Chairman Eccles

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Memorandum to the Board of Governors

From Ronald Ransom

STRICTLY CONFIDENTIAL

The Senate's Select Committee to Investigate Executive Agencies of the Government last year invited the Brookings Institution to make to the Committee a report containing recommendations for executive reorganization. The result of this invitation has been several reports dealing with particular phases of the general problem; and report number 1, with which the Board of Governors is concerned, deals with proposals for the reorganization of Government Financial Agencies. It was released to the public as Senate Committee Print of the 75th Congress, 1st Session, on August 12, 1937.

The recommendations of this report are especially interesting in view of pending legislation regarding Government reorganization, and, both because of probable reorganizing legislation and because the recommended changes would considerably affect the present activities and possible future development of the Federal Reserve System, the report warrants very careful consideration. I should like to discuss the report's conclusions at

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some future time with my fellow Board members. As preliminary to such discussion, I am submitting this memorandum regarding certain of the report's conclusions. This memorandum is not to be taken as implying my own agreement with any of the opinions of the Brookings Institution, and none of the statements in the following pages are binding in regard to my own final views concerning the problems inevitably raised by prospective legislation.

Probably the most important question developed by the report is the relationship of bank supervision and examination to the agencies of credit and monetary control.

I. The Brookings report recommends the continuance of two Federal institutions for the control of banking: the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation. It thus recommends the abolition of the office of the Comptroller of the Currency, rejects the theory that there should be a single Federal control agency to deal with banking and credit, and, incidental to the foregoing, suggests that the Board of Governors should relinquish certain powers it now exercises.

In brief, the report recommends that the F. D. I. C. be granted the functions at present performed by the Board of Governors

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with regard to (a) holding company affiliates, (b) interlocking directorates, and (c) the examination of banks, with the reservation that the Board of Governors would have authority to examine Federal Reserve banks and to make supplementary examinations of member banks and banks applying for membership in the System, when necessary. Beyond such complete transfer of authority, very close cooperation between the Board of Governors and the F. D. I. C. would be necessitated by the following recommended requirements: (a) Consent of the F. D. I. C. before a State bank member can be admitted to the Federal Reserve System; (b) consent of the F. D. I. C. before any insured bank can establish branches, whether or not the bank is a member of the Federal Reserve System, and the consent of the Board of Governors in the case of a member bank, whether national or State; (c) consent of the Board of Governors before the issuance of charters to national banks, the chartering operation to be under the F. D. I. C.; (d) the enlargement of the Federal Reserve Bulletin to include statistics issued by the F. D. I. C.; (e) the housing of the F. D. I. C., if possible, in the Federal Reserve Building; (f) the fixing of rates of interest on time and savings deposits of all insured banks by a committee of five, two members being designated by the Board of Governors, two by the F. D. I. C., and the fifth being

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the Secretary of the Treasury or his representative; and (g) the collection of call reports by F. D. I. C. on forms approved by the Board of Governors.

II. The crucial point in this program is the rejection of any plan to consolidate all Federal control agencies relating to banking and credit. The reasons for this view are contained in the following quotations:

(1) "The principal arguments for complete consolidation of the Comptroller's office, the Federal Deposit Insurance Corporation, and the Federal Reserve System, however, have to do with economic advantages of a unified banking system as against the present system of dual control. Consolidation of the control agencies in Washington would be a long step toward such unification of the banking system. This question involves political and economic issues more than administrative efficiency and economy. It would be beyond the assigned function of this report to weigh the advantages and disadvantages of such fundamental reform. Our recommendations are made on the assumption that it is the established policy of the United States, at least

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for the present, to divide the responsibility for bank supervision between the Federal Government and the States, leaving to the commercial banks the choice between State and national charters, and between membership and nonmembership in the Federal Reserve System." (pp. 37-38.)

(2) "There are over 7,000 insured State banks not members of the Federal Reserve System which are subject to Federal examination only because they have elected to take advantage of the insurance of deposits which is administered by the Federal Deposit Insurance Corporation. It would be out of the question to place the examination in either the Comptroller's office, the Board of Governors of the Federal Reserve System, or the Federal Reserve banks.

