

*Chairman Eccles*  
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STRICTLY CONFIDENTIAL

January 9, 1939

Attached is a tentative draft of material for the Board's Annual Report for 1938. Cooperation of other Divisions in revising and amplifying the report, particularly the sections dealing with jurisdictional and supervisory matters, is requested. Since it is the Board's wish to have the report printed and submitted to Congress before the end of January, it will be appreciated if revisions are sent in not later than Friday, January 13.

E. A. Goldenweiser

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STRICTLY CONFIDENTIAL

January 9, 1939

TWENTY-FIFTH ANNUAL REPORT

of the

BOARD OF GOVERNORS

of the

FEDERAL RESERVE SYSTEM

Covering operations

for the year 1938

(FIRST TENTATIVE DRAFT)

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In 1938 business activity, which had declined sharply in the latter part of 1937, recovered a considerable part of that decline. Recovery began early in the year in the construction industry and gradually spread to most lines of activity. Decline in national income had not been as sharp as that in industrial production and during most of 1938 consumption was at a more rapid rate than production. As a consequence, inventories which had accumulated in 1937 were substantially reduced.

In the spring of the year the Administration announced a program of increased activity and expenditures with the view to encouraging economic recovery. As a part of this program the Treasury discontinued the inactive gold account and the Board reduced by one-eighth the percentage of reserve requirements for member banks. As a result of these actions, together with a large inflow of gold from abroad, excess reserves of member banks at the end of the year were in the largest volume on record.

Loans by banks to trade and industry declined during the year, while their investments increased by a corresponding amount, so that the total volume of outstanding bank credit showed little change. Bank deposits, however, increased sharply as a consequence chiefly of the gold inflow and the disbursement of Treasury balances. The net result was that at the end of the year the banks had a larger amount of funds available for expansion than at any previous time and the public had the largest amount of deposits available for use in business or for investment.

The banking situation therefore appears to be such as to place the banks in a position to contribute to recovery by easily meeting all the demands for funds. The turnover of existing deposits, however, continues to decline.

In the judgment of the Board the present is an appropriate time to review the banking situation, both from the monetary and the supervisory point of view, and to indicate the structural defects in the banking and supervisory machinery and in regulatory powers as they exist today. A clear description of existing defects in our banking and monetary mechanism at this time, when it is under no stress, appears to the Board to be a necessary first step in preparing the ground for its strengthening and improvement. Without such reform the banking system, in the Board's opinion, will not be able to withstand the stress and strain which it may experience in the future as it has in the past. Such a description constitutes the major part of this annual report.

#### NATURE OF OUR MONETARY AND BANKING SYSTEM

Banking is a business vested with the public interest. It is through individual actions of 15,000 separate banks that the current financial needs of commerce, industry, and agriculture are met, and the deposits created through the actions of this multiplicity of banks constitute the principal part of our money supply. Changes in the lending and investment policies of banks tend directly to stimulate or retard business activity, and the deposits created by these loans and investments, as they pass from hand to hand, are the medium through which the bulk of the nation's money payments are made. Consequently, the volume and activity of these deposits are major factors in the nation's economic life.

Success or failure in the banking business is, therefore, not only a matter of concern to those who invest their money in the enterprise. It is a matter of national concern. To take an extreme case, when a bank fails the result is, on the one hand, the elimination of the habitual source of

financial assistance on which the bank's customers have relied, and on the other hand, the loss or tying up of money, belonging to the depositors, who have made their business and personal plans with reference to the possession of this money. The failure of a bank, therefore, represents not only the drying up of an essential source of new money, but also the temporary or permanent disappearance of money already in existence.

The crucial and disastrous consequences in our economy of widespread bank failures are familiar. But even short of failure the willingness or hesitation of the banks in extending credit, their ability to do so, and, on the other hand, their desire or necessity for contracting loans and investments, and consequently, deposits - play a vital part in the nation's economy.

It is for these reasons that banks have been subject to public supervision for nearly a hundred years. But the development of the mechanism of supervision has not been in accordance with a broad and comprehensive plan made with reference to the country's banking needs taken as a whole. Banking legislation, State and national, has reflected the cumulative results of attempts by various governmental authorities to meet competitive conditions and specific situations and emergencies. From it the banking picture emerges as a crazy quilt of conflicting powers and jurisdictions, of overlapping authorities and gaps in authority, of red tape and undue license, of restrictions making it difficult for banks to serve their communities and make a living, and of freedom making it next to impossible for public authorities to exercise adequate restraints. Our banking system at the present time is a mechanism geared to enhance rather than to moderate the perilous swings of our economic life from excessive booms to disastrous depressions.

In view of its responsibilities for the maintenance of sound banking conditions and for contributing to economic stability and the effective utilization of the nation's human, economic, and natural resources, the Board of Governors deems it its duty at this time to call to the attention of Congress the major problems that confront the banking system, with a view to the consideration of such remedies as Congress may deem appropriate. The Board stands ready to offer to Congress all the assistance in the consideration of these problems that it may be requested to contribute. It is convinced that it would be derelict in the discharge of its responsibilities if it failed to present to Congress as full and fair a picture of the banking problems as it is capable of depicting.

