its terms of reference. The Administration position on taxation of mutual savings banks and savings and loan associations was fully developed in hearings on the Revenue Act of 1962 last year.

tee's terms of reference. The Committee has had indications, however, of particular cases of unduly lax supervision.<sup>3</sup>

The Committee has noted that a degree of national regulation is, in effect, provided by New York State, but there are inherent difficulties in regulation by individual States of companies that operate in many States. Furthermore, the setting of national standards may more properly be a function of the Federal Government. The Committee also noted that in the McCarran Act (1945), Congress provided that the antitrust laws would apply to the business of insurance "to the extent that such business is not regulated by State law." This provision raises questions as to the extent of applicability of the antitrust laws.

The Committee realizes that overriding but voluntary Federal chartering would be of only limited effectiveness in creating uniform regulatory standards across the Nation. In States where regulatory standards and entry requirements are relatively lax, Federal charters involving stricter standards would attract few companies. Only to the extent that life companies regard regulation by the States as too onerous or too divergent from State to State would Federal charters be attractive to individual companies and therefore effective in enhancing nationally uniform regulation.

The Committee also wishes to point out that, in view of the interstate character of the life insurance industry, problems of overly lax or disparate State regulation, if they arise, can be handled by specific Federal legislation, even in the absence of Federal charters.

*Conclusion 10.—The Committee sees no objection in principle to voluntary Federal chartering of life insurance companies. At the same time, in view of the apparently lax supervision in some States, the inherent difficulties in State regulation of companies that operate across State lines, and the limited applicability of the antitrust laws, the Congress might wish to conduct a study of life insurance practices and regulation so as to determine whether Federal legislation is desirable.*

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<sup>3</sup>The adequacy of supervision, State by State, is also discussed in *The Insurance Industry: Aviation, Ocean Marine, and State Regulation*, Report of the Committee on the Judiciary, U.S. Senate, made by its Subcommittee on Antitrust and Monopoly, 86th Cong., 2d sess., 1960.

## Chapter VI

### INSURANCE OF DEPOSITS AND SHARES

The Federal Government provides insurance for deposits in commercial and mutual savings banks (through the Federal Deposit Insurance Corporation) and for shares in savings and loan associations (through the Federal Savings and Loan Insurance Corporation). All national banks, State-chartered member banks of the Federal Reserve System, and Federal savings and loan associations are required to be insured; State-chartered member associations of the Federal Home Loan Bank System are not required by law to carry insurance, but as a matter of policy the Federal Home Loan Bank Board does not currently admit associations to membership without insurance. For nonmember commercial banks, for mutual savings banks generally, and for State-chartered savings and loan associations, insurance is voluntary.

In fact, all but 2½ percent (or 329) of the commercial banks in the United States are insured by the FDIC. Uninsured banks account for less than 1 percent of all commercial bank deposits. Among the 515 mutual savings banks, 330 are insured by the FDIC (and 176 of those remaining are insured by the deposit insurance fund of the State of Massachusetts). Mutual savings banks not insured by either the FDIC or the Massachusetts fund account for little more than 0.1 percent of all mutual savings bank deposits. Among savings and loan associations, about two-thirds are insured with the FSLIC and they account for 95 percent of the assets of all associations.

Insurance coverage is presently \$10,000 per account for deposits and shares. When introduced in the early 1930's, coverage was \$2,500. This was raised to \$5,000 in 1934 and to the present level in 1950.

*Recommendations of Commission on Money and Credit.*—The Commission recommended “that Federal deposit insurance for all savings banks and savings and loan associations be available from the Federal Savings and Loan Insurance Corporation, and that chartering authorities urge such participation.”

The Commission's Report noted that savers frequently believe that their deposits and shares in all institutions are insured and that there are differences in the insurance available at various institutions. It suggested that insurance should be brought in line with savers' beliefs

and practice. The Commission also suggested that the maximum insurance coverage per account should be reconsidered in the next few years.

*Principal questions concerning insurance.*—The Committee considered three principal questions in this area: (1) Should deposit and share insurance be compulsory, either for all or for a greater proportion of commercial and mutual savings banks and savings and loan associations? (2) Should the present \$10,000 level be raised? (3) Should share insurance be available to credit unions?

*Purposes of insurance.*—In its deliberations on these questions, the Committee considered that the major purpose of deposit and share insurance is to preserve public confidence concerning the ability of financial institutions to meet their liabilities. This need was amply demonstrated historically by a series of financial panics in which suspension of payment by one or a few institutions was followed by “runs” on many sound institutions, which were in turn forced to close their doors. A related purpose of insurance is to prevent the economic disruption to communities that would result from the failure of banks or other financial institutions, with consequent losses to depositors and shareholders. Still another purpose is to protect the savings of families of moderate means, who often lack the technical ability to make judgments regarding the relative soundness of different institutions.

These purposes could conceivably be achieved in other ways. The central bank could presumably prevent panics and runs on financial institutions by committing itself to lend freely at such times. Effective examination and supervision, buttressing adequate portfolio regulation, might be relied upon to prevent most individual institutions from failing.

Yet the financial history of this country, with its structure of unit banks and other financial institutions, underscores the need for insurance protection in addition to the other governmental powers mentioned above. In any case, Federal insurance is by now an integral part of the financial landscape. Any suggestion that it be curtailed would act to undermine confidence and would serve no useful purpose.

### ***Compulsory Insurance***

The beneficiaries of deposit and share insurance—that is, consumers, businesses and institutions having accounts in insured institutions—do not contract directly for insurance. In this respect, such insurance differs from most other types of insurance protection. A depositor or shareholder protects his funds only by selecting an insured institution. But many citizens—especially those of small means who may

be most in need of protection—lack the financial sophistication to be aware that some institutions are not insured. In fact, because such a large proportion of depositary institutions are insured, the public tends to assume that all are insured, with the result that funds may inadvertently be placed with uninsured institutions; this possibility has been enhanced in some instances by misleading advertising. For these reasons, a case can be made for compulsory insurance at all institutions.

There was sympathy for this viewpoint in the Committee. On the other hand, it was also felt that compulsion should be avoided if possible. In particular, when small local institutions choose to remain uninsured, their nearby depositors and shareholders are likely to be aware of their uninsured status. On this basis, the Committee believes that insurance need not be compulsory as long as uninsured institutions (commercial banks, savings and loan associations, and mutual savings banks), confined their operations to local areas.

*Conclusion 11.—The Committee concludes, with one member dissenting, that uninsured commercial banks, mutual savings banks, building and loan, and savings and loan associations should be prohibited from accepting deposits or shares across State lines.<sup>1</sup>*

The Committee affirms that institutions which benefit from Federal charters or membership in a Federal System ought to carry insurance.

