

Confidential

UNIFICATION OF THE COMMERCIAL BANKING SYSTEM

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UNIFICATION OF THE COMMERCIAL BANKING SYSTEM

SUMMARY

The staff believes that unification should be obtained by requiring all commercial banks 1/

1. To operate under Federal charter, to become members of the Federal Reserve System, and to participate in Federal deposit insurance; or if this program appears inexpedient

2. To become members of the Federal Reserve System and to participate in Federal deposit insurance; or if this program appears inexpedient

3. To participate in Federal deposit insurance and to conform to certain of the minimum standards to which member banks are now subject.

It is further believed that participation of savings banks in Federal deposit insurance should be continued on a voluntary basis.

If the program described under either 1 or 2 is adopted, it probably will be necessary as a practical matter to change some of the existing requirements of Federal statutes with which many sound State banks would have difficulty in complying.

1/ Banks receiving any deposits withdrawable by check or similar instrument.

PRIMARY NEED--A COMPULSORY SYSTEM

There has never been a single authority in this country which was in a position to impose minimum standards of good banking practice upon all commercial banks, despite the fact that the checking deposits of the commercial banks are by far the most important means of making payments at the present time. The possibility of a bank's escaping from the jurisdiction of a particular banking authority has for decades been the outstanding shortcoming of the dual banking system. The management of a bank operating under national charter which did not wish to submit to the banking standards required by the national system sometimes converted the bank to a State institution. Likewise a State bank member of the Federal Reserve System which did not wish to comply with the standards of the System could avoid them by withdrawing from the System. Similar motives have caused some State banks to convert to national charters.

Standards have from time to time been lowered for all classes of banks due to the statutory and administrative competition in laxity which has resulted from the efforts of the State and Federal authorities to retain banks under their jurisdiction or attract additional banks. The establishment of a single authority with power to set minimum standards from which commercial banks cannot escape is the imperative need for a fundamental improvement in the banking structure.

The dual arrangement for chartering and supervising banks by both the Federal and State authorities, long recognized by many prominent bankers, business men, economists, and others as one of the inherent

weaknesses of the American banking structure, has contributed to the record of thousands of bank failures and periodic banking crises and has resulted in a competition between the national and State banking authorities which has weakened both systems.

A letter dated March 29, 1932, to the Committee on Banking and Currency of the Senate contained the following statement which expressed the unanimous opinion of the Federal Reserve Board: "....the establishment of a unified system of banking under national supervision is essential to fundamental banking reform." 1/ During the discussion at the hearing it was pointed out that competition between the State and national banking systems has resulted in weakening both steadily. At this point Senator Glass remarked: "I think the curse of the banking business of this country is the dual system." 2/ He requested the Board to "suggest to us a constitutional method of creating a unified banking system in this country." 2/

Constitutional Question. - In response to this request the General Counsel of the Federal Reserve Board prepared an opinion dated December 5, 1932, which concludes that Congress possesses the power to unify the commercial banking system. As with other constitutional questions, however, there are responsible persons who do not share this view. For example, Senator Glass has indicated on several occasions in recent years that he doubts that the powers of Congress are so broad. 3/ The Board's Counsel, in summarizing his opinion, stated:

1/ U. S. Congress, 72nd, 1st Session, Hearings on S. 4115, Part 2, March 29, 1932, p. 358; see also F. R. Bulletin, April 1932, p. 207.

2/ Ibid., p. 395.

3/ U. S. Congress, 73rd, 1st Session, March 9, 1933, p. 57.

"1. The power to create the national banking system and the Federal Reserve System as useful instrumentalities to aid the Federal Government in the performance of certain important Governmental functions includes the power to take such action as Congress may deem necessary to preserve the existence and promote the efficiency of these systems. McCulloch v. Maryland, 4 Wheat. 316; Farmers and Mechanics National Bank v. Dearing, 91 U. S. 29; Westfall v. United States, 274 U. S. 256.

"2. Having provided the country with a national currency through the national banking system and the Federal reserve system, Congress may constitutionally preserve the full benefits of such currency for the people by appropriate legislation. Veazie Bank v. Fenno, 3 Wall. 533; Legal Tender Cases, 12 Wall. 457.

"3. The existence of a heterogeneous banking structure in which there have been more than 10,000 bank failures during the past 12 years constitutes a burden upon and an obstruction to interstate commerce; and Congress may enact appropriate legislation to correct this condition. United States v. Fergar, 250 U. S. 195; Stafford v. Wallace, 253 U. S. 495; Board of Trade v. Olsen, 262 U. S. 1.

"Any one of these grounds standing alone would be a sufficient constitutional justification for the enactment of legislation restricting the conduct of the commercial banking business to national banks; and, when all three grounds are considered together, there can be no doubt that such legislation would be not only constitutional but also entirely appropriate and in accordance with a proper division of authority between the Federal Government and the States.

"Having the power to confine the commercial banking business to national banks, Congress can exercise that power in any manner which it deems appropriate and adequate for its purposes. It is not necessary that the legislation assume the form of a revenue act or an act to regulate interstate commerce, though either of these means would be appropriate." 1/

The opinion also suggested the following methods by which Congress could exercise the power to confine the commercial banking business to national banks:

1/ Federal Reserve Bulletin, March 1933, pp. 166-167.

"(1) It could forbid the receipt of deposits subject to withdrawal by check by any individual, partnership, or corporation other than a bank organized under the laws of the United States and provide suitable penalties for violations of this prohibition.

"(2) It could impose a prohibitive tax on all checks and similar documents drawn on, or payable at, banks not organized under the laws of the United States.