"As to the member banks of the Federal Reserve System, there may be differences of opinion. But our recommendation that the examination of these banks be placed in the Federal Deposit Insurance Corporation is not based merely on the advantages of unification, but on the fact that

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examination is more important to the Federal Deposit Insurance Corporation than it is to the Federal Reserve System." (pp. 39-40.)

(3) "The Board of Governors of the Federal Reserve System exercise quasi-legislative and quasi-judicial functions of a character which as a matter of long-established policy are regularly entrusted to boards representing divergent interests, rather than to single administrators. The Federal Deposit Insurance Corporation could be administered by an executive head instead of a board, . . . (p. 38.) All of the activities of the Reserve System so far enumerated have to do with the control of the general credit situation, making money abundant and cheap when it is desired to encourage expansion of business activity, and raising rates and making money scarce and dear when restriction is deemed necessary. This is the main function of the Board of Governors of the Federal Reserve System. It is quasi-legislative in character . . . (pp. 15-16.) Our recommendation is based simply on the desirability of freeing the Board of Governors, as far as possible, from purely administrative responsibilities . . . (p. 44.) One desirable effect of the recommendations made above, if they are carried out, would be to reduce the volume of administrative work of the Board of Governors of the

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Federal Reserve System and leave it free to devote more time to the study of credit conditions and the formulation of credit policy. Ever since the creation of the System, there has been a tendency for it to absorb administrative jobs, such as the control of interlocking directorates and of the establishment of branches and supervision of holding-company affiliates, . . . A large board is not an ideal body to carry on administrative tasks. Moreover, the policy-making functions of the Board have grown in importance with the increasing public reliance on credit control as a panacea for business ills. We believe that there will be a considerable gain in the effectiveness of the Board's more important work if it is relieved of much of its administrative responsibility." (p. 46.)

(4) The authors of the report feel that the F.D.I.C. ". . . is the agency which is responsible for the maintenance of bank solvency." Again, the report speaks of ". . . bank solvency, which is the center of the Federal Deposit Insurance Corporation's function." (p. 43.)

III. These excerpts fairly indicate the reasons advanced to explain why the Federal Reserve System is not abolished or placed under an administrative agency such as F.D.I.C. They also explain why the Board of Governors, according to the theory of the report, should be stripped of some of its present duties and why the functions of the

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F.D.I.C. are not placed under the Board of Governors or a new single agency to handle the duties of the Board of Governors, the Comptroller, and the F.D.I.C. In short, the Federal Reserve System is preserved because its board-type of organization is regarded as proper for the exercise of its semi-legislative relation to the quantitative aspects of monetary management and the performance of its responsibilities in this connection can be best accomplished, the thought is, by removing from the Board as many administrative or other routine duties as possible. The F.D.I.C., on the other hand, is almost wholly an administrative agency concerned with bank solvency and is, because of such reasons, regarded as the proper place for nearly all administrative detail. Unification of Federal control agencies is precluded because the United States is presumably committed at present to a division of responsibility between the States and the Federal Government.

(1) The explanation of why a unified agency for the Federal control of banking is not now recommended is either badly expressed or seriously confused. There is an implication that a fundamental banking reform needed in the United States is a unification of the banking system; and it is correctly suggested that a unification of the system involves political questions, which may well have been outside the terms of reference of the Brookings Report. Thus it may have been also true that the authors of the report felt themselves compelled to assume the continuance of a banking responsibility divided between the Federal Government and the State governments and to presuppose the continued existence of what is called "dual control."

