November 23, 1938.

MEMORANDUM:

TO - The President

FROM - Chairman Eccles

Need for banking legislation

In March, 1933, you declared a National Emergency. It should be terminated before your term expires. Yet it cannot be safely terminated until a banking system has been created which can withstand the impact of changing economic conditions, and a coordination of Federal banking supervision has been established that will be capable of exerting its influence towards the control of an inflation or towards cushioning a deflation when either of these conditions becomes dangerous to the national economy.

The Administration's courageous and effective actions in dealing with the most acute banking collapse in history have evoked universal commendation. The restoration of confidence in the banks and the subsequent recovery, however, have tended to obscure the fact that our banking system remains fundamentally unsound. It has been dealt with on an emergency basis. It needs now to be dealt with on a broader, more permanent basis of reconstruction so that it can function effectively as an integral part of the Government's mechanisms for coping not only with potential future emergencies of inflation or deflation but also with an emergency that might be created by the international situation. The effective organization of the banking system is a basic and essential part of any comprehensive program of preparedness.

The system is not now so organized. Responsibilities and authority are scattered among various agencies; there is much overlapping, duplication, conflicting jurisdiction; there is lack of uniformity both in practices and in policies so that, as for example in connection with the Administration's easy money policy, efforts of the Treasury and of the Reserve System to carry out that policy tend to be frustrated because some of the agencies pursue contrary practices or policies; the system is characterized by numerous paralyzing discriminations as between member banks of the Reserve System, insured banks and State banks not under Federal supervision; enforcement of sound banking standards and the Government's ability to carry out national policy in the public interest become a mockery when banks may at will escape supervision by the Federal authorities. This makes for the "competition in laxity" which has long been a blot on the American banking system.

Because of the multiplication since 1929 of Federal agencies either with supervisory or lending powers, or both, the situation has become even more unsatisfactory, and the need for reorganization, consolidation and simplification the more urgent. An excellent precedent is to be found in the Administration's bringing together under the Farm Credit Administration of the scattered authorities that previously were divided among the Federal Farm Board, the Federal Farm Loan Board, the Reconstruction Finance Corporation, the Department of Agriculture and the Treasury Department. As the President declared, this reorganization of the farm credit powers was "to eliminate overlapping, prevent duplication, settle conflicting jurisdictions--in short, to provide a more efficient, logical and consolidated credit service for the farmers at low cost." The same general reasons apply with even greater force to the banking situation today. Another precedent is to be found in the Administration's merging in the Home Loan Bank Board supervision of the operations of the Home Owners' Loan Corporation, the Home Loan Bank System, the Federal Savings and Loan Associations and the Federal Savings and Loan Insurance Corporation.

In striking contrast, the attached chart portrays the disorganized, complex and irrational structure of the Federal banking agencies.

Beyond these conspicuous structural defects, however, the banking system is in no position today to withstand another severe inflationary or deflationary crisis, and the Federal authorities are without adequate means of exerting a control over the vast and volatile credit reservoirs, swollen by the fortuitous inflows of foreign capital and gold, nor has the banking system any adequate means of protecting the domestic economy from these foreign movements.

If the Federal Reserve System, with its nation-wide organization, extensive equipment and trained personnel, has any basic justification for existence it is to exert an influence towards greater economic stability and to mitigate speculative credit excesses and inflationary or deflationary extremes. Yet while the Congress has vested the Reserve System with certain powers to cope with such credit developments, those powers today are wholly inadequate, and the Reserve System is placed in the untenable position of having a tremendous responsibility which it is incapable of discharging because of lack of adequate powers and divided and conflicting banking authorities scattered among Federal and State jurisdictions.

In the past five years there has been an addition of seven billion dollars to the monetary gold stock of the country, resulting principally from a flight of capital from Europe. On the basis of reserves created by this gold there could be a credit expansion that would wreck our economic machine. Yet there is no power in any agency of Government to take action to control these reserves, except the power of the Treasury to do so by increasing the public debt. This is politically difficult and would result in a rise in the cost of borrowing. If the Treasury had to borrow a constantly increasing amount for the purpose of sterilizing present excessive gold stocks, as well as future inflows, the result would be an increase in the interest cost not only on the amount borrowed for this purpose but also on all borrowing that the Treasury had to undertake. Some method other than this must be devised for discouraging the inflow of foreign capital and gold and for controlling the effects on our economy of the gold that has already come to this country and that may come in the future.

