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OPERATION OF THE NATIONAL AND FEDERAL RESERVE BANKING SYSTEMS

APRIL 22, 1932.—Ordered to be printed

Mr. GLASS, from the Committee on Banking and Currency, submitted the following

REPORT

[To accompany S. 4412]

The Senate Committee on Banking and Currency has had under consideration S. 4412, "To provide for the safer and more effective use of the assets of Federal reserve banks and of national banking associations, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes," and reports it back to the Senate with the recommendation that the bill be passed.

The bill thus reported is the result of extensive hearings by a duly authorized subcommittee of the Banking and Currency Committee of the Senate and, more recently, hearings by the general Banking and Currency Committee. The investigation of banking problems was held under the terms of Senate Resolution No. 71, adopted at the second session of the Seventy-first Congress, reading as follows:

Resolved, That in order to provide for a more effective operation of the National and Federal reserve banking systems of the country the Committee on Banking and Currency of the Senate, or a duly authorized subcommittee thereof, be, and is hereby, empowered and directed to make a complete survey of the systems and a full compilation of the essential facts and to report the result of its findings as soon as practicable, together with such recommendations for legislation as the committee deems advisable. The inquiry thus authorized and directed is to comprehend specifically the administration of these banking systems with respect to the use of their facilities for trading in and carrying speculative securities; the extent of call loans to brokers by member banks for such purposes; the effect on the systems of the formation of investment and security trusts; the desirability of chain banking; the development of branch banking as a part of the national system, together with any related problems which the committee may think it important to investigate.

For the purpose of this resolution the committee, or any duly authorized subcommittee thereof, is authorized to hold hearings, to sit and act at such times and places during the sessions and recesses of the Seventy-first and succeeding Congresses until the final report is submitted, to employ such clerical and other assistants, to require by subpœna or otherwise the attendance of such witnesses and the production of such books, papers, and documents, to administer such oaths, and to take such testimony, and make such expenditures as it deems advisable. The cost of such stenographic services to report such hearings shall not be in excess of 25 cents per hundred words. The expenses of the committee, which shall not exceed $15,000, shall be paid from the contingent fund of the Senate upon vouchers approved by the chairman.

Acting upon the authority of the foregoing resolution the Senate Committee on Banking and Currency appointed a subcommittee to conduct the inquiry, which subcommittee proceeded in three ways:

1. It held hearings during the months of January and February of the year 1931 and at these hearings interrogated numerous witnesses, representing the banking, financial, and technical elements in the community, who either indicated a desire to be heard or were invited by the committee as probably possessing information that would be valuable.

2. Inquiries were made among a select list of representative banks by the method of questionnaires. Lists of questions were carefully formulated by experts and transmitted to the banks; and, in nearly all cases, replies of a full and complete description were forwarded by the latter. These have been carefully analyzed and the result published as appendixes to the hearings.

3. Statistical and other investigations were conducted by investigators attached to the committee; and their results reported and published in connection with the hearings. In addition, reports on topics of a technical nature calling for special inquiry were placed before the committee.

In addition to the foregoing the committee carried on an extensive correspondence and received numerous suggestions, recommendations, and other presentations of argument or evidence. It also received various drafts of proposed legislation, and gave due consideration to all. It found, however, that public opinion was in an indeterminate condition on the whole subject, and felt that immediate emergencies were so great that it was wise to defer the preparation of a completely comprehensive measure for the reconstruction of our banking system, such as had been urged by some responsible men. Hence the committee resolved to construct a bill to correct manifest immediate abuses, and to bring our banking system back into a stronger condition. Thus, for example, it seems to be the consensus of opinion among banking authorities that the United States will never have a complete and strong system until such time as it shall succeed in fully harmonizing and adjusting State and Federal laws on banking questions. This might involve a constitutional amendment or some equally far-reaching measure necessitating a long postponement of action.

The immediate measures of reform and rectification are, however, quite important. They include the correction of evils which reached a peak of danger in 1929 and abuses which have gradually grown up within the banking system itself. Immediate dangers and emergencies have been of so pressing a nature as to throw into the background many of the evils which have previously been recognized and to divert discussion from causes to the immediate effects of what was done in recent years. It is, therefore, needful to consider at some length the general background of the banking conditions which culminated in the breakdown of 1929.

INFLATION OF BANK CREDIT

There seems to be no difference of opinion with reference to the statement that the years after 1925, and indeed to a smaller extent those preceding that date and subsequent to 1922, were years of a very great inflation of bank credit—as well as of commercial credit and, especially in the later years, of business. By inflation, in the sense in which that word is here used, is meant the increase of bank liabilities, usually demand liabilities, in a proportion or degree materially greater than the rate of increase indicated by the requirements of a gradual growth of business transactions involving the production and distribution of goods—in a degree or ratio, therefore, greater than that in which the need for media of exchange had grown—usually accompanied by corresponding changes in liquidity. By way of demonstration or illustration of this statement in very brief form, we may simply cite the enlargement of deposit liabilities of the banks during the past few years prior to 1929 and the great subsequent enlargement of investments and frozen loans. This growth was not paralleled by any similar enlargement of the demand for means of exchange, as is suggested by the various indexes reflecting the rate of production.