*Conclusion 12.—State-chartered savings and loan associations that are members of the Federal Home Loan Bank System but are not insured by the Federal Savings and Loan Insurance Corporation or an accepted State fund should either qualify for and obtain insurance from the Federal Savings and Loan Insurance Corporation or give up their membership. All new members should be required to obtain insurance.*

The Committee is aware of the existence of State-sponsored insurance funds, with a history of sound operation. Institutions insured with State funds that have been in existence for a number of years should be exempt from the foregoing proposals. It is not desirable, however, to encourage the creation of additional State insurance systems. In view of the nature of the risks—which are not actuarially determinate—and in view of the fact that reduction of the risks depends in large part on actions by the Federal Government to prevent economic and financial crises, the provision of deposit and share insurance is properly a function of the Federal Government.

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<sup>1</sup>The Committee is aware that a number of institutions are presently ineligible for Federal insurance by virtue of their form of organization. It is assumed that legislation to implement this conclusion would make provision for such problems.

### *Limit on Insurance Coverage*

If the purposes of insurance, outlined previously, are to be achieved and are considered overriding, a case can be made for complete coverage or a considerably higher upper limit than the present \$10,000, especially for demand deposits. If the community needs protection against the economic disruption and hardship that would result from bank failures, this need is not fully met when the public can only count on protection of the first \$10,000 in bank accounts. In order to be certain of full protection, depositors must split deposits among several banks and, for businesses especially, this is inconvenient and inefficient.

In the case of time deposits and shares, the justification for complete or much higher coverage is less compelling. These accounts are not transaction balances and, by definition, are not actively used. To split them among several institutions is less inconvenient and inefficient. Furthermore, it must be recognized that Federal insurance provides a distinct competitive benefit to savings institutions. It enhances their ability to attract funds which savers might otherwise invest directly and enables weaker institutions to compete on more equal terms with more carefully managed institutions. There is some question as to how far the Federal Government ought to go in abetting the promotional activities of savings institutions.

As a practical matter, however, the Federal Government through the FDIC could not provide higher insurance coverage for demand deposits than for time and savings deposits in the same institution. And, it could not provide higher coverage for time and savings deposits at commercial banks than for deposits and shares at other insured savings institutions.

A case can be made against complete insurance coverage on the ground that it would eliminate the incentive to holders of large accounts to investigate institutions before placing funds with them. This process is regarded by some as a desirable supplement to the activities of governmental supervisory authorities in preventing undue risk-taking by institutions. Others believe that governmental authorities can be relied on for this purpose and that the discipline exerted on management of financial institutions by large account-holders may lead to excessive avoidance of risk. One member of the Committee believes that an increase in insurance coverage would weaken the incentive to prudent management, particularly by those banks whose deposits would become fully insured.

In evaluating these various considerations, the Committee, with one member dissenting, agreed that increases in existing coverage are justified from time to time, to take account of rising income and wealth,

among other factors, but that complete coverage of all deposits or shares should not be provided. Studies by the FDIC and the FHLBB have concluded that an increase to as much as \$25,000 at the present time would be justified and helpful.

These studies, in particular, suggest that such an increase in coverage, judging from past experience, would have only a minor effect on the size of the FDIC and FSLIC insurance funds. For example, if coverage at \$25,000 had been in effect during the past decade, net payments by the FDIC to cover depositors' claims on failed or failing banks over this period would have been about \$270,000 or 11 percent higher, thereby reducing the size of the \$2.4 billion fund by a minute fraction. Projections for the next decade prepared by the FDIC and FSLIC, taking into account the growth in deposits and shares but also assuming, for the sake of analysis, a considerably greater number of failures than in the past 10 years, indicate that an increase in coverage to \$25,000 would reduce the projected size of each of the insurance funds a decade hence by much less than 1 percent.

The Committee is aware that it is impossible to forecast with reliability the amount of future drains on the insurance funds. One member believes that sufficient evidence has not been submitted to justify the proposition that insurance coverage could be substantially increased without raising the present assessment rates. Other members believe that the prospects for minimizing economic instability, together with the safeguards provided by bank supervision and examination, justify reliance on past experience in support of the judgment that insurance coverage can safely be increased while the current assessment rates are maintained.

Apart from this question, however, the Committee felt that proposals for increased insurance coverage could not appropriately be separated from consideration and evaluation of supervisory controls, adequacy of provisions for liquidity, and competitive practices in seeking funds, particularly as they may adversely affect lending standards among the various affected financial institutions, since increases in insurance coverage will, in the opinion of some, tend to reduce the care with which depositors or shareholders themselves evaluate the safety and stability of the various institutions, and thereby affect the ability of particular institutions to attract additional funds. The Committee has suggested several areas in which action is needed to strengthen further the supervisory framework and to assure more effectively the solvency and safety of individual institutions, including an extension of reserve requirements to savings and loan associations and mutual savings banks and a strengthening of the authority of supervisory authorities over liquidity positions.

standby authority over rates paid on savings and time accounts, and broadening of safeguards against conflicts of interest to additional institutions. Consequently, the Committee, with one member dissenting, believes that an increase in insurance coverage would be appropriate when these other considerations—insofar as they are relevant to the kind of institution concerned—are satisfactorily resolved.

*Conclusion 13.—The Committee, with one member dissenting, believes that an increase in existing insurance coverage is justified in terms of the adequacy and capacity of the insurance funds for meeting foreseeable contingencies. In considering such increases, however, the adequacy of liquidity, competitive practices in attracting funds as they are related to lending standards, and regulatory and supervisory controls and standards among the various affected financial institutions should be fully considered and continually evaluated.<sup>2</sup>*

The various actions the FDIC may take to assist a failed or failing bank—such as making loans or purchasing assets to facilitate a merger or an assumption of assets and liabilities by another bank—are somewhat limited by the language of existing law. The Committee believes that the language should be modified so as to clarify the conditions under which the FDIC may take such actions to reopen or strengthen banks. One member of the Committee dissents on the grounds that this change would add to discretionary authority, which might not be uniformly applied.

*Conclusion 14.—The Committee, with one member dissenting, favors a clarification of the conditions specified in the Federal Deposit Insurance Act under which the Corporation may assist a failed or failing bank.*

### **Insurance for Credit Unions**

Credit unions are the only depositary-type institutions that do not have insurance available through an instrumentality of the Federal Government. The Committee believes that before a decision is made to provide insurance, a thorough study should be undertaken to determine whether it would be consistent with the character, purposes, and functions of credit unions.

Although fast-growing and to some extent competing with other savings institutions, credit unions have unique characteristics. They do not serve the general public but are limited to accepting funds and making loans to members, who ordinarily have a common bond of

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<sup>2</sup> One member, while agreeing to the general tenor of the statements in conclusion 13, does not consider it necessary to delay increasing the insurance limit to \$25,000. Implementation of the other recommendations in this report would be timely enough even if such implementation followed the change in the insurance limit by as much as a year. Another member, who fully supports conclusion 13, points out that as far as his agency is concerned the aforementioned recommendations are already applied.

occupation, association, or community. Furthermore, credit unions are frequently subsidized one way or another by employers and seldom have full-time management. Their loss experience has been very small.