It is also highly desirable to discontinue purchases of silver which likewise further increase the excess reserves of the banking system. The silver program is an unnecessary and useless one for monetary and credit purposes and serves solely as a subsidy to silver producers. That the silver policy is not even politically justifiable is indicated by the attached resolutions of the American Mining Congress.

Results of present organization of Federal authorities

Not only does the present set-up foster inefficiency, but it leads to disputes over authority and results in the frustration of monetary and credit policies by actions of supervisory agencies. As a recent example, at the President's request last spring a conference of the Federal banking agencies was called under the leadership of the Secretary of the Treasury for the purpose of better coordination of bank examination policy. After extended discussion and compromise, an agreement was finally reached, coupling with it a modification of the Comptroller's Regulation. Sympathetic and understanding administration is necessary to carry out the purpose and spirit of the agreement in practice. Such administration is not to be expected when there are wide differences of interpretation and application of the terms of an agreement representing a compromise of widely divergent views.

Outworn examining practices have not only frustrated Administration policy which the Treasury and Federal Reserve have sought to carry out, but have served to accentuate deflation on the downswing and to encourage over-expansion and speculation on the upswing. Congress has recognized by legislation and the Reserve authorities are endeavoring to follow the principle of taking monetary action so as to reduce the violence of both inflation and deflation. Both the Administration and the Reserve authorities have consistently followed an easy money policy designed to encourage bank lending and investment so as to stimulate business, which, in turn, would relieve the Government of a corresponding amount of public borrowing. The effect of these policies and actions is largely nullified when bank examiners following outworn methods entirely unrelated to monetary policy, criticize the banks for making the kind of loans which are required by the communities in which they operate.

Old-fashioned bank examination methods, still being pursued, attempt to force banks to liquidate on the downswing, thereby accentuating deflation and undermining the banks' loans and investments. This not only discourages the banks from making new loans at the very time the Government is attempting to encourage them to do so, but it places additional burdens upon the Federal budget by requiring the Government to set up Federal agencies to supply the credit which the banking system is thus discouraged from supplying, and to expand the supply of money and put it into circulation through relief and other programs because of the deficiency resulting from bank liquidation and the failure of private credit to expand.

The time for improving the quality of bank assets is under boom conditions. That is when banks make loans and investments that later get them into trouble. However, this is the very time when bank examination policy fails to discourage unsound loans and investments because it persists in measuring value by the artificial yardstick of ticker quotations, which are likely to be as unrepresentative of true worth in a speculative period as they are when all prices are abnormally depressed.

I have set forth the foregoing at some length not only as an example of conflicting policies, due to the existing diffusion of authority, but because this case particularly reflects the necessity for close coordination of bank examination and investment policy with Government monetary policy.

Authority over monetary policy is largely useless unless such authority is closely integrated with bank examination and investment policy. In principle, authority over all these functions should be vested in one agency, but, in any case, should be vested in closely coordinated agencies.

The situation calls for action at this session of Congress

These problems should not be left for consideration later than this winter inasmuch as a year from now the country will be on the eve of a presidential election. The banking holiday should be terminated before that time. To leave the situation until after 1940 would involve a delay that might prove disastrous in the face of future speculative and inflationary potentialities and taking into account world conditions together with the exposure of our credit system to foreign influences.

To let the situation drift would not only indicate unawareness or unwillingness to face it, but would give the opposition an opportunity to make an issue of it in the 1940 campaign. If the Administration were to put the responsibility up to Congress at this session, not only would there be no opportunity to make such a case against this Administration, but responsibility for future consequences would be upon the shoulders of the Congress.

The procedure

It would be desirable if the President in his message to Congress would in a paragraph or two indicate in a general way the need for further constructive banking legislation to enable the banking system to deal more effectively with the present situation and future developments. Then, in its annual report to Congress, the Board of Governors, it seems to me, should make a reasonably complete statement of the existing conditions and express willingness to appear before Congress, if called, to advise on appropriate legislation. Or, should the Board for any reason not see its way clear to make such a report, then the Chairman at least should do so.