Inflation was also indicated by the uses to which the credit thus established was put and the advance in prices thereby brought about. It is now evident that the increase in deposit credit on the part of the banks already described was largely used in three ways: (1) In the carrying and inflating of the prices of securities, especially common stocks, (2) in the overdevelopment of real estate and real estate enterprises, and (3) in the upbuilding of a large capital equipment paid for with short-term accommodation but not funded at the time into longer-term loans.

BEARINGS ON CREDIT EXPANSION

Analysis of the sources from which the excessive credit used in the stock market during past years was drawn, is a primary factor in determining what was really at fault in the management of banking during the years in question. This is of special interest in connection with the so-called brokers' loans.

The loans in question are divided into two main groups, the one obtained from banks and bankers while a second represents those obtained from "others." These "others" were corporations and other nonbanking lenders, including investment trusts and many others having funds to spare who chose to advance them for use in supporting securities transactions. The question is thus naturally raised: Where did the "others" thus spoken of obtain their funds? They obtained them, of course, in substantial measure from the public at large through sales of new issues, which rose steadily through this period. In part, also, they were a result of the use of large war-time and postwar earnings, which were retained from stockholders instead of being paid out as dividends.

The major source of the inflation, however, was the creation of new bank credit through large loans and investments by banks that had substantial surplus reserves, owing to gold imports, open market operations of the reserve banks, etc.

USE OF PROCEEDS OF NEW ISSUES OF SECURITIES

A large portion of the funds obtained by these issues of securities from the public was unavoidably used in new construction and in carrying out the legitimate purposes of the businesses which thus obtained them from the investors of the country. Another large portion was, however, left over; it was not directly required for immediate use, the issuers of securities having overborrowed or overcapitalized themselves, so that they were in possession of more current funds than they needed. This surplus of funds went into the stock market and fostered excessive speculation, although it also stimulated business by being transferred to sellers of securities later on.

Where did the public which bought the securities of such corporations get the funds they thus supplied? Some portion of the money naturally came from savings and current incomes, but a larger fraction was unquestionably obtained from the banks by means of the security borrowings to which reference has been made at an earlier point. The banks were thus lending directly in unprecedentedly large amounts directly to brokers; but they were also lending in even larger amounts on collateral to the general public, which was then taking the funds so supplied and using them in large degree for the purchase of securities whose proceeds were applied to speculative loans in the market. The flow of funds through the hands of the general public into those of the corporations, and from the latter into the hands of brokers and dealers, who then re-lent the funds to the public engaged in speculation, was thus primarily the result of a loose banking policy which had turned from the making of loans on commercial paper to the making of loans on security. This policy was critically referred to by the Federal Reserve Board, which often called attention to it in its annual reports.

THE GROWTH OF ACCEPTANCE CREDIT

The general ease and accessibility of credit under the régime which existed prior to 1929 was accentuated by the issue of the instrument known as the bankers' acceptance. In its original purpose this form of lending was intended to include only unquestionably liquid obligations, growing out of the actual sale of goods in foreign trade, so that the acceptance became a short-term claim payable in international funds, usually gold. It was this conception of the instrument which was originally adopted in the Federal reserve act, and on which the use of the instrument by the Federal reserve system was founded. Later amendments to the reserve act, adopted during the World War, broadened the use of the acceptance and opened the door to the application of a conception of its use which was practically that of a finance bill—a bill drawn without reference to the immediately liquid character of a given transaction, and primarily based upon the general power of the parties to it to see that it was liquidated from some sourse. The use of the acceptance to supply what was called dollar exchange, although doubtless of advantage under proper restrictions, undoubtedly opened a door to grave abuses, which were in some measure responsible for the credit difficulties that later made their appearance in South American finance. These difficulties, however, were after all comparatively minor, the real dangers of the acceptance being exhibited in connection with the stretching of the definition of various transactions so as, for instance, to include storage of commodities as an incident to their moving abroad or moving from one market to another so that acceptances protected by such stored goods were regarded as acceptances made against goods actually moving in international trade. It was easy to pass from this view of the situation to another and more advanced view, wherein stored goods not sold during the period of the acceptance were used as goods properly providing a basis for renewal of the acceptance so that revolving acceptances or acceptances growing out of revolving credits became common, notwithstanding official warnings against them.