The Committee is concerned that insured status might tend to change the character of credit unions so that some of them would become aggressive institutions that would use the insurance feature for promotional purposes. In order to assure preservation of the unique and useful status of credit unions, the Committee believes that neither cash reserve requirements nor Federal insurance should be adopted without more study.

## Chapter VII

### STRUCTURAL CHANGES AND COMPETITION AMONG FINANCIAL INSTITUTIONS

In discharging its responsibility to assure that financial institutions remain both solvent and responsive to the needs of the community, the Federal Government inevitably is concerned with the structure of the markets within which financial institutions operate and compete. Federal agencies charter new institutions. They provide deposit or share insurance directly to federally chartered institutions and make such insurance available on a voluntary basis to institutions chartered by the States, thereby affecting their ability to compete. Generally, they approve or disapprove new branches, mergers, and holding company relationships among financial institutions, both Federal and State chartered. (For State-chartered institutions, approval of State supervisory authorities is required before action by the appropriate Federal agency is taken.)

These responsibilities give rise to administrative problems and to substantive policy problems. The administrative problems in this area represent one aspect, albeit a crucial one, of a more general problem regarding coordination of policy among Federal supervisory agencies with overlapping jurisdictions in the field of banking. This question is dealt with in Chapter IX of this report.

The substantive problems concern the standards to be applied in approving or disapproving structural changes, such as the chartering of new institutions, branches for existing institutions, mergers among existing institutions (which may either convert an independent institution into a branch of another institution or consolidate two or more offices into one), and holding company acquisitions.

#### *Nature of Problem*

In the period since World War II, the structure of financial institutions and their competitive relationships—especially in the field of commercial banking—have been subject to special stresses. Migration of people and businesses to the suburbs has led to a need for more varied lending and depositary services of banks and other financial institutions in areas where little such need was evident earlier. At the same time, more and more consumers have become bank depositors,

and banks have had a greater incentive to compete for personal deposits. Growth in the size of business units has generated pressures for larger size banking units to serve business needs. The potential economies from use of automatic accounting and computing devices are providing a new inducement toward combination. In addition, general prosperity has apparently made it difficult for smaller financial institutions to hold and attract managerial talent.

The result has been a strong movement toward expansion, on the one hand, and toward consolidation, on the other. New institutions and, where permitted by State laws, new branches have been opened in many areas. At the same time, formerly independent institutions have been converted into branches by means of mergers. In the past decade 5,000 *de novo* branches of commercial banks have been opened, while more than 1,300 independent banks have been converted into branches through mergers. Holding company acquisitions and other forms of affiliation have also been widespread.

In recognition of the problems created by these developments, Congress has enacted two major laws in recent years. The Bank Holding Company Act of 1956 required prior approval by the Board of Governors of the Federal Reserve System of acquisitions of banks by holding companies. The Bank Merger Act of 1960 (an amendment to the Federal Deposit Insurance Act) specified the factors that Federal agencies were to consider in weighing a merger and emphasized the importance of considering the effect on competition, by providing that the agency having the responsibility to approve a merger should receive an advisory opinion on the competitive effect of the proposed merger from each of the other two banking agencies and the Department of Justice.

In deciding cases under these statutes and in approving or denying applications for new charters and branches, Federal agencies are necessarily exerting a major influence on the structure of financial institutions and the pattern of competitive relationships among them. Furthermore, decisions to grant charters and to approve branches, mergers, and holding company acquisitions are by their nature irreversible. It is important, therefore, that the criteria applied by Federal agencies be conducive to the type of financial structure that will over the years best serve the needs of a growing, efficient economy and that such criteria be consistently applied among the agencies involved and over time.

These criteria must take account of a great variety of local and regional circumstances, from small communities with a single bank to metropolitan centers with numerous giant financial institutions of all types. Policy approaches with regard to charters, branches,

mergers, or holding companies that promote competition while encouraging soundness in one type of community or region might lead to excessive concentration elsewhere.

### *Nature of Financial Markets*

Financial institutions, especially banks, operate and compete in circumstances that differ in several respects from those in which other businesses operate and compete.

In contrast to the situation that largely prevails in commerce and industry, the chartering of new financial institutions is subject to special limitations. The economic disruption and hardship that results from the failure of financial institutions has led governments to limit the establishment of new institutions in accordance with the "convenience and needs" of the community and with an eye to preventing the failure of the new or existing institutions.

Competition is also limited by other governmental restrictions. Regulation of interest rates paid by commercial banks reduces the extent to which banks may engage in price competition for demand, time, and savings deposits. For this and other reasons, competition often tends to be manifested in the nonprice elements of deposit relationships and loan contracts. Some portfolio restrictions also limit the area of competition.

Another feature is that the market in which financial institutions, especially banks, operate is difficult to define. In some of their loan and deposit operations banks serve a local market which may be sheltered from competition. In other transactions, they deal in national markets which are highly competitive. The absence of a single well-defined market complicates the task of judging the impact on competition of mergers and other structural changes.

Within finance, there is a significant degree of interindustry competition, which is relevant to decisions on structural changes. For example, banks compete not only with each other but with other types of savings and of lending institutions in attracting deposits and making loans and investments.

Although financial markets have special characteristics, including limitations on competition, it is important not to confuse banks and other financial institutions with public utilities. In the case of many public utilities, it is recognized that competition would be wasteful, and the discipline of competition is replaced by detailed governmental regulation of prices, types of service, etc. In finance, on the other hand, regulation is much less comprehensive. Considerable leeway exists for the play of competition and, in fact, competition is relied upon as a spur to adequate service and as a means of assuring that

interest rates and other credit terms serve a useful allocative function on an equitable basis.

### ***Recommendations of Commission on Money and Credit***

The Commission recommended that—

1. The provisions of the National Banking Act should be revised so as to enable national banks to establish branches within “trading areas” irrespective of State laws, and State laws should be revised to provide corresponding privileges to State-chartered banks.
2. In exercising this power to grant branches, the chartering authority should adopt the following practices:
  - a. It should avoid undue concentration of the local market.
  - b. It should give new entrants a chance to compete even if their business must be partially bid away from existing competitors, and should place considerable reliance on the applicant’s integrity, managerial competence, and his judgment in regard to the earning prospects of the new branch.
  - c. It should treat the applications for new branches on a par with new unit bank applications.
  - d. It should treat applications for new branches of non-local banks on a par with applications for new branches of local banks.

In its background discussion, the Commission expressed “its concern about the need for clarification of present legislation and diffusion of authority for administrative action in relation to financial mergers. At the same time, in its opinion, policy in regard to mergers should be discriminatng. Mergers that result in operating economies and which are forced by competition to pass on the benefits of operating economies clearly should be encouraged by public policy. The Commission’s judgment is that more precise criteria than are now in use can and should be evolved for drawing the line between mergers that are and mergers that are not in the public interest.”