This course seems to me to be far preferable at this time to attempting to bring about an agreement among Federal banking agencies upon a specific piece of legislation, which would be regarded as an Administration bill and would be almost certain to be attacked on partisan grounds. Moreover, as you are aware, the members of Congress are jealous of their prerogatives and resentful at having any one agency present cut-and-dried legislation for passage. If the President requested Congress to assert this prerogative and to work out necessary legislation, hostile members of Congress would not be able to side-step the responsibility, and all agencies interested in the legislation would have an equal opportunity to present their views.

If legislation results, the credit would redound to the Administration. Whereas, if Congress fails to act after having been requested to do so, the onus will be on the Congress or on the groups that blocked action. Instead of leaving an issue for the Republicans to make much of in 1940 and against which the Democrats would find it difficult to make a defense, those responsible for blocking the legislation will be on the defensive.

Form of legislation

I believe that Congress would be willing to initiate a program bringing about a merger of Federal banking supervisory agencies that would largely avoid conflicting jurisdictions and effect a much better set-up of the Federal agencies.

The Comptroller of the Currency is almost entirely to-day an examining agency for national banks, the other functions of the office being minor. The Federal Reserve System examines State member banks. The Federal Deposit Insurance Corporation examines State insured banks that are nonmembers. It would seem to me to be politically feasible to obtain legislation which would merge the examining functions of the Comptroller's office and of the Federal Reserve System with the Federal Deposit Insurance Corporation, whereas any other method of complete consolidation of these functions would, in my opinion, be impossible to obtain from Congress. This would be logical because all of the banks now examined by the various Federal agencies are insured banks. This would place in one agency all Federal examination, supervisory and chartering functions, while there should be consolidated in the Reserve System all of the regulatory functions, thus eliminating the numerous discriminations now existing between member banks and nonmember banks. Attached is a memorandum showing the many existing discriminatory provisions of law.

If this were done, it would be important, however, to have examinations, chartering, supervision of trust departments, and other supervisory functions carried on with close coordination with the Federal Reserve. To bring this about, I would suggest, if called upon to testify, that the Chairman of the FDIC be appointed to the vacancy now existing on the Board of Governors and that the Chairman of the Board of Governors be put on the FDIC to fill the vacancy on that Board which would result from merging the office of Comptroller. I would suggest that the third member of the FDIC be designated by the Secretary of the Treasury to represent him on the FDIC Board and to serve at his pleasure. The effect of this would be to have on the FDIC Board two out of three members who are also members of the Federal Reserve Board. This would afford an excellent opportunity to work out a harmonious and co-operative program of relations and of integrating examination with monetary policy. In the new Federal Reserve Building there is considerable available space and there is also an adjoining vacant building lot for future expansion of all the offices required by such a merger. This joint housing would, in turn, eliminate duplication of statistical and other functions.

I mention the foregoing possible solution of the organization problem, but should some better set-up be devised, or should you prefer some other course, I would naturally wish to defer to your judgment. My own guiding view is merely that the present set-up is unsound and impractical, and I am not wedded to any one solution but only to the necessity of getting some solution. The most practicable compromise, I think, would be the plan suggested, calling upon both the Reserve System and the Comptroller's office to give up their examining functions to the FDIC, then coordinating the FDIC and the Reserve Board so that policies, now and in the past repeatedly in conflict, may be harmonized.

An important part of this pattern, I think, would be to do away with the existing legal berriers to membership in the Reserve System, and, in fact, to scrap altogether the restrictive membership requirements, by blanketing all insured banks into the System and requiring that they carry their reserves with the Reserve banks, at the same time, of course, being entitled to all of the privileges of the Reserve System. One provision that I favor, which would, in my judgment, make this proposal more attractive to the insured banks, would be that they be relieved of paying insurance assessments on the funds they carried with the Reserve banks as reserves. This would also have the desirable effect of tending against the over-concentration of correspondent bank balances in the large money centers, chiefly in New York. It would have an incidental effect of serving to put a bottom of 1/12th of 1 per cent on interest rates.

I would also recommend, if asked, that the Federal Reserve System be completely freed from private banker influence and made unequivocally a public body. While the truth is that the System is not banker dominated, it has been much criticized by Patman, Coughlin and others because private bankers are on the boards of the twelve Federal Reserve banks and because member banks hold stock in the Federal Reserve banks, on which stock they receive a 6 per cent dividend, a rate that is out of line with current returns.