From the domestic standpoint, it would seem clear that not a few banks had fallen into the habit of supplying their customers with funds through the issue and sale of their acceptances, without much regard to the question whether such acceptances were called for or not. That the large amount of reserve credit thus created prevented effective control of security loans and investments of the banks, and thus fostered the stock market boom, there can be little doubt.

Through these and similar means, too, a very large commitment on the part of American banks taken on behalf of foreign banks came into existence. Germany, in particular, proved to be a great borrower on this score, and the total of acceptances made directly or indirectly in order to provide funds for foreign banks grew to unprecedented amounts. The effect of these transactions upon the German banks themselves, in leading up to the German financial collapse of July, 1931, has been carefully traced by the international committee of bankers which met under the chairmanship of Mr. A. H. Wiggin in Basle, after the breakdown of Germany during the past summer, for the purpose of discussing ways and means of dealing with the German credit situation.

BANK INSOLVENCIES

Every discussion of the conditions which preceded the panic of 1929 must make full allowance for the bank insolvencies which during the years after 1924 began to grow so numerous. The following brief tabulation furnished to another subcommittee affords the facts regarding bank insolvencies during the year 1931, while figures for earlier years were furnished by the Comptroller of the Currency during the hearings of the past winter, and are computed on a somewhat different basis by the Federal Reserve Board in its monthly bulletin. It is obvious that bank failures, whatever may be the basis upon which they are computed, have reached an unprecedentedly high level after a long continued growth extending over a decade. The effect of these insolvencies prior to the panic of 1929, was twofold. They tended to break down the business structure of the country and particularly of the places and regions in which they were most numerous, and they tended to bring on local hoarding over large areas. The condition of affairs is complex, growing as it did, out of a variety of conditions. Most of these circumstances have been outlined in the hearings, and there is little use in further reviewing them at this point. For the most part they are well known.

There should, however, be no failure to recognize the important rôle played by these insolvencies in preparing the way for the general breakdown of 1929. The fact that they occurred more largely among "small banks," as has often been urged, in no way reduces the significance of the phenomenon. It points to a gradual disintegration of banking under present conditions and it reflects the community's way of gradually curing the evils complained of, though a lengthy and costly process. It was this tendency to bank failure starting 10 years ago after the depression of 1920–21 and steadily growing more and more pronounced, except during the boom years, until it reached the astonishing height touched in 1930 that has culminated in the great total of nearly 2,300 failures occurring in this country during the year 1931. This drift toward failure among banks laid the foundation for extreme difficulties experienced during the latter part of 1931, and necessitated the remedial measures that were then undertaken. Bank failures can not but be regarded as one of the fundamental symptoms that must be given primary study in the search for remedies to be applied to present conditions.

Bank suspensions in 1931, preliminary figures

	All banks		National banks		State bank members		Nonmember banks	
	Number	Deposits	Number	Deposits	Number	Deposits	Number	Deposits
Year 1931, total	2,290	$1,759,000,000	410	$473,000,000	108	$302,000,000	1,772	$984,000,000
Last quarter of 1931	1,049	866,000,000	199	244,000,000	51	155,000,000	799	467,000,000
November and December, 1931	527	388,000,000	99	128,000,000	26	37,000,000	402	223,000,000
October, 1931	522	478,000,000	100	116,000,000	25	118,000,000	397	244,000,000
November, 1931	174	69,000,000	35	28,000,000	8	4,000,000	131	37,000,000
December, 1931	353	319,000,000	64	100,000,000	18	33,000,000	271	186,000,000

STOCK-EXCHANGE SPECULATION

Stock-exchange speculation in excess is often spoken of by some as the cause and by others as an unfortunate result of the business, banking, and credit conditions which culminated in the panic of 1929. It was neither of these, but was an accompaniment or symptom of unsound credit and banking conditions themselves. The facts as to the expansion of such speculation are well known, and its history requires no repetition, but the major data, facts, and conclusions may be briefly summarized as including: (1) A steady increase in bank security loans and investments; (2) rising price resulting from the increased resulting demand; (3) a sporadically enlarging volume of stock-exchange operations and new issues made possible by popular enthusiasm thus engendered; and, finally (4) a violently fluctuating course of prices on the stock exchange continuing until the whole structure fell of its own weight, resulting in the sharp downward movement which began in the autumn of 1929 and has been followed by sporadic collapses at various times since.