"(3) It could forbid any officer of the United States or any Federal reserve bank, national bank, Federal land bank, joint stock land bank, Federal intermediate credit bank, or Federal home loan bank to receive in payment, on deposit, for the purposes of exchange or collection, or for any other purpose, any check drawn upon any bank not organized under the laws of the United States.

"(4) It could forbid any bank organized under the laws of the United States to make loans or extend credit to, or deposit any of its funds in, or permit the use of any of its facilities by, any commercial bank not organized under such laws.

"(5) It could forbid the deposit of public funds of the United States in any bank not organized under the laws of the United States.

"(6) It could exempt all national banks from taxation, State or Federal, except taxes on real estate." 1/

Present Opportunity. - With the recollection of the banking crisis still fresh in mind the present occasion would appear to be a particularly timely one to attempt to unify the commercial banking system. If the administration with its overwhelming Congressional majority gave a program of this character its enthusiastic support, the possibilities of success would be greater than they may be again for decades.

The following paragraphs will discuss the advantages, disadvantages, and obstacles to attempting a legislative program of unification through

1/ Ibid., p. 186.

requiring all commercial banks

- (1) To operate under Federal charters, or
- (2) To become members of the Federal Reserve System, or
- (3) To participate in Federal deposit insurance.

COMPULSORY FEDERAL CHARTERS

Most Direct and Effective Method. - Compulsory Federal charters for all commercial banks would completely eliminate competition in laxity between Federal and State authorities by bringing to an end the so-called dual banking system of this country, as State authority in the field of commercial banking would cease. It would no longer be possible for a bank to switch from Federal to State charter in order to avoid complying with banking standards of the Federal system.

A unified banking system was temporarily achieved in a large measure in the years following 1863, primarily because national banks were accorded the privilege of issuing bank notes while the notes of State banks were subjected to a prohibitive tax. Senator Sherman, Chairman of the Finance Committee and chief sponsor of the National Bank Act, stated during the debates on the measure to tax the circulation of State bank notes: "The national banks were intended to supersede the State banks. Both cannot exist together..." ^{1/} For about 20 years the amount of banking business controlled by State incorporated institutions was negligible. During this period about 5 national banks per year failed on the average. If such a condition had obtained through the subsequent decades, it is likely that supervision, unaffected by the kind of competition that was later to develop, would have been able to maintain a higher standard of banking practice. Deposit banking began to develop on so large a scale, however, that State banks found it increasingly profitable to operate without the

^{1/} Congressional Globe, 38th Congress, 2nd Session, p. 1139.

privilege of issuing notes, and from about 1880 State banks have grown steadily in relative importance.

State banks have had many competitive advantages over national banks, notably in the matter of lower minimum capital and other requirements for receiving charters, and in more extensive powers and privileges which provided greater opportunities for making profits. Over the decades the Federal Government has been under pressure to grant similar powers and privileges to national banks. The granting of these powers has tended to remove some of the sound restrictions previously imposed by the National Bank Act. Thus it was that about the beginning of the present century, or somewhat earlier, there began between the national and the several State systems that form of rivalry which has been referred to above as competition in laxity.

Safety Record of National System. - Despite the competition in laxity which has weakened the standards of banking practice among banks operating under Federal charter, the safety record of banks in that system has been superior to that of banks exclusively under the jurisdiction of the States. On June 30, 1920, there were in operation 8,024 national banks. In the following decade and a half there were 32 suspensions among national banks for every 100 in existence in 1920. The comparable ratio for State member banks was 38 and for nonmember banks 51. During the decade and a half national banks which suspended involved \$15 of deposits for every \$100 of national bank deposits in existence in 1920. The comparable ratio for State member banks was \$17 and for nonmember banks \$37. Thus the ratio for nonmember banks was more than twice as

great as for national banks. During the years of liquidation beginning in 1930 the rate of reduction in deposits of nonmember commercial banks was about twice that of member banks.

It cannot be doubted that if all commercial banks had operated under Federal charters during the past 15 years the rate of bank failures would have been less. Not only did the weaknesses of State banking systems result in the failure of many State banks but their failure affected national banks and made it more difficult for national banks to resist bad times. It is impossible to disassociate the actual failure record from the competition in laxity existing over the decades which weakened the national system as well as the State systems. If all commercial banks had been under Federal charter, uniform standards of good banking practice could have been enforced. Privileges, restrictions, and supervision would have been sounder and more uniform. Rules with respect to capitalization, reserves, branches, and investment policies would have been equally applicable to all commercial banks. The banks would have been unable to play the State and national authorities against each other by threatening to shift from one system to the other. As difficulties or abuses appeared from time to time, they could have been promptly and adequately corrected without fear that the corrections might be nullified by banks withdrawing from the system.

Lesson of the Banking Crisis. - No more graphic picture of the infinite confusion that can be connected with the multiple system of bank supervision and control has occurred in the history of banking in the United States than the banking holiday of March 1933 and

the events leading up to it. During the summer of 1932 when there were signs that the long recession in business the world over was coming to an end, it was apparent that at the then existing prices of securities and other bank assets a large percentage of the banks in America was insolvent. There were those who felt at that time that matters had resolved themselves into a race between a recovery in prices and some spectacular failure. The Reconstruction Finance Corporation was propping up one situation after another, but it seemed inevitable that an unmanageable situation would appear somewhere.

If all commercial banks at that time had operated under Federal charter, a clear-cut policy might have avoided the banking crisis of 1933. There existed, however, the State powers in the field of banking; and because of the great number of parties at interest, they could not be brought together on common grounds.