In accordance with the two-fold nature of the banking function, to keep in existence an adequate supply of money and to supply needed accommodation to business, the Board proposes to discuss in this report, first, the monetary problem of regulating the volume and the cost of money, and, secondly, the supervisory problem of keeping banks in sound condition. These two problems are interrelated and inseparable; they constitute, in fact, two aspects of the same problem, the quantity and the quality of credit, but for convenience of presentation, and on account of differences in the techniques involved, they can best be discussed separately.

#### THE PROBLEM OF BANK RESERVES

##### Reserves and credit regulation

The problem of monetary regulation is largely a problem of dealing with bank reserves. Under our system, banks are obliged to keep a definite proportion of their deposit liabilities in the form of reserve balances with the Federal Reserve banks. This means that in order to extend more credit the banks

must have reserves in excess of their requirements and since, for the System as a whole, deposits result from the making of loans and investments, the banks must have additional reserves if deposits are to be expanded. By increasing or decreasing the amount of reserves available to the banks, therefore, the Federal Reserve System can encourage or discourage the expansion of bank credit and bank deposits. For a complete exposition of the functions of reserves, reference is made to the Board's Annual Report for 1936.

Prior to recent years, when the pressure for credit expansion was considerable and the volume of reserves somewhat limited, the usual situation was for the banks to have practically no reserves in excess of legal requirements. In other words, the banks were at all times loaned up. Any increase in loans and investments, therefore, involved borrowing from the Federal Reserve banks. When the banks borrow they become subject to the discount rate and also to more complete control of their operations under other sections of the Federal Reserve Act. When the System wished to encourage the expansion of bank credit, it could give the banks reserves by buying securities in the open market which enabled the banks to pay off what they owed the Reserve banks, or to expand their credits. On the other hand, when the System wished to restrain expansion, it sold Government securities, thereby taking money out of the market and placing the banks in debt and making them subject to the discount rate and other restraining regulations.

All this technique of operation was feasible only so long as the banks did not have a volume of reserves far in excess of their current needs. In recent years this situation has not prevailed. At the end of 1938 the banks had excess reserves of over \$3,000,000,000. In these circumstances, the traditional methods



of encouraging or discouraging bank expansion through the medium of reserves are wholly ineffective. This situation prevails, moreover, notwithstanding the fact that reserve requirements have been increased by 75 percent above the percentages stated in the statute.

In the following pages there is a statement of the sources from which this volume of excess reserves has been derived.

#### Sources of reserves

From the end of 1929 to the end of 1933 there was a growth of about \$300,000,000 in the total of member bank reserve balances, resulting from the purchase by the Federal Reserve banks of \$2,000,000,000 of Government securities, the proceeds of which were used for the most part to reduce the banks' indebtedness and to meet an increase in the demand for currency. Since bank deposits decreased sharply during the period, required reserves also declined, and at the end of 1933 member banks had excess reserves of \$850,000,000. Since that time reserve balances of member banks have increased by \$6,000,000,000 to the present unprecedented total of over \$9,000,000,000, of which, notwithstanding the increase in required reserves through growth of deposits and advance in requirements, more than \$3,000,000,000 are excess reserves.

Growth in reserves since 1933 is attributable primarily to the extraordinary inflow of gold to this country after the adoption of a fixed price for gold at the end of January 1934. The increase in the price of gold from \$20.67 to \$35 an ounce increased the dollar value of the country's gold stock by \$3,000,000,000 to \$6,800,000,000 and since that time additions to the stock at the new valuation have raised it to \$14,500,000,000. About \$7,500,000,000, however, of the

growth in the country's monetary stock of gold has been reflected in a corresponding growth of member bank reserves. To this amount about \$1,800,000,000 of the initial gold increment from revaluation, held in the Stabilization Fund, and \$500,000,000 of gold held in the Treasury's general fund may be added whenever the Treasury decides to utilize it.

Of the gold added to the nation's stock in the 1934-1938 period about \$600,000,000 was from domestic mines and other domestic sources. The remainder of the gold, about \$7,000,000,000, came from abroad.

This inflow of gold arose to the extent of \$1,600,000,000 from an excess of sales of goods and services by Americans to foreigners, to the extent of \$4,200,000,000 from the movement of foreign short and long-term capital to the United States, and the remainder from payments and transfers the exact nature of which cannot be determined from existing data. Part of the capital movement to this country has represented investment by foreigners in American securities, part has resulted from repatriation of foreign securities previously held in the United States, and part a building up of foreign balances held with American banks.