### ***Other Recommendation***

The Advisory Committee on Banking to the Comptroller of the Currency recommended legislation that would permit national banks to establish branches within a limited area irrespective of the law of the State in which the national bank is located.

### ***Needs for Study***

As it considered the problems in this area, the Committee was aware of the difficulty of formulating reliable criteria on which policy decisions may be based. In contrast to many of the items within the

Committee's terms of reference, which have been the object of analysis and recommendation over the years, the issues pertaining to industrial organization, performance, and market structure among financial institutions have received little systematic study. Yet Federal agencies must act on a steady stream of applications for structural changes. The Committee urges that strong encouragement be given to research efforts, within the Federal Government and elsewhere, aimed at evaluating the performance of financial institutions with different types of structure and at studying the interaction between performance and structure.

*Conclusion 15.—The Committee urges that intensive studies be undertaken, within the Government and elsewhere, with a view to providing an essential body of information and analysis on which to base sound policy guidelines for decisions on applications for charters, branches, mergers, and holding company acquisitions.*

### ***Structural Changes and Competition Among Commercial Banks***

*Statutory standards.*—The Federal statutes authorizing charters for national banks, branches for national and insured State banks, admission to deposit insurance, and admission to membership in the Federal Reserve System specify a number of factors that the supervisory agencies must take into account before acting. In general the so-called “banking” factors, which the agencies are required to consider before acting on an application, include the financial history and condition of bank (or banks), capital adequacy, future earning prospects, character of management, corporate powers, and the convenience and needs of the community. The more recent legislation on bank holding companies and mergers includes similar factors but also explicitly adds “the effect on competition” as a factor.

It is clear, from legislative history and regulatory practice, that each of these factors is not necessarily given equal weight. In particular, the effect on competition, although it is only one of seven factors specified in the Bank Merger Act, is accorded substantial weight. Frequently, the problem facing the supervisory agency with primary responsibility is to balance the combined banking factors against the competitive factor.

Some members of the Committee believe that even greater weight should be given to the competitive factor than has been the practice in the past, and they would achieve legislative support for this objective by reducing the number of factors to three: banking soundness, convenience and needs of the community, and effect on competition. Other members of the Committee believe that such a change would serve no purpose and that the present statutes give adequate emphasis to the competitive factor.

*Consistency of standards.*—The market environment in which banks compete is affected by each of the four types of structural change over which the Federal Government has supervisory authority. Yet the statutes do not lay down completely consistent standards as a basis for decisions by supervisory authorities. In particular, although the effect on competition is specified as a relevant factor in merger and holding company cases, the statutory authority to grant charters and branches does not require that the effect on competition be considered.

In practice, the supervisory authorities tend to apply the same standards to charter and branch applications as to merger and holding company requests. The Committee believes that this practice is appropriate. It was observed, for example, that the establishment of new branches may not always enhance competition. Where the alternative to a new branch of an existing institution is a new independent institution, competition might be greater if the branch application is denied and the charter application is approved.

The Committee differed on whether or not the practice of supervisory agencies in applying the competitive factor to charter and branch applications should receive explicit statutory endorsement. Some members believe that this is unnecessary, in view of existing practices. A majority favors legislative authorization for the practice of basing decisions on charter and branch applications on “the effect of competition” along with the criteria already specified by law. The result would be that each of the supervisory agencies would be directed to apply similar, if not identical, standards to each type of significant structural change—charters, branches, mergers, holding company acquisitions and any other form of affiliation which might be regulated.

*Conclusion 16.*—*Although existing statutory standards are interpreted as authorizing consideration of the effect on competition in the granting of charters and the approval of new branches, the Committee concludes that the statutory standards applicable to granting of charters and approval of new branches should explicitly include “the effect on competition.”*

In addition to the need for consistency in evaluating different types of structural changes, application of standards among the several supervisory agencies should be consistent. Whether or not the Federal agencies have been consistent in their decisions is a matter of some disagreement.

The general problem of uniformity in bank supervision at the Federal level is discussed in chapter IX of this report. The need for specific measures to encourage greater uniformity in decisions on bank

structure depends on what action is taken with regard to coordinating bank supervisory functions generally.

A degree of coordination is achieved in merger cases by the provision of the law that each of the other bank supervisory agencies and the Justice Department submit to the agency responsible for decision an advisory opinion on the effect of the proposed merger on competition. Some members of the Committee see merit in a proposal that this procedure be extended, on a permissive basis, to other types of structural change, including charters, branches, holding company acquisitions, membership in the Federal Reserve System, and admission to deposit insurance. Thus each supervisory agency and the Department of Justice would be given notice of applications received and would have an opportunity to submit an advisory opinion on the effect of such proposed actions on competition. It would be understood the agencies would not be required or expected to submit advisory opinions in the case of each application, but only when they had a substantial reason for doing so. Other members oppose this proposal on the grounds that such interchange would be needlessly burdensome.

As an alternative to this coordination procedure, and pending more general decisions with regard to bank supervision, some members of the Committee favor establishment of a single board (consisting of representatives of each of the three bank supervisory agencies) to act on all applications for charter, branch, merger, or holding company acquisition. Other members believe that the arrangements for informal coordination which have generally prevailed in recent years are satisfactory and adequate.

*Conclusion 17.*—*The Committee believes that in the case of each application for charter, branch, membership in the Federal Reserve System, and admission to deposit insurance, the banking agencies not directly concerned and the Justice Department should have the opportunity to submit an advisory opinion on the effect of the proposed action on competition.*<sup>1</sup>

*Branching problems.*—In considering the recommendations concerning branches of national banks that have been put forward by the Commission on Money and Credit and by the Advisory Committee on Banking to the Comptroller of the Currency, the Committee was well aware of the controversial and emotion-laden aspects of this issue.

In the case of banks, the Congress has taken the position that State laws should remain paramount in determining the branching privileges of both State- and Federal-chartered banks. In the case of

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<sup>1</sup> Three members dissent on the grounds that this conclusion would place new and burdensome responsibilities on the affected agencies and create unnecessary confusion concerning the locus of responsibility and the standards to be applied in an area in which adverse competitive implications are seldom a critical factor.

Federal savings and loan associations, however, the Federal statutes impose no limitations on the authority of the Federal Home Loan Bank Board to grant branching privileges.

Under existing law, branch banking is completely prohibited in eight States. An additional eight States prohibit branches with limited exceptions, such as drive-in facilities close to the main office or paying and receiving stations in communities without established banking facilities. At the other extreme, branching is authorized without local limitation in 10 States. In the remaining States, branch banking is permitted under varying limitations. Where limited branching is permitted, the statutes in most States are more liberal regarding branches near the main office than for more distant branches.