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However, there seems to be a non sequitur in the report's apparent opinion that divided responsibility between the Federal and State governments of itself necessitates a division of the agencies by which the Federal Government shall exercise its relationship to the banking system. The proper question with respect to executive reorganization is, "Should the functions of the Federal Government with respect to banking and credit be exercised by one or more agencies?" And if, as the Brookings Report seems to think, it is necessary to assume the continuance of both State and Federal controls in banking, then the second question is a restatement of the first: "Granted a division of authority between the State and Federal Governments, is there anything in that circumstance to prevent a proper expression of the Federal powers through a single agency?" The Brookings Report asks the first question but never addresses itself to the second. Instead, in the only place it deals with the problem explicitly, it seems to assume that divided Federal supervision of banking and credit is required by the fact that State banking systems may continue. Such a conclusion is entirely too important to be accepted merely by the process of assumption; and, if the other chief points made by the report are intended to support the conclusion by implied application, then the case for a divided Federal supervision must be judged on each of these arguments specifically.

(2) It is true, of course, that many insured State banks are not members of the Federal Reserve System. It is also true that these banks

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are subject to Federal examination only because of deposit insurance. Having made these observations, the Brookings Report goes on simply to take for granted that "it would be out of the question 1/ to place the examination in either the Comptroller's office, the Board of Governors of the Federal Reserve System, or the Federal Reserve Banks." The report emphasizes its point by saying that there may be differences of opinion "concerning member banks of the System" but, though acknowledging the possibility of differences of opinion in the case of member banks (which differences of opinion are apparently not thought of as even possible in connection with nonmember banks) goes on to recommend that the Reserve System rely on the F.D.I.C. for the examination of member banks.

Just why it would be "out of the question" to place the examination of State insured banks within the Federal Reserve System needs clear and direct exposition. Doubtless the insurance of deposits, in view of the present organization of American banking, implies the necessity of bank examinations. But the mere allegation that the Federal Reserve System, if it took over the function of deposit insurance, would then be compelled to deal with nonmember banks is not of itself convincing on this point. After all, if a Federal agency is to insure the deposits of State banks, some Federal agency must invade the privacy of insured State banks through the examination process; and, unless there is something very mystical about this problem, there must

1/ Emphasis mine, throughout.

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be an explanation of why it would be proper for one Federal agency to examine insured State banks in connection with the function of deposit insurance and improper for another Federal agency, such as the Board of Governors, to examine insured State banks in connection with exactly the same function. Perhaps it would be improper, and perhaps politically impossible, but the point needs demonstration. It may be recalled in passing that the System already deals with a very large number of nonmember State banks that have come within the par clearance arrangements of the System.

(3) The thought that the Board of Governors should be largely relieved of administrative detail is plausible. In connection with deposit insurance, however, the Brookings Report has supplied in a measure the answer to its own contention. It has insisted that the operation of Federal deposit insurance is largely an administrative task. That point is questionable and may turn out to have minimized too greatly the problems and difficulties that will in the long run attach to deposit insurance. Nonetheless, if deposit insurance is, as the Brookings Report suggests, largely a matter of routine administration, in which there are few policy-making decisions, then it could be handled under the Board of Governors by an administrative official without serious infringement upon the time of the Board.

The administrative work of the Board of Governors is by no means a negligible problem. It does not appear, however, to be an insuperable obstacle to any plan of reform that might otherwise be

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a sound system of Federal banking and credit control. Even if the administrative work of the Board of Governors were substantially expanded, it does not seem at all impossible to reorganize the administrative aspects of the Board's work along lines that would confine the Board, acting as a body, to the sort of quasi-legislative determination of general policy that the Brookings Report indicates as a proper Board function. The twelve Federal Reserve banks and their branches provide administrative agencies through which examinations can be carried forward. To be sure, the habits of the Board might need alteration in order to handle a considerably expanded administrative load, and probably legislation permitting the Board to delegate functions might be required; but an enlargement of the Board's duties would of itself probably compel an expedited manner of dealing with detail.