It would not be too much to hazard a guess that the American banking system would never have had to go through the banking holiday of March 1933 if competition in laxity had not existed for three quarters of a century between the multiple banking jurisdictions of the United States.

It was not a fortunate thing, moreover, that the Federal administration was forced to fall back on a war power in order to declare the banking holiday beginning with March 6, 1933. The administration indeed was on such uncertain ground that prompt confirmation of its action was sought from Congress in the Emergency Banking Act. Even then it was said by some that the matter of Federal

closing of nonmember banks was a usurpation of constitutional authority, that the States were under no compulsion, and that success depended upon voluntary cooperation.

The Bank Conservation Act, passed by Congress on March 9, 1933, was of tremendous help in rehabilitating national banks. Since States do not possess as broad powers in the bankruptcy field as does the Federal Government, it is doubtful whether they could enact as constructive legislation to deal with a banking crisis.

Disadvantages of Continuation of State Powers. - The chief disadvantage of a plan for unifying the banking system such as compulsory Federal Reserve membership or compulsory deposit insurance, which would retain State charters and State supervision, seems to be the unfortunate alternative of indirect supervision or double supervision which the Federal authorities would be forced to accept. If such a system were adopted, the Federal supervisory authorities would either be forced to cooperate with and to a certain extent rely upon the State supervisory authorities and thus be content with a sort of indirect supervision, or they would have to institute a complete system of direct supervision while the banks continued to be subjected to the burden of superfluous parallel State supervision.

Another objection would be that the State authorities apparently would continue to handle the receiverships and liquidations of State banks. Unfortunate preferences often result when an insolvent bank is allowed to remain open. Conceivably this might be altered by Federal statute but to do so would be almost as drastic as requiring Federal charters. The present system under which the Federal Deposit Insurance

Corporation is authorized to accept the receivership of closed insured State banks if tendered by the State authorities clearly does not put this function under Federal authority. Every one of the eight insured State banks which suspended in 1934 was liquidated by State authorities; and 18 of the 20 such banks which suspended in 1935 were similarly liquidated. Damage may result to both the solvency of the insurance fund and the general credit situation of the country from too rapid or too slow liquidation of suspended insured banks. There is, of course, the additional fact that any waste or inefficiency in such liquidations necessarily become a direct burden upon the insurance fund.

Another difficulty which results from retaining State charters is the fact that although limitations might be placed upon the powers of the banks by Federal law, the banks would have no greater powers than those given them under the State law. Thus when the program was inaugurated to strengthen the banks through purchase of stock by the Reconstruction Finance Corporation, banks in many States could not participate in the program until special enabling legislation was enacted. In some States such legislation could not be enacted because of constitutional provisions. Similar situations arise in connection with reorganizations and consolidations. As long as the banks derive their charter powers from the States, it would seem that such situations are almost certain to recur.

While compulsory Federal Reserve membership or compulsory deposit insurance might serve to check the opening of unsound banks or branches, continuance of the State authorities in this field might greatly hamper and embarrass the Federal authorities. For instance, if State authorities chartered a bank or authorized a branch, even though the Federal authorities might veto such action and thus prevent the operation of

the bank or branch, the previous favorable action of the State authorities might easily be used by the interested parties as a strong argument and embarrassment to the Federal authorities.

Obstacles. - The outstanding disadvantage in a program to legislate all commercial banks under Federal charter is a political one. There are many more commercial banks in the country which operate under State charter than under Federal. On December 31, 1935, there were 5,386 national banks with deposits of \$24,800,000,000 compared with State commercial banks of 9,505 with deposits of \$20,300,000,000. This large number of State institutions and the State supervisory authorities would be the rallying point of strenuous political opposition to conversion to Federal charter.

The State banking system is regarded by some as a haven from what they consider oppressive Federalization. Many of these interests would like to continue to enjoy the advantages of a system of competition in laxity. A former President of the American Bankers Association said that, if all commercial banking were under Federal control, business could no longer conduct its affairs in entire independence of Federal influence; ours is a government of checks and balances, and the fact that banking has a free choice whether it shall render its services to the people under Federal or State charter is one of the most important of these.

While many would have been glad to see all commercial banking carried on under Federal charter, they have not regarded it as a practical objective. For example, the Governor of the Federal Reserve Board, in testifying before the House Committee on Banking and Currency in March 1935, told the Committee that, although he thought it would be

desirable to abolish State powers to create banks, it was impracticable at that time, since "we cannot go faster than the people of the country are willing to have us go." 1/

Many of the important institutions in the country have been in favor of a unified banking system through compulsory membership in the Federal Reserve System. Those that operate important trust companies organized under State laws, however, would be likely to join with others in opposition to unification through Federal charters. When a trust company is converted to Federal charter, various problems may arise in connection with fiduciary business. For example, in the Worcester County National Bank case a Massachusetts trust company was merged with a national bank and the courts held that under the law of that State the national bank would be required to procure new court authorizations for acting in the case of trusts administered by the previously existing State institution. Perhaps difficulties of this character could be overcome by leaving the fiduciary business in the trust company and transferring the commercial banking business to a newly organized bank operating under Federal charter. The definite termination of competition in laxity might lead to the repeal of State laws which produce such difficulties.

It is possible that because of sentimental or other reasons some institutions operating under State charters granted scores of years ago would have strong objections to conversion to Federal charter. These objections might be lessened if institutions in making the conversion were permitted to retain their well established names.

1/ U. S. Congress, 74th, 1st Session, Hearings on H. R. 5357, March 1935, p. 427.