The Committee believes that extreme limitations on authority to permit branching by commercial banks in some States may operate to the detriment of the interest of businesses and consumers in those States. In other States, relatively unrestricted authority to permit branching may have led to excessive concentration of banking facilities. Leaving aside considerations involving the relationship between the Federal and State Governments, it is difficult to defend the extreme disparity among the States in the prevalence of branch banking. It is likely that the public interest would be better served by a more consistent policy among the States regarding branches.

An argument in favor of permitting banks to establish branches more freely is that it brings some of the benefits of economies of scale to users of banking services in areas which cannot support large unit banks or perhaps any unit bank. In addition, the establishment of new branches can sometimes increase competition and thereby improve and lower the cost of banking services.

A major disadvantage attributed to broad statutory authority for branching is that, unless carefully administered, it can lead to undue concentration of banking facilities. It is also argued that independent unit banks are more responsive to the needs of the local community. Finally, it may be argued that in some areas a freer chartering policy by supervisory authorities would introduce more competition without the additional concentration that comes with branching.

One way to work toward a more uniform approach to branching is through the branching authority for national banks. Opinions differ on whether the economic advantages from such an approach would be great enough to warrant disturbing the existing balance between Federal and State supervision. It is certain that considerable controversy would ensue if it were proposed that the Federal Government permit national banks to establish branches in areas where this is not presently permitted to State-chartered banks.

*Conclusion 18.*—The Committee believes that extreme limitations on branching of financial institutions in some States may impede the provision of banking services and effective competition. On the other hand, it is important to avoid excessive concentration of banking (and other financial) facilities through branching. It seems quite likely that branching, properly regulated, can encourage more favorable competitive conditions and the provision of more effective banking services, particularly in local areas, without affecting the soundness of banks (and other financial institutions). The Committee concludes therefore that the Federal and State Governments, within their respective authorities, should review present restrictions on branching with a view to developing a more rational pattern, subject to safeguards to avoid excessive concentration and preserve competition.

*Other forms of affiliation.*—At present, only branching and bank holding company relationships are subject to Federal supervision. There are, however, other forms of affiliation among banks and other financial institutions which may require supervision. The Committee has in mind widespread instances of ownership of two or more banks by individuals, sometimes referred to as chain banking. The Committee believes that additional studies are needed to determine whether such other forms of affiliation require Federal supervision.<sup>2</sup>

### ***Structural Changes and Competition Among Savings and Loan Associations***

The Committee believes that federally supervised savings and loan associations and mutual savings banks should be subject to Federal standards regarding charters, branches, mergers, and holding company supervision similar to those applicable to commercial banks, as discussed previously. This would include authority to the Federal Savings and Loan Insurance Corporation to pass on application for branches of State-chartered associations in a manner parallel to the authority of the Federal Deposit Insurance Corporation over State banks.

Federal law, as noted, does not limit the authority to permit Federal associations to branch. As a matter of policy, however, the Federal Home Loan Bank Board follows the principle of permitting branches for Federal savings and loan associations in any locations where State laws permit (or do not prohibit) other financial institutions to have some form of affiliate office. Pending outcome of the decision on branch banking, the Committee does not suggest a change in either the legislation or the policy regarding branches of Federal savings and loan associations.

<sup>2</sup> One study of this type has recently been published: *Chain Banking*, Report by Wright Patman, chairman, to the Select Committee on Small Business, House of Representatives, 87th Cong. (Jan. 3, 1963).

*Conclusion 19.*—*In principle, the Committee believes that federally supervised savings and loan associations should be subject to Federal standards regarding charters, branches, mergers, and holding company supervision similar to those applicable to banks. However, pending outcome of the study on branching recommended above, the Committee does not suggest a change in either the legislation or the policy regarding branches of Federal savings and loan associations.*

*Conclusion 20.*—*The Committee believes that the Federal Savings and Loan Insurance Corporation should be given authority to pass on branching applications of State-chartered insured associations in a manner parallel to the authority of the Federal Deposit Insurance Corporation over insured State banks.*

### ***Interlocking Relationship Among Financial Institutions***

Section 8 of the Clayton Act has two parts. The first part, which applies only to banks, prohibits (with exceptions) interlocking relationships between member banks of the Federal Reserve System and other banks in the same or a nearby community. But interlocking relationships among nonmember banks, savings and loan associations, and other financial institutions are not covered by the law. Mutual savings banks are explicitly exempted, as are relationships involving a member bank if the banks are not located in the same or a "contiguous" or "adjacent" city, town, or village. The Committee sees no reason why these limitations on interlocking relationships should apply only to member banks.

Although the second part of section 8 deals with corporations in general, it contains a reference to banks and is therefore pertinent to the work of the Committee. That part of the section prohibits interlocking directorates between two or more *competing* corporations engaged in commerce (if one has a capitalization above \$1 million). There is an exemption, however, for "banks, banking associations, [and] trust companies." This exemption was presumably inserted in order to omit from coverage of the second part of section 8 those relationships among banks already covered by the first part. It might be interpreted, however, as exempting an interlocking directorate between a bank and a competing financial institution even though the latter type of interlocking relationship is not covered by the first part of section 8. The Committee believes that the Clayton Act needs clarification in this respect.

*Conclusion 21.*—*The Committee believes that the provisions of section 8 of the Clayton Act which govern interlocking relationships involving financial institutions should be clarified and probably strengthened.*

## Chapter VIII

### CONFLICTS OF INTEREST

The Commission on Money and Credit recommended that, in view of the rapid postwar growth of financial institutions, existing legislation, regulations, and examination procedures be reviewed "to ensure against any unwarranted personal benefits accruing to individuals responsible for handling institutional funds, which might be associated with or derived from the use or investment of the funds."

This is a matter on which the Committee was not in a position to make an intensive examination. The Commission's recommendation refers not to violations of existing law but to inadequacies in law and regulation, including the extent of their applicability, which might permit unwarranted personal benefits by reason of association with financial institutions. For example, officers, directors, or employees of financial institutions may have other business interests (such as insurance or real estate) to which direct benefits accrue as a result of their association with the financial institutions.

Legislative restraints are more stringent for some types of financial institutions than for others. The Federal statutes contain a number of limitations on transactions between member banks and their officers and directors and also between member banks and affiliated organizations. Also, certain criminal statutes relating to conflicts of interest are applicable to directors, officers, and employees of insured banks. But the Federal statutes pertaining to savings and loan associations do not include all the safeguards contained in the Federal banking laws.