INFLUENCE OF PUBLIC FINANCE

It must be noted, in reviewing the situation which preceded the panic of 1929, that methods then adopted in connection with public finance had a very substantial share in bringing on the collapse of that year. Almost all governments both here and abroad have permitted themselves to overborrow on short term. When such borrowing has been effected at banks, as has been the case in most instances the result has been to add to inflation by getting the banks to carry as credit what was really long-term capital investment. In the United States very low money, the result of exceptionally low interest and discount rates, rendered it possible to effect such borrowing on a very economical basis. The result was the extended use of the banks for the purpose of carrying unfunded public debt, often in the expectation that such debt would be shortly funded and could be so funded at any time determined upon by the borrowing government as suitable. The growth of very large public-bond holdings, including not only the obligations of the United States but of various States and cities, operated strongly to limit the banks' liquidity by engaging their funds in what were really long-term investments. From the outbreak of the panic and during the subsequent depression there was never a favorable time for refunding, and the result has been to leave many banks with unduly large burdens of public bonds. So far as Federal reserve banks were concerned, the fact that the obligations of the Federal Government could always be used to protect member-bank borrowings inevitably tended to encourage such members in developing frozen portfolios.

REAL-ESTATE INFLATION

One element which deserves special notice in any study of prepanic conditions is afforded by real-estate inflation and speculation. It is not possible to find authoritative statements of the growth of the volume of real-estate loans and security investment in the portfolios of the banks and elsewhere, but the general facts in the case are clearly enough known. The immense increase in the volumes of real-estate bond issues and of real-estate mortgages both in banks and among the holdings of the financial institutions generally are the subject of widespread comment. What is less well recognized is the fact that an immense overexpansion of real-estate values was set in motion and that in consequence the coming on of the panic and their recognition that the country was "overbuilt" added an element of great difficulty to the situation. This element of difficulty is vividly illustrated by the circumstance that many institutions now find themselves hopelessly embarrassed by their real-estate commitments and by the fact that rents and selling values have so seriously shrunk.

PROBLEMS OF RESERVE BANKS

At times the reserve banks have held an unprecedented amount of gold during the past two or three years and the gold stock of the country has occasionally been well above $5,000,000,000, so that the reserve percentage of the reserve banks has been steadily high, notwithstanding fluctuations and a recent tendency to recede. These high ratios, however, have much less direct bearing upon the actual condition of the system than is generally supposed. The real problem of reserves is furnished by the relationship between the outstanding deposits of the banks of the country and the gold reserve which the reserve banks themselves carry. This ratio or relationship has until recent months shown continuous tendency to decline. The great gold movements of the past half year and the liquidation of many banks have somewhat changed the situation, but it has continued true that the ratio was inadequate while the tendency of a portion of the public to hoard currency has necessitated the issue of reserve notes in large volumes with corresponding shrinkage of the so-called free gold available. During the three years before the collapse of 1929 unduly low discount rates were a cause of danger to reserve banks. They have been viewed by some banking authorities as a chief cause of the difficulties which compelled Great Britain to abandon the gold standard in the summer of 1931. The question of reserve policy is an involved and complex one on which your committee took much testimony and also pursued an extended study whose results are stated, in the words of the reserve banks themselves, in part 6 of the hearings (appendix). So fully are the facts there reviewed and so authoritatively are they stated by the reserve-bank authorities that it has not been thought necessary to enlarge more fully upon the situation in this report.

CONDITION OF MEMBER BANKS

The outstanding development in the commercial banking system during the prepanic period was the appearance of excessive security loans, and of overinvestment in securities of all kinds. The effects of this situation in changing the whole character of the banking problem can hardly be overemphasized. National banks were never intended to undertake investment banking business on a large scale, but the whole tenor of legislation and administrative rulings concerning them has been away from recognition of such a growth in the direction of investment banking, as legitimate. Nevertheless it has continued; and a very fruitful cause of bank failures, especially within the past two years, has been the fact that the funds of various institutions have been so extensively "tied up" in long-term investments. The growth of the investment portfolio of the bank itself has been greatly emphasized in importance by the organization of allied or affiliated companies under State laws, through which even more extensive advances and investments in the security market could be made. This question, like that relating to the policy and situation of reserve banks, has extensive ramifications which must be studied statistically. In order to provide material for such a study, the results of questionnaires addressed to a selected list of large banks, each possessing one or more affiliates, have been assembled in general tabular form with such explanation as is necessary to enable the reader to evaluate the figures thus given. They are presented as part 7 of the hearings (appendix).

ANALYSIS OF PRESENT BANKING PROBLEM

We have furnished thus far a merely descriptive account of the financial and credit conditions which preceded the panic of 1929. It now remains to consider these facts as exhibiting a distinct kind of banking problem and to inquire in what way remedies for it may be found. Specific conditions which stand out as requiring some remedy are therefore taken under consideration, as follows:

1. *Bank loans and their uses.*—It is evident from what has been said that the underlying factor in the whole prepanic situation was excessive use of bank credit. The question of "excess" is a question of judgment and can only be determined by noting in specific terms the forms it has taken and the remedies to be applied to them.