There are some other requirements, such as certain restrictions on loans, which apply only to national banks and which would create problems only under an attempt to require Federal charters. Others, such as restrictions on investments, par clearance, and capital requirements, apply to both national and State member banks and would create problems in connection with either compulsory Federal charters or compulsory Federal Reserve membership. The last two perhaps are the most prominent.

Par Clearance Problem. - There cannot be any doubt that hundreds of small banks find Federal charters and the Federal Reserve System unattractive because of the matter of par clearance. Although more than 6,000 banks not members of the Federal Reserve System were participating in the par collection system at the end of 1935, there were at that time 2,553 nonmember banks, concentrated largely in 15 States, which were making charges for remitting funds outside of their localities. Of these 2,553 banks, 2,190 had deposits of less than \$500,000 each. In the case of many small banks the earnings from exchange charges represent the difference between a little net profit and none at all.

At a meeting of the Governors of the Federal Reserve banks held in Washington on May 28, 1935, at which a discussion was held with respect to why nonmember banks do not join the Federal Reserve System, reluctance to forego the income from exchange charges, upon which some of the small banks depend very largely at this time, was given as one of the principal obstacles to their applying for membership. In recent months a number of national banks in the Northwest have converted into State banks and, upon conversion, have elected not to be included in

the Federal Reserve par list, apparently so that they might add to their income by charging exchange.

Minimum Capital Problem. - A requirement compelling all commercial banks to operate under Federal charter or as members of the Federal Reserve System would raise the problem of minimum capital requirements. Depending upon circumstances of location and organization, banks to be admitted to Federal Reserve membership must in some cases have capital of \$25,000, \$50,000, \$100,000, or \$200,000. To be eligible for conversion into a national bank a State bank must have a capital of not less than \$50,000.

Of the 8,500 commercial banks which were not members of the Federal Reserve System at the end of 1935 about 1,900 had less than \$25,000 capital and about 600 other banks could not meet the present capital requirements for Federal Reserve membership. This is exclusive of more than 300 branch operating banks which lacked the even higher capital requirements prescribed for branch systems. In addition there were more than 200 State member banks and 2,900 nonmember banks with a capital of \$25,000 or more but less than \$50,000, which could not be converted into national banks. Thus nearly 6,000 State banks were not eligible for conversion into national banks under present provisions of the National Bank Act.

No doubt the soundest principle with respect to the two outstanding problems of capital requirements and par clearance would be to require all commercial banks to meet the standards of the Federal system. In view of the high mortality among banks with capital of less than

\$50,000, it might be more in the public interest if all such banks were required to increase their capital, go out of business, or be taken over as branches of larger institutions within a reasonable period of time.

It has been suggested that the problem of capital requirements might be simplified if the present provision of Federal law were repealed and a provision substituted to require capital which appeared adequate to the supervisory authorities, who would take into consideration the deposit liabilities of the bank and other corporate responsibilities. It is quite possible that the Federal authorities would find many banks whose capital is low in amount and yet sufficient in relation to deposits and other factors to warrant their being converted to Federal charter or admitted to Federal Reserve membership. Some minimum capital, however, should be required.

COMPULSORY FEDERAL RESERVE MEMBERSHIP

The First Alternative to Compulsory Federal Charters. - If it appears inexpedient to press for Federal charters in the near term, compulsory membership in the Federal Reserve System might nevertheless be attained. This method of unification would avoid the necessity of destroying at one stroke the powers of the States in the commercial banking field. It would, therefore, be likely to encounter less opposition from State bank supervisors and others interested in the preservation of the State banking systems. It would also avoid some of the difficult problems which would be associated with transferring the commercial business of some large trust companies to Federal charter. This degree of unification would make it possible for the first time in the history of American banking to prescribe some standards from which no commercial bank could escape.

Just as the establishment of the national banking system was intended by its sponsors to eliminate State institutions from the commercial banking field, so in 1913 it was hoped that the Federal Reserve System would provide a means of unification of commercial banks operating under national and State charters. Even the urgent proposals of President Wilson during the war days, that State banks join the Federal Reserve System as a patriotic measure, brought in relatively a small number of the State banks and trust companies, though practically all those of large size did become members. The last two decades have amply demonstrated that it is idle to hope for unification by any voluntary method.

The safety record of State bank members of the Federal Reserve System during the past 15 years was substantially as good as the record

of national banks and better than that of nonmember banks. This was partly the result of the fact that member banks were stronger and larger institutions on the average than nonmember banks. Nevertheless the whole commercial banking structure would have been in a better position to meet the banking crisis of 1933 if all State banks had been members of the Federal Reserve System.

Many of the advantages which would result from compulsory Federal charters would result from compulsory membership in the Federal Reserve System if broad powers to prescribe and enforce sound banking standards were conferred. The division of responsibility with State authorities, however, would continue. The disadvantages of continuing State powers, pointed out in the discussion of compulsory charters, are serious enough to suggest definitely that the plan of compulsory Federal charters is much to be preferred.

The Chief Advantages. - An advantage of compulsory Federal Reserve membership as contrasted with compulsory deposit insurance is the fact that all banks would automatically become subject to a number of sound provisions to which member banks are now subject but insured banks are not.

A vital thing that compulsory membership in the Federal Reserve System would accomplish which would not be attained by compulsory participation in Federal deposit insurance concerns the power of the Board of Governors to influence credit conditions by making the reserve position of banks easier or tighter. If some commercial banks do not carry their reserves with Federal Reserve banks, the policy actions of the System affect nonmember commercial banks indirectly rather than directly as is the case with member banks.