*Conclusion 22.—The Committee believes that the safeguarding provisions now applicable to either member or insured banks should be broadened so as to apply to all commercial banks, savings and loan associations, mutual savings banks, and credit unions subject to Federal supervision. They should also be made more effective—for example, by strengthening the definition of affiliated organizations and by extending the class of transactions that are limited or prohibited. At the same time, these provisions might be made more equitable (for example, by increasing the present ceiling of \$2,500 on the amount an executive officer of a bank may borrow from his bank and by permitting public bank examiners to obtain mortgage loans from an insured bank on real estate that they occupy as residence).*

*More generally, consideration should be given to authorizing supervisory agencies to issue regulations, as they deem it necessary, to prevent unwarranted benefits to individuals from their association with financial institutions.*

## Chapter IX

### SUPERVISION AND EXAMINATION OF FINANCIAL INSTITUTIONS

This chapter is concerned with the organization within the Federal Government of supervisory activities over private financial institutions. These activities are presently performed by three Federal agencies in the case of commercial banks and by one agency each in the case of mutual savings banks, savings and loan associations, and credit unions. It should be noted at the outset that in its deliberations the Committee assumed continuation of the so-called dual system of banking and finance, with its division of supervisory and chartering responsibilities between the Federal and State governments.

The Federal supervisory agencies and their major present functions are as follows:

The Office of the Comptroller of the Currency, in the Treasury Department, charters, supervises, and examines the 4,500 national banks and approves new branches and mergers in which the resulting institution will be a national bank.

The Federal Deposit Insurance Corporation provides insurance to national and State-chartered banks that are members of the Federal Reserve System, and admits to insurance State nonmember commercial and mutual savings banks that apply and qualify for insurance. The Corporation regularly examines the 7,000 insured nonmember commercial banks and the 331 insured mutual savings banks. New branches of insured nonmember banks and mergers, where the resulting bank is an insured nonmember, require the approval of the Corporation.

The Board of Governors of the Federal Reserve System, in addition to its central banking functions, admits State-chartered banks to membership in the Federal Reserve System and examines State member banks. Branches and mergers, where the resulting institution will be a State member bank, and the acquisition of any bank by a holding company require the approval of the Board. (Membership in the System includes the 4,500 national banks and 1,570 State banks.)

The Federal Home Loan Bank Board charters, supervises and examines Federal savings and loan associations; provides insurance, through the Federal Savings and Loan Insurance Corporation, and

examines State-chartered insured and member associations; also it provides advances to member associations through the Federal home loan banks. Branches and mergers involving Federal associations require the approval of the Board. (Membership in the System consists of 1,900 Federal associations, 2,900 State-chartered associations of which 2,300 are insured by the FSLIC, and 20 mutual savings banks.)

The Bureau of Federal Credit Unions, in the Department of Health, Education, and Welfare, charters, supervises, and examines the 10,000 Federal credit unions.

*Recommendations of Commission on Money and Credit.*—The Commission recommended “increased coordination of examining and supervisory authorities. At the Federal level there should be only one examining authority for commercial banks. The Comptroller of the Currency and his functions and the FDIC should be transferred to the Federal Reserve System.” The Commission also recommended “that there be a unified authority at the Federal level for the examination of all federally insured savings and loan associations and mutual savings banks. The activities and standards of these two Federal authorities should be coordinated with each other and with the respective State examining and supervisory authorities.”

Four members of the Commission appended footnotes endorsing consolidation but questioning whether the responsibility should be shifted to the Federal Reserve. Another member favored consolidating bank supervision in the FDIC.

*Other proposals.*—In recent speeches, Gov. J. L. Robertson of the Federal Reserve Board has proposed that a new Federal banking commission be established to take over all the bank supervisory functions of the three agencies. The Federal Reserve would confine itself to monetary policy and the functions of the other two bank supervisory agencies would be transferred to the new commission. This new agency would have two major divisions, one to deal with insurance and the other to deal with examination, changes in bank structure, and related matters.

Chairman Coker of the FDIC has suggested in a recent speech that the Federal Reserve should be relieved of responsibility for bank supervision and that the FDIC, as insurer, should examine all insured banks, alternating examinations with the Comptroller of the Currency in the case of national banks and with State authorities in the case of State banks. The FDIC would investigate, concurrently with the Comptroller or the State chartering authority, proposals for changes in bank structure.

The Advisory Committee on Banking to the Comptroller of the Currency recommended recently that the Federal Reserve be divested

of all nonmonetary functions and that all supervisory, examination, and regulatory authority relating to national banks be transferred to the Comptroller of the Currency. All Federal supervisory, examination, and regulatory authority over State-chartered banks would be transferred to the FDIC, but authority to approve branches of State banks would be relinquished to the State supervisory authorities. The FDIC would be reorganized under a single administrator and transferred to the Treasury Department.

*Committee's approach to supervision problems.*—The Committee first examined the working of the present tripartite organization of Federal bank supervision. Finding that differences in approach and deficiencies in coordination are possible under the existing arrangement, the Committee went on to examine the advantages and disadvantages of a more unified approach to Federal bank supervision.

### ***The Present System of Federal Bank Supervision***

The existing organization of bank supervision at the Federal level is the result of historical evolution. The National Bank Act (1863) established the Office of the Comptroller of the Currency as supervisor of national banks. From 1863 to 1913, there was a clear and complete division of authority, without overlap, between Federal supervision of national banks and State supervision of all other banks.

With the creation of the Federal Reserve System in 1913, national banks became subject to supervision by the Federal Reserve as well as by the Comptroller, and State banks that chose to join the System became subject to some measure of Federal supervision. Finally, with the introduction of deposit insurance in 1933, nonmember State banks came under Federal supervision (by the FDIC) if they chose to be insured, while both National and State member banks, for which insurance is mandatory, acquired a relationship with a third Federal supervisory agency. At the same time, State-chartered banks, whether members or nonmembers of the Federal Reserve System, and whether insured or not, continued to be supervised by State authorities. It has turned out, therefore, that the only group of commercial banks not subject to some measure of multiple supervision are the 300 uninsured banks, out of a total of about 13,400 commercial banks.

The system of overlapping supervision of commercial banks has been made workable by a division of jurisdiction and by procedures for coordination. Primary responsibility for Federal supervision and examination has been apportioned by law as follows: national banks by the Comptroller of the Currency; State member banks by the Federal Reserve; and insured nonmember banks by the Federal Deposit Insurance Corporation. Yet each agency continues to have

functions affecting banks primarily under the jurisdiction of one or both of the other agencies.

The three agencies perform some similar functions. Each examines and each approves branches and mergers. Over the years, various techniques, formal and informal, have been developed to facilitate coordination. Each agency has access (in some cases by statute) to the relevant examination reports of the others, and such reports have been standardized to a large extent. Under the Bank Merger Act of 1960, each agency plus the Justice Department is required to render to the agency with primary responsibility an advisory opinion on the effect of each proposed merger on competition among banks. Over many years, although not currently, all three agencies had exchanged full information and views on charter and branch applications and had jointly operated a school for bank examiners.

### *Advantages of Present System*

The existing organization of bank supervisory functions at the Federal level is defended on the grounds that (1) it prevents abuses that might result from concentration of authority in a single Federal agency; (2) it reflects differences in function, which call for separation of authority; and (3) coordination among the three agencies can prevent inconsistent policies and duplication.