(*a*) The excessive use of bank credit in making loans for the purpose of stock speculation or, more generally stated, for the excessive carrying of securities with borrowed money was generally admitted before the panic of 1929, and almost universally since that time, to have been one of the sources of major difficulty, far exceeding in its scope any total that could be reasonably asked for as a basis for the financing of legitimate investment business. Under this same topic, too, must be mentioned the so-called "brokers' loan." These are merely a special form of securities loan in which a bank or commerical corporation or other enterprise advances funds through an intermediary—the broker—instead of lending direct; an excessive volume of brokers' loans must be considered in the light of the total volume of security loans outstanding. The category of brokers' loans obtained from "others" is a separate and especially difficult aspect of this problem.

(*b*) It seems clear that any remedial measure of legislation should seek to provide some check upon the abnormal growth of all security loans at banks as well as seek to limit the loans to brokers, especially those loans originating with "others." Such legislation, if successful, should operate to lessen the danger of a repetition of the experience of 1929. It is often suggested that control of this form of credit ought to be effected in some way through stock exchanges. Whatever may be thought of that method of approaching the subject, it is at all events certain that nothing of the kind would be likely to succeed without adequate banking control, while on the other hand, banking control alone may greatly ameliorate conditions in this field of credit.

(*c*) The line of reasoning thus presented leads us to propose:

(1) Legislation designed to control and limit brokers' loans, particularly to limit the use of funds of the reserve banks for this purpose.

(2) Legislation designed to restrain the diversion of bank funds to an undue degree into direct loans upon securities whether to brokers or to others.

(3) Legislation intended to prevent, so far as legislation can, speculative market loans by corporations engaged in industrial or business enterprises.

2. *Banking affiliates.*—There seems to be no doubt anywhere that a large factor in the overdevelopment of security loans, and in the dangerous use of the resources of bank depositors for the purpose of making speculative profits and incurring the danger of hazardous losses, has been furnished by perversions of the national banking and State banking laws, and that, as a result, machinery has been created which tends toward danger in several directions.

(*a*) The greatest of such dangers is seen in the growth of "bank affiliates" which devote themselves in many cases to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock often largely with the resources of the parent bank. This situation was never contemplated by the national banking act, and it would, therefore, appear that the affiliate system calls for the establishment of some legislative provisions designed to deal with the situation. It has been suggested from many quarters that the affiliate system be simply "abolished." This suggestion has much authority behind it, but, in addition to the manifest difficulty of enforcement, owing to the existence of well-known subterfuges to maintain control, there remains the question whether it would be of much real service so long as State legislation permits the growth of affiliates in connection with State banks and trust companies. The committee has, therefore, determined to present proposed legislation aimed at the following objects:

(1) To separate as far as possible national and member banks from affiliates of all kinds.

(2) To limit the amount of advances or loans which can be obtained by affiliates from the parent institutions with which they are connected.

(3) To install a satisfactory examination of affiliates, working simultaneously with the present system of examination applicable to the parent banks.

(*b*) *Group banking.*—Closely allied in many points of similarity with the affiliate system is the plan of group banking in operation in some parts of the United States, working, in a few cases, on a large scale. In this system a holding company is organized under State law and proceeds to buy a majority of the stock of a series of banks, operating them thereafter through the holding company. In this way in some districts such holding companies control the reserve bank of the district through ownership of enough banks to carry an election. The difference between this plan and the affiliate system itself is that in the one banks are owned by a State-organized holding company, while in the other State-organized companies (affiliates) are owned by a national bank's stockholders, or in some cases directly by trust companies, under some form of law which amounts to ownership by the parent bank itself. The evils of indirect control are similar in the two cases, and they may lead to similar abuses, as is seen when it is noted that holding companies also usually control companies organized for security financing. However, such companies have in some parts of the United States become well rooted, and the difficulty of eliminating or abolishing them in any effective way is similar to the difficulty of eliminating or abolishing the affiliates of city banks. It is, therefore, thought best to attempt the control and oversight of these companies on the following terms:

(1) Since the companies are State corporations, Congress has no control over them, except that which may be voluntarily granted. However, since the staple of their ownership or holdings is the stock of National and State member banks, it would seem that Congress may control the conditions under which such stocks may be owned and particularly voted.

(2) The affiliates of this type (holding companies) are prohibited from voting the stocks of national banks unless they are willing to undertake to accept examination by the Federal Reserve Board, divest themselves of ownership of stock and bond financing concerns, and comply with regulations designed to insure their ownership of sufficient free assets to make sure that they can satisfy the double liability of their shareholders in case any of the banks owned by such a company should go into the hands of receivers or be closed.

(3) It is thought that, in any event, holding companies should not be allowed, except in a severely limited way, to vote at elections of Federal reserve bank directors, since otherwise the Federal reserve bank would become merely the creature of the holding company. Such voting is therefore definitely restricted.