It is true that members of the Federal Reserve System had \$28,000,000,000

of demand deposits on December 31, 1935, while banks outside the System had only \$3,100,000,000 of such deposits. ^{1/} However, as long as membership in the Federal Reserve System is voluntary, the danger exists that the Board's power to influence monetary conditions through altering the reserve position of member banks may be nullified or rendered ineffective by withdrawals from the System or by the possibility of such withdrawals. This danger is increased greatly as reserve requirements are raised. It is unfortunate for decisions with respect to altering the reserve position of banks to be influenced by considerations as to whether action will affect voluntary membership in the System.

Nonmember banks usually hold their reserves in the form of deposits with other banks. One of the most important purposes of the Federal Reserve Act was to lessen this condition known as pyramiding of reserves, which can result in a large volume of deposits to the public being supported by almost no real reserves. The existence of numerous nonmember banks perpetuates these unsound possibilities, which unfortunately may become more serious if changes in reserve requirements, now an important instrument of national monetary control, result in withdrawals from the Federal Reserve System.

Aside from the matter of credit policies, a distinct advantage would accrue to small banks in carrying their reserve balances with Federal Reserve banks instead of with city correspondents. The State-wide banking holidays declared in several States in early 1933 are traceable to the difficulties of small banks which resulted from the freezing of their reserve balances held by their city correspondents which had been forced to suspend

^{1/} Time deposits excluded since compulsory Federal Reserve membership has not been suggested for mutual savings banks having about \$10,000,000,000 of such deposits.

payments.

While it would not be as easy to do as under a system of compulsory Federal charters, compulsory Federal Reserve membership would make it possible gradually to work toward substantial uniformity of standards with respect to charters, examinations, supervision, loan and investment policies, etc.; to inaugurate a policy for improvement in bank management; and to take other measures which cannot be made fully effective now because of the possibility of withdrawals from Federal Reserve membership.

Favorable Opinion. - Numerous men of affairs and responsible business groups have time and again recommended that all commercial banks be compelled to operate as members of the Federal Reserve System. One of the country's leading industrialists and financiers made a recommendation of this character at a Congressional hearing in 1931. At the same time, he indicated that in the long run he hoped that all commercial banks would operate under Federal charter, though he did not think this move should be pressed as a first step. 1/ The Banking Board of the State of New York in 1933 recommended compulsory membership in the Federal Reserve System for all banks and trust companies of that State. 2/ A report of a committee of the Chamber of Commerce of the United States recommended that every bank doing a commercial banking business should ultimately be made a part of the Federal Reserve System. The report stated that "Bringing all commercial bank deposits into a single unified system under Federal regulation will result in (1) effective control over the principal circulating medium of the country; (2) effective influence upon the volume and,

1/ U. S. Congress, 71st, 3rd Session, S. Res. 71, Part 2, Feb. 4, 1931, pp. 353 ff.

2/ Report on Banks of Deposit and Discount, Annual Report of the Supt. of Banks of N. Y., 1933, p. 41.

to some extent, upon the directions of use of bank credit; (3) more uniformity of commercial banking policy and practice; and (4) an opportunity to concentrate effort on measures to secure the safer operation of banks." 1/ The California Bankers Association, 2/ the Reserve City Bankers Association, 3/ and others could be similarly cited.

Obstacles to Compulsory Federal Reserve Membership. -- Many of the practical considerations which are obstacles to compulsory Federal charters are also obstacles to compulsory Federal Reserve membership. Some of these obstacles might be removed by granting the Federal supervisory authority power to waive statutory requirements under appropriate conditions. This could be done somewhat more readily under a program for compulsory Federal Reserve membership, because some of the restrictions now applicable to national banks do not apply to State bank members of the Federal Reserve System.

Among the obstacles to Federal Reserve membership as well as to Federal charters are the reluctance of small banks to forego remittance charges, the lack of sufficient capital among small banks to meet the requirements prescribed for membership, and the inexpediency of lowering Federal Reserve standards in order to admit banks to membership. Other such objections include the fear of increased reserve requirements, the absence of need for Federal Reserve rediscount accommodations, the requirements with respect to

1/ Banking Legislation, Chamber of Commerce of the U. S., March 1933, p. 4.

2/ The California Banker, June 1933, p. 268.

3/ Summary of Arguments on Title II of the Banking Bill of 1935, prepared by the Commission on Banking Law and Practice, Association of Reserve City Bankers, May 20, 1935, pp. 40-41.

reports of affiliates, the restrictions on loan and investment policies, and the heavy capital requirements in certain circumstances in connection with the establishment of branches.

Some of these objections might well be cited as good reasons why commercial banks should be compelled to be members of the Federal Reserve System. So long as a large number of State banks is allowed to operate under lower standards than those implicit in the matters just referred to, the weakening effects upon the Federal system growing out of competition in laxity will not be obviated.

The strength of the opposition to compulsory Federal Reserve membership is illustrated by the experience of recent legislative history with respect to permitting banks not members of the Federal Reserve System to participate in Federal deposit insurance. The original provisions in this connection, passed June 16, 1933, contemplated that after the lapse of a short period all banks enjoying the protection of the Insurance Fund should become members of the Federal Reserve System. Opposition to this provision in Congress has been such as to modify it substantially. By the terms of the Banking Act of 1935 the present stipulation is that compulsory membership in the Federal Reserve System will be required after July 1, 1942, only for insured State banks with deposits aggregating \$1,000,000 or more. Only one out of 7 of the approximately 8,500 commercial banks which do not belong to the Federal Reserve System had as much as \$1,000,000 of deposits at the end of 1935.