It may be acknowledged, moreover, that the general idea of those who desire to reduce as far as possible the work of the Board is genuinely attractive. Behind nearly all such plans appears the belief that the Board's main function,-namely, monetary management, will thus receive an improved and more constant attention. The opinion seems to be that the Board should sit in its suite in an uninterrupted condition of reflection regarding the state of business and credit. Unfortunately, while the quality of thinking may have some relation to the time spent upon it, the identity between the qualitative aspects of thought and the time factor is by no means complete. In the long run, the quality of the Board's reflection is probably dependent more

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upon its experience and upon the accuracy and completeness of the facts passed up to it by the staff than by time available for churning over and over again a body of incomplete and inaccurate information. It is probable that the future of the Board's functioning as an organization for monetary management depends more nearly upon the ability of the staff to extend the frontiers and precision of the information upon which the Board must act than upon a simple extension of the time available for unadulterated logic. This is not to minimize, of course, the difficulty of the problems the Board must decide, nor to allege that time for full consideration is not requisite; but it is to say that a simple extension of the time available for discussion and debate will not of itself insure the Board's success.

In any event, it must be noticed that the recommendations of the Brookings Report would call on several scores for the very closest and most harmonious of relationships between the F.D.I.C. and the Board of Governors. Now, it can be hoped that such mutually helpful cooperation would continuously exist. Considerable disagreement, however, is by no means unknown between financial agencies, and for reasons that will be indicated below, the F.D.I.C. and the Board of Governors will each be in a position to handicap the other, so that it may be questioned why the establishment of two organizations dealing with Federal banking functions should be advocated when these organizations will necessarily be in the process of more or less continuous negotiation. Such procedure will be time consuming, occasionally productive of disagreement, and, on the basis at least of general considerations, it would

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appear more desirable to place all Federal functions relating to banking under the same organizational control, so that various problems impinging upon each other are automatically a part of the consciousness and intelligence of the same controlling body. It may be asked whether the problem of administrative legislation, properly organized, would represent a greater load on the Board of Governors, if deposit insurance were placed under the Board, than would the necessity of continuous dealing with F.D.I.C. in mutual problems, which is necessitated by the Brookings proposals.

(4) With regard to examinations, the report says simply that F.D.I.C. is more concerned with bank examination than the Federal Reserve System. That conclusion seems to rest upon the thought that there is a clear distinction between the functions of the Board of Governors and the question of bank solvency, which is presumed to be the problem of F.D.I.C. These points are attractive; but countervailing considerations are available.

In the first place, the Federal Reserve banks have need of examinations. That fact is acknowledged in the report. The Reserve banks must deal with member banks as borrowers; and, in the extension of credit, the whole policy and history of a borrowing bank may well be in question. It is hardly satisfactory simply to say that the examination reports assembled under the direct control of the F.D.I.C. would be available to the Board of Governors and to the Reserve banks. Information of importance that could be conveyed in informal conferences between Reserve bank officials and examiners may not appear in

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examination reports. Such informal avenues of information and mutual suggestion can hardly operate well when the examiners are not responsible to the Federal Reserve System. The mere fact that the Federal Reserve System, moreover, must now rely in large measure upon the examination reports of the Comptroller of the Currency, and thus would be no worse off if forced to rely on the F.D.I.C., is not wholly to the point. That may be true, and it may also be true that examinations have not in the past been properly used as an adjunct to monetary policy. But the examination function can and should be so used in the future, and the separation of examinations from the central banking authority is, at the time at least, an impediment to effective monetary management in a unit banking system such as we have.

Of more general significance, however, is the question of credit control. It is on this point that the Brookings Report is weakest, for the basic idea, apparently, is that a definite distinction exists between the function of the Board of Governors in quantitatively "making money abundant and cheap" or in "making money scarce and dear", and the function of the F.D.I.C. in examining the qualitative character of bank assets to determine the solvency of banks. Actually, the two problems tend to become very completely merged at various stages in the business cycle and for marginal assets of banks at almost any stage of the business cycle. The character of banking assets is by no means subject to automatic determination by rule-of-thumb methods. A judgment of bank assets must necessarily

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take into account such factors as the quantity of means of payment that are to be added to or subtracted from the economy by the policies of central banking and fiscal agencies, and upon the course of the price level, of business, and of economic conditions in particular communities and regions. What is true for a substantial body of bank assets at the extreme peaks and extreme valleys of a business cycle, when decisive changes in economic direction occur, is also true for the judgment of borderline assets at almost any time in the business cycle. The quality of bank assets, in other words, depends in considerable measure upon the course of business, of the price level, and other factors that are presumably to be influenced by the quantitative credit decisions of the Board of Governors. The point is, can the F.D.I.C. or any other Federal agency examine banks generally with a view to determining their soundness without an intimate knowledge of the actions and policies of the central banking authority.