3. *Insolvency of banks.*—Within the past few years, the insolvency of banks has been a major cause of distress and business difficulty in all parts of the country. There is no one sovereign remedy for this condition or tendency. It grows out of the weakness of the banking system and the way to correct it is, of course, to correct defects in the system itself. However, we believe that this tendency to constitutional weaknesses is to be remedied or alleviated by measures of several sorts. These we shall briefly enumerate as follows:

(*a*) Strengthening of the capital of banks.

(*b*) Provisions for closer and stronger supervision.

(*c*) More careful restriction of investments.

(*d*) Requirements for the truthful valuation of assets.

(*e*) Protection of depositors and limitation of their losses through a liquidating corporation.

These provisions if acted upon in good faith by administrators will do something to correct the insolvency situation, but there is no denying the fact that our banking system is going through a period of great change and that the ultimate destination of the system is not yet fully clear. Because of that fact, provision for branch-banking powers under carefully qualified conditions with a view to making a larger experiment with branch banking is deemed essential and due provision for it is made. Specifically, what is proposed is the grant of power to establish branches of national banks not merely in the towns and cities in which they are located but also outside of such limits at any point within the borders of the State in which they exist, irrespective of State laws. Also, it is proposed that if by reason of the proximity of a national bank to a State boundary line the ordinary and usual business of the bank is found to extend into an adjacent State, the Federal Reserve Board may permit the establishment of a branch or branches in an adjacent State but not beyond 50 miles from the place where the parent bank is located. No national bank is to be permitted, however, to establish a branch outside of the city, town or village in which it is located unless it has a paid-in and unimpaired capital of not less than $500,000. sec 19

4. *Strengthening of Federal reserve system.*—The Federal reserve system has been seriously impaired of recent years and has wandered far away from its original function. This is the result of many complex conditions. Among these conditions has been the uncertainty of policy in the matter of exercising plainly authorized control by the central supervising authority at Washington and the tendency to submit rather timidly to considerations of immediate expediency. Among the reserve banks themselves there has been a decidedly dangerous drift toward the conversion of the system into a medium for transacting financial rather than commercial business. Further, the establishment of understandings or agreements with foreign central and other banks, and the attempt to carry out plans and measures of a hazardous nature relating to discount rates and problems of technique, have had unfortunate results.

To reform these conditions the committee recommends:

(*a*) Improvement of membership, and increase of independence of Federal Reserve Board.

(*b*) Restoration of the requirement that two members of the board shall be men of experience in banking.

(*c*) Elimination of the Secretary of the Treasury from membership.

(*d*) Better definition of powers with respect to speculative transactions, particularly as to authority over open market dealings, by establishing a so-called "open market committee" with designated authority.

(*e*) Definition of powers of the board in the management of foreign affairs.

5. *Protection of bank depositors.*—The great number of banks now in the hands of receivers with assets which are said to aggregate something like $2,500,000,000 has created a situation in which a very large number of persons are unable to meet their obligations and in which many business houses are embarrassed through inability to get the use of their funds. In the natural course of events it would be a long time before these conditions are very greatly relieved through the liquidation of these closed banks. The continued postponement of liquidation is a very heavy burden upon a large portion of the community. Furthermore, there is and can be no assurance that further failures of considerable amount and number can be avoided. They will from time to time recur even under the best conditions. In order to provide against a repetition of the present painful experience in which a vast sum of assets and purchasing power is "tied up," we have recommended the creation of a Federal liquidation corporation.

The proposal is that this corporation shall have a capital stock contributed by reserve banks to the extent of one-quarter of their present surplus, or a sum of about $68,500,000, while member banks shall subscribe to the extent of one-fourth of 1 per cent of total net outstanding time and demand deposits or a sum of approximately $75,000,000, so that the enterprise would have a subscribed capital of about $143,000,000. In addition, it is proposed that the Government contribute $125,000,000 to the corporation as paid-in surplus, and the corporation is empowered to issue notes, bonds, debentures, and other such obligations in an amount equal to not more than twice the sum of its capital and the amount appropriated out of Government funds. The sum thus made available would be adequate to deal with any probable failure conditions of the future. If the Government should add to it a proportionate sum for the benefit of State nonmember banks it would be able to include their necessities along with those of the system's own members as a subject of treatment. The corporation may be left free to invest its excess funds in the assets of banks that have already failed before it came into existence and it may thus materially help in clearing up the bad situation that has been left as a result of the panic.