1. It is frequently argued that division of responsibility for bank supervision among three agencies has the advantage of diffusing power and therefore lessening the possibility of arbitrary action by government officials. A related argument is that the existence of more than one supervisory agency provides financial institutions an opportunity for relief from arbitrary or unduly stringent regulation.

A counter-argument is that this is not an appropriate way to provide for relief from arbitrary or unduly stringent regulation, where and when it exists. It is the rule rather than the exception for supervisory and regulatory functions to be concentrated in one agency. For example, there is a single Federal supervisory authority over insured savings and loan associations, railroads, communications companies, etc. Furthermore, if the principle implied by the above argument were generally followed, it would require multiplication of supervisory agencies with similar functions in other areas.

2. A major consideration advanced in favor of multiple supervision is that since the functions of the agencies are distinct, they can be more effectively conducted on a separate basis. In a dual banking system, the nature of Federal supervision over State banks is quite different from that over national banks and calls for separate treatment. For example, it is argued that unless there is complete separa-

tion between the chartering and insurance authority, a danger exists that the Federal insuring authority will favor federally chartered over State-chartered institutions.

In opposition to this viewpoint, it is argued that under the present arrangement no agency has authority commensurate with its responsibilities. For example, the FDIC has no discretion whether or not to provide insurance to National and State member banks; its authority extends only to insure nonmember banks. It is also observed that both the Federal Reserve and the Federal Home Loan Bank Systems supervise Federal and State-chartered institutions, and there is no reason to believe that they show favoritism.

3. The third major defense of the present arrangement is that machinery for coordination eliminates duplication and the danger of differences in policy approach. As noted earlier, various procedures, both statutory and informal, have been developed over the years to encourage coordination and these procedures have ordinarily accomplished their major purposes.

A counter-argument is that, since much of this coordination is voluntary, it cannot always be counted on to be successful. Moreover, it may involve an undue expenditure of time and effort by executives and staff of the three agencies.

### *Disadvantages of Present System*

Some of the problems in the existing arrangement are noted in the previous section. The other major disadvantages attributed to the present tripartite system are that (1) it makes possible differences in supervisory policy and practice between one group of banks and another; (2) it makes possible a degree of rivalry among supervisory agencies; and (3) it is illogical and inefficient.

1. The Committee's discussion brought out the possibility of differences in policy approach. The major policy questions currently facing the three agencies are in the field of bank mergers. The Bank Merger Act of 1960 specifies seven factors to be considered by the responsible agencies when they judge applications; six of these are so-called banking factors and the seventh is the effect on competition. The Merger Act requires advisory opinions from the other two banking agencies and the Department of Justice only on the effect of the proposed merger on competition, while the agency with primary responsibility must weigh not only this but all the factors specified by Congress. But the act does not and cannot provide specific guidance, and differences in approach are possible. Although the Committee is aware that a pattern of decisions under the 1960 legislation may be in process of evolution, it is conceivable that mergers would be more freely per-

mitted among banks under one jurisdiction than under another, with unfortunate and irreversible results.

2. A second disadvantage of the existing organization is that there is a possibility of rivalry among the agencies, involving competition to attract banks that are under the jurisdiction of one of the other agencies. Such rivalry could, in turn, lead to a competitive lowering of regulatory standards.

3. Finally, it may be argued that even if a division of authority were desirable, the present demarcation cannot be defended on any logical basis. In particular, division in Federal examining authority over insured State-chartered banks between the Federal Reserve and the FDIC seems hard to defend.

### *Committee Analysis*

The Committee recognizes that the present arrangement makes possible lack of uniformity in Federal bank supervision. It is clear that the degree of uniformity has varied from time to time depending on the views and temperaments of the responsible officials.

At the very least, procedures for coordination should be strengthened. One way to accomplish this would be to replace the informal methods of coordination with statutory requirements. In the area of charters, branches, mergers, and holding companies, the Committee is making specific recommendations (in Chapter VII) for greater opportunity for interchange of advisory opinions among the three agencies. Although the procedures recommended in Chapter VII are designed to encourage more consistent policies with regard to bank structure changes, those procedures would increase the duplication of effort that now exists. Furthermore, although the rendering of advisory opinions may encourage, it does not assure, uniformity of policies.

As another step, the Committee considered the pros and cons of reducing to two the number of bank supervisory agencies, by removing the Federal Reserve from the field of bank supervision. As noted, Governor Robertson of the Federal Reserve included the latter suggestion in his proposal for a single agency, and both Chairman Cocke of the FDIC and the Advisory Committee to the Comptroller of the Currency have put forward proposals for a two-agency system of Federal bank supervision. Chairman Cocke proposed that the FDIC take responsibility for Federal supervision of all insured State banks and that it share with the Comptroller examination and some supervisory functions over national banks. The Advisory Committee to the Comptroller recommended a complete separation of these functions, with the FDIC having sole responsibility for Federal supervision of insured

State banks and the Comptroller having sole responsibility over national banks, but with both under the general supervision of the Secretary of the Treasury.

These proposals would clearly eliminate some of the disadvantages of the existing arrangement. Both would end the division of responsibility for Federal supervision of insured State-chartered banks, and the Advisory Committee proposal would also accord full responsibility for the supervision of national banks to a single agency. General supervision of both agencies by the Secretary of the Treasury, as recommended by the Advisory Committee to the Comptroller, would reduce the scope for divergence in policy approach. Neither proposal for two agencies would, however, automatically eliminate the possibility of differences in treatment for particular groups of banks.

The two-agency proposal would have the additional advantage of permitting the members of the Federal Reserve Board to concentrate their time and energies on their principal responsibility—the formulation and implementation of monetary policy. There may be disadvantages, however, in removing the Federal Reserve from the field of bank supervision. Although its main task is monetary policy, the central bank is also vitally concerned with the soundness, flexibility, and competitive structure of the commercial banking system. These characteristics of the banking system can significantly affect the transmission of monetary policy actions to the economy at large. Furthermore, the intimate knowledge of banking conditions that comes from examination and supervision is very helpful, if not essential, to the effective conduct of monetary policy.

The Committee also gave consideration to unifying Federal bank supervision in a single agency. Such a proposal would cope with most of the disadvantages in the present system. It would facilitate execution of consistent and uniform policy with respect to banking structure changes. It would end the possibility of rivalry among Federal agencies and eliminate the time and effort now devoted to the machinery for coordination. Such an agency would represent the focal point of Federal responsibility for bank supervision in the eyes of the President; the Congress, and the general public, as well as the banks subject to supervision.

*Locus of responsibility.*—Even those who favor such consolidation find it is easier to state the advantages of a single supervisory authority than to determine the most desirable locus for that authority.

The FDIC has a broad base among commercial banks. It now insures over 97 percent of all commercial banks and has cooperative arrangements with the State bank supervisory authorities. It would therefore be a logical repository for all Federal supervisory functions.

However, an agency with an insurance function might be so concerned with protecting the insurance fund that overly strict supervision of banks would hamper innovation and growth. In addition, the FDIC is publicly identified with State nonmember banks and its selection as the single supervisory agency might be taken—regardless of merits—as a threat to the national banking system.