Something like an acknowledgment that this cannot be done is made when the Brookings Report remarks that, "Under the present system it is practically impossible for the Federal Deposit Insurance Corporation to be certain, in the case of banks which are close to the margin of solvency, when it should take action to protect the interests of its depositors and its own interest as the insurer of the deposits of less than $5,000." In the case of such a bank, many factors might and probably would be involved: The general application of expansionist or restrictionist measures by the central

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banking authority, the business cycle, the extent to which the Federal Reserve bank would be willing to lend to the bank in difficulties, the economic position and tendencies of the community involved, including the balance of payments, the credit policies of surrounding banks, and so on. Many of these points on which a sound judgment concerning the closing of a bank must rest are normally part and parcel of the information and consciousness of a central banking system. To make generally satisfactory judgments the F.D.I.C. would need to have the most intimate and continuous knowledge of the Reserve System's operations and programs and either to avail itself of the facilities for economic investigation now possessed by the System and in process of development or in part to establish duplicate facilities for its own use.

On the other hand, the examining process, ostensibly designed to determine the quality and soundness of bank assets, can and normally would have an exceedingly important impact on the quantitative policies that the Federal Reserve System is supposed to pursue. This point has been put by Professor Viner as follows:

> "It is evident, therefore, that bank supervision and examination are neither necessary nor sufficient conditions to assure that the banking system will be strong enough to withstand a severe depression without wholesale collapse, although it may be presumed that the record of the American banking system would have been even worse if it had been wholly free from supervision and regulation. But unless it is directed with this danger in mind, the nature of the examining process is itself such as to impose upon the activities of

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> the banks a perverse cyclical pattern from the point of view of stabilization. The examiners, through qualitative credit standards which they impose on banks, indirectly influence the quantity of bank credit. When business is prosperous and optimism prevails, examiners, like the bankers themselves, must tend to appraise credit risks in terms of the favorable conditions of the moment. The bankers, and especially the small bankers, confident that what is good enough to pass the scrutiny of the examiners should be good enough to meet their own standards, persist on their career of credit expansion. Later, when the tide of business turns, when banks begin to fail and loans which were passed without criticism during the boom days have to be written off as bad debts, the examiners are blamed. Reacting in a perfectly natural manner, they become stricter and more exacting in the standards they apply, and they press the banks to liquidate loans and investments which the banks, if left to their own devices, would be happy to keep in their portfolios. The process of bank examination thus tends to encourage credit expansion during the upswing of the business cycle and, more seriously, to intensify credit contraction during the downswing.
>
> "There is an obvious cure for this perverse effect of bank examination, requiring three innovations in the administration of the examinations: unified control of bank supervision and examination; co-ordination of examination policy with credit control policy; and systematic and continuous supervision and instruction of the examiners in terms of a uniform and flexible policy. Fully to attain all of these objectives would require the centralization of all bank examining functions under the direction of the Federal Reserve Board."

In other words, the work of a central banking authority is likely to be seriously impeded and disturbed if it does not control the examination policy. Such an impediment and disturbance may well have greater significance in the future than in the past, since it is only in recent years in the United States that the role of central

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banking in economic stability has been generally emphasized, more or less recognized by law and by the Governors of the System, and popular expectations regarding its effectiveness aroused. And with two organizations operating in a way that permits the one to interfere with the other, the possibility of recrimination and conflict becomes, in the long run, almost a certainty. There is an inevitable confusion of responsibility. Moreover, a division of responsibility and power, unavoidably puzzling to the public mind, has a specifically bad effect on supervisory agencies themselves. It encourages the development of a mental attitude by which called-for action tends to be too long deferred, and afterward, since we are all human, there is a spoken or unspoken tendency, whatever the facts, to ascribe the onus of failure or of an unpopular action to the other agency.