When the modification described above was in process of enactment, its supporters in the House of Representatives clearly indicated that they were unwilling to sponsor unification through membership in the

Federal Reserve System. This position has been reiterated in the interim. The Chairman of the Banking and Currency Committee of the House of Representatives in addressing the convention of State bank supervisors in Detroit in September 1936 affirmed the attitude in this connection of the element which he represents. 1/ The public opinion which thus registers itself in Congress has been indicated by numerous resolutions of meetings of State bank supervisors and State bankers associations as well. 2/

On the matter of lowering Federal Reserve standards in order to admit banks to membership, one group of responsible bankers has said: "To many, instead of lowering the Federal Reserve standards, it would seem preferable to give the Federal Deposit Insurance Corporation power to work with the large number of small banks which have survived the depression and which are rendering a useful service, until such time as they can conform to the standards of a nation-wide banking system. Then and only then is it likely that this country will have a banking structure which will survive in bad times as well as in good." 3/ It might be noted in this connection, however, that the large banks of the cities have sometimes been accused of having no enthusiasm for seeing their country correspondents join the Federal Reserve System because it would result in reducing some of the lucrative relationships of the city banks.

1/ American Banker, September 21, 1936, p. 15.

2/ Proceedings of the 33rd Annual Convention of the National Association of Supervisors of State Banks (1934), p. 104. Also Report of Committee on Resolutions of the Missouri Bankers Association in 1935.

3/ Summary of Arguments on Title II of the Banking Bill of 1935, prepared by the Commission on Banking Law and Practice, Association of Reserve City Bankers, May 20, 1935, pp. 41-42.

COMPULSORY DEPOSIT INSURANCE

If it appears inexpedient to press for compulsory Federal charters or membership in the Federal Reserve System for all commercial banks, the commercial banking system could nevertheless be strengthened considerably through requiring all commercial banks to participate in Federal deposit insurance and gradually to conform to as many as possible of the sound provisions to which member banks are now subject. A program of this character would make it easier to avoid such obstacles as par clearance and minimum capital requirements and at the same time preserve the existing standards of Federal Reserve membership.

Federal authority over insured State banks would not, of course, be nearly as strong or effective as in the case of a single system of banks operating under Federal charter, nor even as effective as it would be if all commercial banks were required to be members of the Federal Reserve System. Nevertheless the bringing together of all national and State commercial banks under some form of coordinated supervision would be a distinct improvement over the present situation, under which banks may at will remove themselves entirely from Federal jurisdiction. Compulsory Federal deposit insurance would provide the nucleus for a completely effective control of commercial banks in the long term. Indeed some proponents of the plan of compulsory Federal charters would much prefer to bring about such a result step by step rather than at a single stroke.

Present Participation in Deposit Insurance. - The Deposit Insurance System already comprehends nearly 95 percent of the number ~~and~~ 98 percent

of the deposits of all commercial banks. The following tabulation shows that at the end of 1935 there were 9,505 commercial banks with deposits of \$20,300,000,000 outside of the national system, and 8,507 banks with nearly \$6,700,000,000 of deposits did not even belong to the Federal Reserve System. Only 836 commercial banks, however, with deposits of \$1,200,000,000, were not participating in Federal deposit insurance.

Commercial Banks, December 31, 1935

(Each with some demand deposits)

Class of bank	Number	Deposits (millions of dollars)
Non-insured	836	1,158
Insured banks not members of the Federal Reserve System	7,671	5,523
National	5,386	24,802
State member	<u>998</u>	<u>13,648</u>
Total	<u>1/ 14,891</u>	45,131

1/ Includes 95 Morris Plan, industrial, and private banks reporting some demand deposits, and 39 cash depositories (all in South Carolina); excludes 567 mutual savings banks, 70 other banking institutions without demand deposits, 82 banking institutions without any deposits, and 253 banking institutions for which figures on deposits are not available.

Many banks which are not on the Federal Reserve par list are nevertheless participants in Federal deposit insurance. For example, in the 10 States, Minnesota, North Dakota, Wisconsin, Nebraska, Tennessee, Mississippi, Georgia, North Carolina, Louisiana, and Alabama, where sentiment for remit-

tance charges is strong, there were on December 31, 1935, about 1,600 non-member banks that had not agreed to remit at par but had become members of the Federal Deposit Insurance Corporation. There were, however, in these States 1,566 member and nonmember banks on the par list, any one of which could have withdrawn from Federal Reserve membership or from the par list if it had found par remittance too burdensome.

Compulsory vs. Voluntary Insurance Participation. - It is well known that compulsory membership in the Federal Reserve System is generally opposed by the supervisors of banking in the various States. On the other hand, many such authorities favor Federal deposit insurance and give it much credit for restabilizing the banking system. One supervisor had gone so far as to say that banks which do not belong to the insurance fund should be regarded as leeches upon the other banks that support the fund, which may be given credit for restoring the confidence of the people in the banking system of the country.^{1/}

There were many persons, such as Senator Glass, who accepted deposit insurance in the Banking Act of 1933 because it was hoped that it might serve to bring all commercial banks under a single authority. Senator Glass stated that the only excuse for deposit insurance was as an agency to bring about a unified system through membership in the Federal Reserve System and that the President and the then Secretary of the Treasury had felt the same way. All of them had been persuaded to go along with the insurance principle for that reason.^{2/} Many students of banking doubt whether voluntary participation in Federal

^{1/} Superintendent of Banks of Iowa, Proceedings of the Thirty-fourth Annual Convention of the National Association of Supervisors of State Banks, November 7-9, 1935, p. 33.