Another possibility would be to accept the recommendation of the Commission on Money and Credit that all Federal supervisory responsibilities over commercial banks be transferred to the Federal Reserve. The Federal Reserve is not historically identified with either national or State banks and has broader responsibilities than bank supervision. Moreover, as noted earlier, the central bank has a strong interest in the structure of the banking system.

The major disadvantage is that even the present supervisory tasks of the Board interfere with its main responsibility. How much that interference would increase compared with the present arrangement is not clear. But, as noted earlier, a case can be made for relieving the Board of bank supervision and lessening that interference. An alternative would be to center the supervisory task at the Federal Reserve but to change its organization, by statute, to provide for the delegation of responsibility for bank supervision to individual Board members or to senior staff. (Indeed, this might be desirable even if the Board retains only its present responsibilities.)

Finally, there is the possibility of creating a new agency to incorporate the supervisory functions now vested in the Comptroller, the Federal Reserve, and the FDIC (which could be transferred as a corporate entity to the new agency). The major consideration against creation of a new agency devoted only to bank supervision is the danger that it might come to be identified with, or even dominated by, the industry it supervises. Some have contended that unification of Federal bank supervisory functions might be interpreted as a threat to the dual banking system. But experience with a single Federal supervisory agency in the case of savings and loan associations does not support this contention.

On the favorable side, such an agency would have the advantage of starting with a clean slate, without traditional identification with a particular segment of the commercial banking system. A new agency could be made a part of the Treasury Department, where it would have the advantage of access to the Cabinet through the Secretary, or it could be given independent status, which might enhance its ability to attract officials of the highest calibre.

*Conclusion 23.—The Committee concludes that practices of bank supervisory and examining agencies in the Federal Government have*

*not always been fully satisfactory in achieving needed cooperation and coordination.<sup>1</sup>*

*Existing agencies should strive to achieve greater cooperation and coordination under common standards, regulation and procedures, than has been achieved in the past. Reviews should be made, however, at the discretion of the President, to determine whether this approach is proving successful in anticipating and resolving major common problems. If the reviews indicate that important public purposes in this area still are not being achieved, consideration should then be given to more basic approaches, such as consolidation of bank supervision in the hands of two agencies, or a single agency or commission.*

### ***Federal Supervision of Other Financial Institutions***

In the case of savings and loan associations, Federal supervision is organized in a single agency. Examination, regulation, and insurance are all concentrated in the Federal Home Loan Bank Board, which manages the Federal Savings and Loan Insurance Corporation. The Committee does not recommend that this arrangement be altered in any fundamental way.

It has been proposed that, should Federal charters be made available to mutual savings banks, the Federal Home Loan Bank Board be designated as the supervisory authority. This would also involve insurance. The result would be that the Federal Home Loan Bank Board would be supervising two types of institution; furthermore, the question would then arise whether State-chartered but federally insured mutual savings banks should remain under the jurisdiction of the Federal Deposit Insurance Corporation. The Committee has no solution to these organizational problems but regards them as relevant if and when consideration is given to the proposal for Federal charters.

The Committee has no comment regarding supervision of Federal credit unions.

On the question of coordination between agencies supervising commercial banks, on the one hand, and other financial institutions, on the other, as recommended by the Commission on Money and Credit, there is no reason why such coordination cannot be worked out on an informal basis, as needed. Such coordination would become especially relevant if the Committee's recommendations on cash reserve requirements at mutual savings banks and savings and loan associations and on standby regulation of interest and dividend rates are implemented.

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<sup>1</sup> Four members believe that not only the practices but the organization of bank supervision is not fully satisfactory.

*Conclusion 24.—The Committee concludes, in the interest of improved coordination and implementation of Federal laws, regulations and policies affecting all federally supervised financial institutions (including savings and loan associations and credit unions), that the Federal chartering, supervisory and insuring agencies should meet at regular times, at less than quarterly, to discuss and resolve matters of current or mutual interest.*

## APPENDIX

THE WHITE HOUSE,  
Washington, March 28, 1962.

Memorandum to :

The Chairman of the Council of Economic Advisers.  
The Secretary of the Treasury.  
The Attorney General.  
The Secretary of Agriculture.  
The Director of the Bureau of the Budget.  
The Chairman of the Board of Governors of the Federal Reserve System.  
The Chairman of the Home Loan Bank Board.  
The Administrator of the Housing and Home Finance Agency.  
The Comptroller of the Currency.  
The Chairman of the Federal Deposit Insurance Corporation.

Subject: The Establishment of a Committee on Financial Institutions.

Pursuant to my Economic Report to the Congress, I am requesting the persons to whom this memorandum is addressed to form a Committee on Financial Institutions to review legislation and administrative practice relating to the operations of financial intermediaries. I am asking the Chairman of the Council of Economic Advisers to serve as Chairman of this Committee. The Committee should seek the views and advice of appropriate Government agencies and may also consult with interested private parties and independent experts.

The recommendations of the Commission on Money and Credit on this subject provide a point of departure for the Committee, but its deliberations need not be limited to the issues raised by the Commission. The Nation's monetary, credit, and financial system makes important contributions to the functioning of our free enterprise economy and to the effectiveness of Government policies under the Employment Act of 1946. The general task of the Committee is to consider what changes, if any, in Government policy toward private financial institutions could contribute to economic stability, growth, and efficiency. Recommendations for changes should provide for equitable treatment of the various types of financial institutions and for transitional arrangements that may be necessary to minimize any temporary disruptive effects.

Among the topics for consideration by the Committee should be the following :

- (a) The scope of controls over commercial banks and other financial intermediaries exercised by the Federal Reserve System and other governmental and quasi-governmental agencies: for example, membership in the Federal Reserve System and in the Federal Home Loan Bank System, reserve requirements, regulation of interest rates on deposits and other liabilities and on Government-guaranteed mortgages.
- (b) The possibility and desirability of broadening the permissible portfolio choices of various kinds of financial institutions.
- (c) The scope of Federal deposit and share insurance programs: criteria for voluntary and compulsory participation.

- (d) Federal chartering of financial institutions: life insurance companies, mutual savings banks.
- (e) Federal legislation with respect to branching of banks and other financial intermediaries.
- (f) Coordination and possible consolidation of Federal responsibilities for supervision, examination, and chartering of financial intermediaries and for regulation of merging and branching.
- (g) Adequacy of legislation and regulations to insure against unwarranted benefits to individuals handling funds for financial institutions.

In order to be of use in drawing up the Administration's legislative program for the 1963 session of the Congress, the Committee's report and recommendations should be submitted to me by November 30, 1962.

I am enclosing for your information copies of the memoranda establishing separate committees on Corporate Pension Funds and Other Private Retirement and Welfare Programs and Federal Credit Programs.

(S) JOHN F. KENNEDY.