6. *Emergency relief.*—Within recent months there has been a very widespread demand for some means of furnishing emergency relief to banks that are in difficult straits. The Federal reserve system was intended to furnish a means of mutual aid and if properly administered was entirely adequate to the necessities of the case. However, with conditions as they stand it is likely that some plan whereby

actual assistance could be furnished to banks which are willing to stand sponsor for one another and thus enable them to clear up danger spots in their own several communities would be helpful. We therefore suggested such a plan as an additional means of strengthening and rendering useful the provisions of the Federal reserve system. The general plan so recommended was founded upon the idea of joint action by clearing houses or groups of banks in different localities designed for the purpose of getting accommodation on their joint unsecured notes at reserve banks up to such amount as might be held prudent; likewise, in exigent cases, relief was provided for individual banks. Such emergency credit should be retired as soon as possible, and therefore it seemed best to provide severe restrictions upon its use and duration. This proposal was lifted from the body of the bill as first prepared and has already been enacted into law. (See Public No. 44, 72d Cong.)

TERMS OF BILL RECOMMENDED

Having thus outlined in general broad terms the main objects of the new legislation, although without endeavoring to do more than suggest the major features of the enactment, we think it best to review the actual provisions of the accompanying measure point by point in order to indicate the precise content of the various sections and their main provisions:

Section 1.—Provides a short title for use in citation, for convenience in discussion, and for certainty of reference.

Section 2.—Defines the language used in the bill and undertakes to make the meaning definite.

Section 3.—Places general restrictions upon the operating policy of Federal reserve banks with the intent to limit them to the extension of credit for ordinary business purposes and to make plain that their resources are not to be used to support speculation. The Reserve Board is given power to oversee and direct such use of the resources of banks.

This section also provides that where two or more member banks are affiliated with the same holding company, they may participate in the nomination and election of directors of the Federal reserve bank in their district through one of the banks to be designated for that purpose by the holding company.

Section 4.—Amends the first paragraph of section 7 of the Federal reserve act so as to eliminate the requirement of the payment of a franchise tax to the United States by Federal reserve banks.

Section 5.—Provides for reports of condition of affiliates of State member banks and for the examination of all such affiliates by examiners selected or approved by the Federal Reserve Board.

The section also subjects State member banks to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks. (See sec. 14.)

It is also provided that after three years from the date of enactment of the bill no certificate representing the stock of a State member bank shall represent the stock of any other corporation except a member bank nor be conditioned in any manner whatsoever upon the ownership, sale, or transfer of a stock certificate of any other corporation except a member bank. This corresponds to the provision in section 16 which is applicable to national banks.

Section 6.—Provides for eliminating the Secretary of the Treasury as a member of the Federal Reserve Board and restores the former requirement that two members of the board shall be men of tested banking experience. It also readjusts the term of members of the board so as to secure as nearly as possible the expiration of terms of members at equal 2-year intervals.

Section 7.—Adds a new section 12A to the Federal reserve act providing for the creation of a Federal open-market committee of 12 members to supervise the open-market operations of the Federal reserve banks and the relations of the Federal reserve system with foreign banks. This in effect legalizes and gives official recognition to the present open-market committee.

This section also adds to the Federal reserve act a new section 12B providing for a Federal liquidating corporation which is given power to liquidate the assets of member banks which have been closed by action of the Comptroller of the Currency, the appropriate State authorities, or by vote of their directors. The management of the corporation is vested in a board of five directors consisting of the Comptroller of the Currency, a member of the Federal Reserve Board, and three persons chosen annually by the governors of the 12 reserve banks. The capitalization of the corporation has already been referred to. (See p. 12.)

Section 8.—Imposes certain limitations upon advances by Federal reserve banks to member banks on their 15-day promissory notes. It is provided that if, during the life of any such advance and despite an official warning of the Federal reserve bank or the Federal Reserve Board to the contrary, any member bank increases its outstanding loans made to members of any organized stock exchange, investment house, or dealer in securities for the purpose of purchasing or carrying stocks, bonds, or other investment securities (except obligations of the United States) the advance to the member bank shall be immediately due and payable and the bank shall be ineligible as a borrower on 15-day paper for such period as the Federal Reserve Board shall determine.

Section 9.—Gives the Federal Reserve Board power to supervise all relations and transactions of any kind entered into by Federal reserve banks with foreign banks or bankers.

Section 10.—Prohibits member banks from acting as the medium or the agent of any nonbanking corporation, partnership, association, business trust, or individual in making loans on the security of stocks, bonds, and other investment securities to brokers or dealers in such securities.