Aside from the foregoing general considerations, it should be observed that the examination function, if vested in the Board of Governors would be a valuable instrument for dealing with problems that cannot now be satisfactorily managed. For instance, the Board of Governors and the Reserve banks are not at present equipped to control such a phenomenon as the Florida boom, the chief effects of which were in evidence in only a small geographical area. None of the present instrumentalities of the Board or of the Banks can be used to apply pressure in such a situation without at the same time applying pressure elsewhere in the economy when such general pressure

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may neither be necessary nor desirable. It cannot be pretended, of course, that even the process of bank examinations could wholly control such a situation as existed in Florida; but the examination process could have been used, both directly and by indirect influence, to have forced Florida banks rigidly to cleanup their portfolios as the boom progressed, and the whole banking situation in the State could have been kept on a much more conservative basis.

Much the same sort of thing can be said regarding booms that are not geographically confined but that tend to direct themselves toward some particular phase of the economic system. In this connection, there will be remembered the anxiety regarding security loans in the late twenties. Leaving aside all questions concerning whether security loans were or were not made in greater volume than a sound development of the banking system and the economy would have called for, it may simply be observed that a control of bank examinations would have allowed the Federal Reserve Board to deal with the problem by the process of direct action. Without the examining authority (or some authority similar in effect), the Board was practically powerless unless it used control measures that would have an impact far beyond the objective aimed at.

It is not necessary, of course, that the Board of Governors have control of the examination function in order for that function to be exercised in conjunction with monetary policy. All that is necessary is that it should be exercised with an intimate knowledge

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of monetary policy and with full cooperation. Such a development may occur under the arrangement suggested by the Brookings Report. It may even follow more or less automatically from the responsibilities of F.D.I.C.; but that is to be doubted. What is more likely is that, during the upswing of the cycle, the F.D.I.C. will apply somewhat more stringent standards than the Comptroller's office has been wont to do, and, in a downswing, having its insurance at stake, as the Comptroller's office has never had, will apply standards still more severe. To expect it to do otherwise is to expect that the F.D.I.C. will, when a downturn had gotten under way, shift its examining standards.

(5) The Brookings Report contemplates that the liquidation of insured failed banks would be in the hands of the F.D.I.C. Elsewhere in the report the fact has been emphasized that the Federal Reserve System is equipped with all of the facilities, personnel, and experience requisite for the conduct of banking operations (p. 22), and it is recommended that the Reserve banks act for the Government as liquidating agents in connection with Reconstruction Finance Corporation loans. At least from the operating standpoint, it is difficult to understand why the Federal Reserve banks are not the proper agencies for liquidating the affairs of closed banks. They possess, as the Brookings Report has indicated, practically all of the facilities for doing this work satisfactorily and must either undertake the task in behalf of the F.D.I.C. or else the latter

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must duplicate the facilities of the Reserve banks.

It seems to me reasonable to conclude from a study of the Brookings report that there is need for a unification of the whole banking system through some Federal agency, that this agency should be charged with the examining function, and that it becomes difficult in theory to disassociate examination from the agency charged with responsibility for monetary and credit control. The Federal Reserve System is an agency that can centralize the functions relating to national policies and can decentralize administrative functions through the twelve banks and twenty-five branches and agencies.

In the statement on "Objectives of Monetary Policy" released by the Board under date of July 30, 1937, it was said: "The Board recognizes that even an adequate supply of money will not perform its functions adequately, if the banking structure through which it must operate is in an unsound condition, and that a sound banking structure cannot be sustained if the supply of money is insufficient, and a deflation is under way. The Federal Reserve System, therefore, must work toward economic stability through its influence both on the flow of money and on the soundness of banking conditions." This is a clear statement from the Board itself of the necessity for combining the functions of supervision with the proper exercise of credit and monetary control.

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