I, accordingly, would recommend that bankers be removed from the directorates of the Federal Reserve banks; that such directorates consist of three representatives of commerce, agriculture and industry who would be elected by the banks; that three others representative of the public interest be appointed, as now, by the Board of Governors, and that a seventh director be chosen either from among or by State bank supervisory authorities. This would reduce the number of directors from nine, as at present, to seven, and would give the Board an equal number with those elected by the banks, while the State banking authorities would be represented by the seventh member.

I would also recommend that the Reserve bank stock be done away with entirely, as it is not necessary. I would suggest that the Reserve System be permitted to accumulate in its capital account out of earnings a sufficient amount to offset the loss of capital due to paying off the stock, but all earnings in excess of such amount to be paid into the Treasury each year as a franchise tax. These two changes would remove two principal, though exaggerated, complaints against the present set-up of the System.

It is also important that the Reserve System be given increased power to deal with foreign balances, particularly those of foreign governments and foreign central banks. Likewise, the Reserve System should have restored to it the power to buy Treasury bills directly from the Treasury as can be done by every other central bank in the world.

There are various other recommendations I would make, if called upon, which I feel would strengthen and simplify the existing banking system, but the foregoing are the principal and most important ones.

It would be very helpful to me to feel that I had your moral support in connection with remedying the banking situation at this time. I would not want to make recommendations contrary to your wishes, if I should be asked to testify before Congress. The steps I have outlined would, I think, meet with a minimum of political resistance, while accomplishing desirable results.

Retention of Reserve System

Since no modern economy can get along without a central banking organization, I have assumed the continuance of the Reserve System in any plan of reorganization. The Reserve System, created nearly a quarter of a century ago, performs numerous essential functions for the banking system, and if abolished would have to be replaced by some other system to perform the same functions. The Reserve System has an extensive physical plant, consisting of the 12 Federal Reserve banks with their 24 branches and agencies, located in principal cities throughout the country, and the Board of Governors in Washington occupying a recently constructed building with ample facilities to accommodate all existing Federal banking functions, and with material savings in the elimination of duplication. All of this represents a large investment in property. In addition, the Reserve System has a continuing and trained personnel both in the field and in Washington.

The Board of Governors of six members now--seven required by law--has its own trained staff of lawyers, examiners, statisticians, economists, etc., the personnel in Washington numbering more than 350. Under the law the Board is a continuing agency, and it is able to contribute that expertness which follows from continuous service. It is able to devote its full time and resources to the single purpose of dealing with banking and monetary matters. The present Board was selected entirely by this Administration. It is one, therefore, in which the President can have confidence. Under existing circumstances, the Board is in the unenviable position of lacking authority to discharge the responsibilities imposed upon it by law, and I question whether the Board can hold or continue to attract the services of public-spirited men if this situation is not remedied.

Speaking for myself, I would not wish to continue in the Chairmanship of a System which in the minds of the public and of Congress is charged with great responsibility for exercising controls over domestic credit and monetary conditions, when, in fact, as it exists today, the System's powers and authority are largely limited to the performance of mechanical functions.

<u>In conclusion</u>

Without venturing to speak for other members of the Board, I, as the Chairman, find myself in the situation where I would be open to the charge of failing in my public duty, and I feel that I would be equally remiss in my obligation to the President, if I were to let the impression stand that I felt that the banking situation was safe, and that no steps needed to be taken to safeguard it against the dangers ahead. My term expires a year from February, and I have no right choice, it seems to me, except to bring to your attention well in advance of the end of my term the necessity for remedial action before the problems become acute, and there is a flare back of criticism. Otherwise I would be justly charged either with not knowing the facts or withholding them for some reason. While my reappointment, a year from February, may be out of the question for other reasons, in any case, as I view it, I should not put the President in the position of considering for reappointment an official who had so far failed in the discharge of the responsibilities of his office.

I think it is clear that, as Chairman of the Board, I have a responsibility to bring these general considerations to your attention so that, if you consider it appropriate to do so, you may include in your message the request that the Congress take cognizance of the situation with a view to providing the necessary remedies and safeguards. Thereby, I feel, the Administration will have done its part, and the responsibility for action will be clearly upon the Congress.

Attachments.