^{2/} U. S. Congress, 74th, 1st Session, Hearings on S. 1715 and H. R. 7617, April 1935, p. 85.

deposit insurance will ever result in a unification of the banking system. The possibility of a bank's doing a successful business as an uninsured bank exists, as the tabulation given above indicates.

It would not be any great hardship to require the few hundred uninsured commercial banks to become insured, and they should not be permitted to profit from the stability which insurance has brought to the banking business without supporting the principle. Experience has amply demonstrated that no single authority will ever gain complete jurisdiction over the commercial banking system through indirection and enticements. This end must be attained by Federal legislation.

The friends of Federal deposit insurance compose the elements which have always been able in the past to prevent unification through Federal charter or membership in the Federal Reserve System. These elements might find persuasive an argument that everything should be done to preserve Federal deposit insurance. However, they have not had occasion to express themselves on a definite proposal for compulsory deposit insurance. Their friendliness for the insurance principle might not extend to a measure which would run counter to some of their own desires by curtailing competition in laxity and weakening the influence of the State authorities.

If creation of the Federal Deposit Insurance Corporation was constitutional, presumably Congress has the power under McCulloch v. Maryland to do whatever is necessary to preserve it. The principle of insuring the deposits of commercial banks can be kept sound only by giving the insuring authority the power to impose sound banking principles upon the entire commercial banking system.

Since it is possible for a commercial bank to operate outside of the insurance system, insured banks which do not wish to submit to principles of sound operation may withdraw from the insurance system. Lax banking practices which could obtain among uninsured banks could undermine the business of the insured banks. For example, Federal legislation prohibits an insured bank from paying interest on demand deposits. It does not appear equitable, nor would it be sound from the standpoint of the insurance system, to allow commercial banks to escape this regulation by staying out of or withdrawing from the insurance system and drawing off deposits of insured banks by paying interest on demand deposits. The success of Federal deposit insurance could be best secured by providing for compulsory insurance for all commercial banks.

Greater Power for Insurance Authorities. - To be effective compulsory participation by commercial banks in Federal deposit insurance would have to be accompanied by a strengthening of powers of the Federal supervisory authorities. They should be given the power to impose sound banking principles on all insured banks. They should have the power to remove incompetent managements and the power and funds to recapitalize a bank before all of its capital is exhausted. They already have power over the establishment of branch banking offices by the various classes of insured banks, and compulsory insurance would give them the power to veto the granting of a charter by State authorities to a bank if there were no sound basis for its organization. As many as possible of the other provisions that apply to member banks should gradually be made applicable

to insured banks, for example, the provisions regarding security affiliates, purchasing and dealing in securities, excessive investment in bank premises, excessively large boards of directors, and loans to executive officers.

An arrangement of this character might work in the direction of the abandonment by States of their supervisory activities with respect to commercial banks. In this connection there may be cited the agitation which has existed in North Carolina in the past year or two for the practical abandonment of State supervision of banks.

Competition in laxity would not end completely because there would still be 49 different systems clothed with the power to charter and supervise banks and to appoint receivers (or to fail to appoint them) when banks became insolvent. All the difficulties which have previously been mentioned in connection with the retention of State charters and State supervision would remain; and to the extent that member bank provisions named above were not made applicable to insured banks, other difficulties would remain.

Wisdom of Extending the Insurance Principle. There are some who would like to dispense with the insurance principle as soon as possible since they regard it as unsound. To such persons a program of forcing non-insured banks to participate in Federal insurance would appear to be progress in the wrong direction. Whatever the opposition may be to deposit insurance from the point of view of sound banking principles, however, it has strong friends. They believe that it was a necessity when enacted and has made distinct contributions to stabilizing banking conditions. The

sponsorship which put it through Congress clearly had popular support at the time of enactment. The evidence would indicate that this support has strengthened in the interval rather than weakened.

Recently the American Bank Depositors Association was formed under the chairmanship of a national banker. He has said that his organization proposes to campaign against any movement directed toward the emasculatation of the Federal deposit insurance principle and expects political leaders to make clear where they stand on the issue. The association holds that it is wholly American for the Government to promote the continuation and the success of the Insurance Corporation which has made all banks safe depositories for the money of the people, protecting them against losses from bank failures, and accounting for an unprecedented increase in bank deposits.^{1/}

If the banking structure can be so improved that failures are insignificant, as appears to be the case in certain other English speaking countries, deposit insurance may be dispensed with as unnecessary at some future date. On the other hand, if the banking structure is not progressively improved, it may degenerate progressively and the principle of deposit insurance might disappear through its own insolvency. Supervisory authorities should be interested in bringing all commercial banks under a single aegis so that experience will work toward the first condition rather than the second.

^{1/} American Banker, July 18, 1936.

SAVINGS INSTITUTIONS

Non-commercial Banks. The tabulation presented in earlier paragraphs brought out the number of banks as of December 31, 1935, that can be identified as in whole or in part commercial; that is, at least some of the deposits of each are demand deposits, which in general are subject to circulation by check. Official figures as of the end of 1935 accounted for the following other banking institutions:

	<u>Number</u>	<u>Deposits (millions)</u>
Mutual savings		
Insured	57	\$1,067
Non-insured	510	8,888
Others having no demand deposits	70	108
Having no deposits at all (mostly trust companies)	82	--
Distribution of demand and time deposits indeterminable	<u>1/253</u>	<u>108</u>
Total	972	10,171

1/ Includes the following non-insured institutions: 172 commercial banks, 63 small private banks, 16 Morris Plan and industrial banks, and 2 branches of foreign banks.

The 567 mutual savings banks, having deposits of approximately \$10,000,000,000 and located almost wholly in New York and New England, would be the only important class of banks which would not be compelled to join a unified system if the definition of banks for inclusion be "commercial banks."