Section 11.—Imposes certain limitations upon loans or extensions of credit by member banks to their affiliates and also limits the amount which such banks may invest in the securities of such affiliates. In general, the maximum limit is 10 per cent of the capital stock and surplus of the member bank in the case of any one affiliate and 20 per cent of the capital stock and surplus in the case of all such affiliates. It is also required that each such loan or extension of credit be secured by collateral having a market value of at least 20 per cent more than the amount of the loan or extension or at least 10 per cent more than the amount of the loan or extension if it is secured by obligations of any State or political subdivision of a State. The provisions do not apply, however, to loans or extensions of credit secured by obligations of the United States, the Federal intermediate credit banks, the Federal land banks, or by paper eligible for rediscount or purchase by Federal reserve banks. Certain types of affiliates are also exempted from the application of the provisions of this section.

Section 12.—Adds a new section 24A to the Federal reserve act which imposes a maximum limit upon the amounts which national banks and State member banks may invest in bank premises or in the stock, bonds, debentures, or other such obligations of a corporation holding the premises of any such bank, and the amounts which such banks may lend to any such corporation.

Section 13.—Provides that all suits of a civil nature to which any corporation organized under the laws of the United States shall be a party, arising out of transactions involving international or foreign banking, shall be deemed to arise under the laws of the United States, and the district courts of the United States are given original jurisdiction of all such suits. It is also provided that a defendant in any such suit may at any time before the trial thereof remove the suit from a State court to a Federal district court in the same manner as now provided by law for the removal of other suits.

Section 14.—Undertakes to broaden the national banking laws by giving national banks all powers possessed by State banks of deposit and discount organized in the States in which such national banks are located, except in so far as they may be prohibited by Federal legislation. National banks are to be permitted to purchase and sell investment securities for their customers to the same extent as heretofore, but hereafter they are to be authorized to purchase and sell such securities for their own account only under such limitations and restrictions as the Comptroller of the Currency may prescribe, subject to certain definite maximum limits as to amount.

Section 15.—Provides for the amount of capital of national banks depending upon the population of the places where they are to be located and also prohibits the admission of a bank into the Federal reserve system unless it possesses a paid-up unimpaired capital sufficient to entitle it to become a national bank.

Section 16.—Provides for separating the certificates representing ownership in national banks and ownership in affiliates other than member banks so that in the future they will not be written upon a single certificate of ownership. This corresponds to the provision contained in section 5 of which is applicable to State member banks.

Section 17.—Provides for the voting of national-bank stock held by holding companies under voting permits obtained from the Federal Reserve Board. Certain limitations are imposed upon such holding companies which they must agree to comply with at the time the voting permits are obtained. These limitations relate chiefly to examinations, reports of condition, reserve requirements, and ownership and control by holding companies of organizations engaged in the issuance, underwriting, and distribution of securities. These provisions are also made applicable to holding companies affiliated with State member banks. (See sec. 3.)

Section 18.—Provides for eliminating after a period of three years all affiliations by member banks with corporations, associations, business trusts, or other similar organizations engaged principally in the issuance, underwriting, or distribution of securities.

Section 19.—Authorizes national banks to establish branches at any place within the States in which such banks are located, and also allows the establishment of branches in adjacent States under certain conditions, subject to the approval of the Federal Reserve Board, but not beyond 50 miles from the seat of the parent bank. No such association is to be permitted, however, to establish a branch outside of the city, town, or village in which it is located unless it has a paid-in and unimpaired capital of not less than $500,000.

Section 20.—Amends the act of November 7, 1918 (relating to the consolidation of national banks), to the extent necessary to carry out the policy provided for in section 19.

Section 21.—Limits the interest that may be charged by a national bank to that which may be charged by local banks in the State where the national bank is located, or to a rate 1 per cent higher than the discount rate on 90-day commercial paper in effect at the Federal reserve bank in the district where the national bank is located, whichever is greater. If no rate is fixed by State law, the maximum rate the national bank may charge is limited to 7 per cent, or 1 per cent in excess of such discount rate, whichever is greater.

Section 22.—Provides that in estimating the total amount of loans which may be made by a national bank to a corporation, the obligations to the bank of all subsidiaries of the corporation in which it owns or controls a majority interest are to be counted.

Section 23.—Provides for reports of condition of all types of affiliates of national banks. This corresponds to the provisions of section 5 which are applicable to affiliates of State member banks.

Section 24.—Relates to the examinations of affiliates of national banks. There is a corresponding provision in section 5 relating to affiliates of State member banks.

Section 25.—Provides for the removal from office of directors and officers of member banks who have continued to violate the banking laws or who have continued unsafe and unsound banking practices after being warned by a Federal reserve agent or the Comptroller of the Currency.

Section 26.—Reserves the right to alter, amend, or repeal the act and provides for separability of its provisions in case any part of the act is held invalid.

The changes which are thus suggested are considered to represent essential matters called for in the interest of immediate improvement of present conditions and the avoidance of financial dangers and there is none of them which can wisely be omitted. All afford solutions that have been indicated by investigators in many quarters as unavoidable and all are thought urgent for the purpose of correcting or eliminating actual hazards.

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