It has been the general feeling in the Federal Reserve System for years that it would serve little useful purpose for these mutual savings institutions to be members of the System. They are not monetary banks

facilitating the exchange of goods and services as commercial banks are but deal with the accumulated wealth of their depositors.

The Insurance of Savings Accounts. - In view of some of the objectives which influenced the enactment of Federal deposit insurance, the question can readily be raised as to why compulsory participation in insurance should be required of only such banks as have demand deposits, omitting pure savings institutions.

Since no depositor is insured in a sum in excess of \$5,000, the holder of small deposits is more fully protected than the holder of large ones. The statistical evidence clearly indicates that among insured banks the weight of large uninsured deposits is demand deposits while the savings deposits are insured to a much larger extent. This situation is no doubt in keeping with two of the principal objectives of the framers of the insurance act. The first of these was to protect the savings of small savers against loss; the second, to protect banks from hysterical runs for which small savings depositors are often responsible. It would appear clear that the authors of the act have not been much concerned with protecting large demand depositors who by and large represent business interests capable of taking care of themselves.

On the other hand, it has worked out under voluntary participation in deposit insurance that the major fraction of deposits no portion of which is insured is held by the more than 500 mutual savings banks which do not belong to the Federal Deposit Insurance Corporation. Other apparently satisfactory arrangements have, however, been made for the pro-

tection of mutual savings banks and their depositors in at least two principal States in which they operate. In New York, for example, where half of all mutual savings deposits are concentrated, a special trust company has been organized to act as a liquifying agent for mutuals. In Massachusetts a special system for insuring deposits of mutuals, the deposits of which in that State aggregate \$2,000,000,000, is in operation as well as a rediscount organization. Similar arrangements exist in some other States where mutual savings banks operate.

The protection already provided for mutual savings banks and their depositors perhaps is adequate in view of the special character and stability of these institutions. Mutual savings bank deposits cannot be circulated by check and the depositor must appear at the bank's window to get his funds. The aggregate of funds which may be accepted from one depositor is usually limited to an amount such as \$5,000, \$7,500, or \$10,000. All of their deposits (with possible minor exceptions in individual cases) are time deposits and the contracts under which they are accepted specify that notice may be required before they are surrendered. It is true that in ordinary times mutual savings banks have not required that the notice be given, but following the banking holiday they had no difficulty in enforcing the requirement of notice and in restricting withdrawals. On the other hand, an ordinary commercial bank, which has not been requiring notice for withdrawal of savings accounts, cannot begin to do so without casting suspicion on its position and starting a run in its demand department.

Building and Loan Associations, Credit Unions, etc. - If mutual savings banks were to be included in a unified system of deposit banks, the question might well be raised as to why other groups of savings institutions should not also be included.

Building and loan associations by and large have functions similar to the mutual savings banks, since they bring together the savings of the people and invest them, not in liquid resources, but in the capital assets of the country, principally mortgages on urban real estate. They do not facilitate, as do the commercial banks, the exchange of goods and services by means of checking deposits. There are in the country about 10,600 building and loan associations with assets of \$5,900,000,000. ^{1/} It is true that the claims of savers on building and loan associations are generally in the form of shares of stock, but as a matter of practice many building and loan associations stand ready to meet claims upon the associations on demand or short notice.

Credit unions also represent a class of financial institution which deals with savings, returning them upon comparatively short notice. Policyholders in life insurance companies have savings claims which are subject to withdrawal upon short notice. The cash surrender value of life insurance policies in this country at the present time is said to approximate the life insurance reserves of the companies, a figure not far from \$20,000,000,000.

The broadness of the field comprehended by savings institutions suggests caution in invading it by compulsory unification. There are also certain constitutional arguments, based on the Federal Government's

^{1/} Latest available figures - Federal Home Loan Bank Review, October 1936.

monetary powers, which support compulsory unification of commercial banks but would not apply to compulsory unification of savings institutions. Moreover, from a political point of view it has often been argued that in a program of unification good strategy recommends leaving something to the States.

Savings Deposits in Commercial Banks. - The group of about 15,000 commercial banks which would be brought into a unified banking system under any plan of compulsion includes only 562 banks which had no time deposits on December 31, 1935. The remainder had some such deposits, aggregating \$13,000,000,000 for all banks. Their demand deposits aggregated \$32,000,000,000.

However, there is considerable difference between subjecting time deposits in commercial banks to this incidental compulsory unification and attempting to compel purely savings institutions to enter a unified system. The existence of these time deposits in commercial banks does not alter the necessity for compulsory unification of commercial banks.

Problems arising out of operating both a demand and savings deposit business within the same institution are the subject of considerable current discussion. Some leading bankers suggest the possibility of changing the nature of the contract with respect to savings funds. One suggestion contemplates the issue of short-term debentures to savers in lieu of a deposit credit. It is argued that an arrangement of this sort would mitigate the evils connected with attempting to liquidate long-term assets caused by savings depositors' demanding the banks to pay them on short notice. Some students go so far as to suggest that a thoroughgoing reform of the American banking system would look toward

the separation into specialized institutions of the two types of business. Under such a reform there would be two classes of institutions, on the one hand pure savings banks, and on the other pure commercial banks. Whether this is an ideal objective or not it cannot be realistically suggested as part of a near-term program. There is, for one thing, too large a school which does not find persuasive the argument that the two businesses cannot be soundly operated in one institution. Those who are convinced of the unsoundness of the mixture of the two businesses are stumped by the practical problem of unscrambling the existing situation.