The free movement of capital from country to country at a time of practical uncertainties and financial disorganization has been one of the most disturbing factors in the financial fabric of post-war years. It has accounted for the greater part of the reserve problem with which this country has to contend. Free capital movements are bad both for the country that receives the capital and for those that lose it. Accumulation of foreign balances in a chosen money

market, which appears for the time being to offer the best security or the greatest opportunity of profit, is disturbing to the monetary system of the country where this market is located. It creates for it an immediate problem of excess reserves or artificial monetary ease, and also creates a vulnerable situation with a large volume of foreign funds subject to withdrawal on demand. Capital withdrawals, on the other hand, cause contraction and retard business activity in the country from which the capital is withdrawn. Capital movements for long-term investment and seasonal movements in anticipation of exports of goods have long been a part of the international financial mechanism. Erratic large-scale movements of capital, however, in response to political and speculative situations are wholly undesirable and fraught with danger to the world's financial stability.

About \$1,200,000,000 has been added to member bank reserves through the issuance by the Treasury of silver certificates in payment for domestic and foreign silver purchases. Certificates have been issued to cover the amounts paid for the silver, and an additional \$1,300,000,000 of these certificates can be issued under the law, without further purchases, to cover the difference between the prices paid and the maximum authorized amount of \$1.29 per ounce.

Of the amount that has been added to reserves through gold and silver operations, about \$1,300,000,000 has been absorbed through an increase in money in circulation and about \$1,200,000,000 through an increase of Treasury and nonmember bank deposits at the Federal Reserve banks.

As a net result of all these developments and transactions, \$6,000,000,000 was added to member bank reserves in the five years 1934-1938. Of this amount \$3,600,000,000 was absorbed by increases in required reserves, due both to increased ratios of required reserves to deposits and to growth in the banks' deposit liabilities. Excess reserves of member banks have increased by \$2,400,000,000 and at the end of 1938 were over \$3,200,000,000. With the return flow of currency in circulation and the decline in Treasury balances, excess reserves may be close to \$4,000,000,000 by the end of January.

There is a possibility, moreover, on the basis of existing reserve material, even without gold imports or silver purchases, of a large further increase in excess reserves. The Treasury's total funds, now held in vault or on deposit with the Reserve banks, that may be added to member bank reserves amount to about \$4,000,000,000, so that from this source alone excess reserves may be doubled in the future. A continuation of gold inflow would further add to excess reserves.

Following is a table summarizing changes in the reserve position of member banks from the end of 1933 to the end of 1938.

FACTORS IN CHANGES IN RESERVE POSITION OF MEMBER BANKS  
DECEMBER 31, 1933 TO DECEMBER 30, 1938

(Approximate figures in millions of dollars)

Additions to member bank reserves due to -

Operations in gold:	
Revaluation of gold stock	2,818
Net imports and releases from earmark	7,003
Domestic production and other sources	<u>654</u>
Total	10,475
Less:	
Gold in Stabilization Fund	1,800
Gold in Treasury working balance	564
Gold used for retirement of national bank notes	<u>640</u>
Total	3,004
Net additions due to operations in gold	7,471
Purchases of silver (valued at \$1.29 an ounce)	2,521
Less silver bullion held in Treasury	1,300
Net addition due to purchases of silver	<u>1,221</u>
Total	8,692

Deductions from member bank reserves due to -

Increase in money in circulation	1,333
Increase in Treasury deposits at Reserve banks	920
Increase in other deposits at Reserve banks	309
Other Federal Reserve and Treasury operations	<u>135</u>
Total	2,697
Net addition to member bank reserves	5,995
Increase in required reserves due to -	
Increase in reserve requirements	2,333
Growth in deposits	<u>1,316</u>
Total	3,649
Increase in <u>excess reserves</u>	2,346
Excess reserves at end of 1933	<u>859</u>
Excess reserves December 30, 1938	3,205

Process of credit expansion

On the basis of existing and prospective reserves the banking system could double the amount of its loans and investments, and the amount of its customers' deposits before it would be obliged to resort to the Federal Reserve System for accommodation and thus to subject this expansion to the System's regulatory powers. Furthermore, the present volume of deposits is already larger than at any previous time and would be sufficient, if it were more actively used, to finance a much larger volume of business than now exists or is in prospect in the immediate future. The average turnover of deposits in 1938 was about 15 times per year, which means that each dollar of deposits did fifteen dollars' worth of business during the year. With a turnover at the rate of 30 per year, such as prevailed in 1929, the present volume of deposits could be used for twice the volume of transactions. Consequently, the amount of financial transactions made during the year could be doubled without any increase in the volume of deposits merely by an increase in activity of the existing supply.

The long-run problem created by the existing large volume of bank deposits and bank reserves is quite distinct from the immediate problem of making bank credit available for the current requirements of business.

In recent years it has been the policy of the Government in general and of the Federal Reserve System in particular to encourage the expansion of credit and the use of existing deposits. This has constituted the so-called policy of monetary ease, which has been aimed at keeping banks supplied with an abundant volume of reserves, so as to encourage them to expand their loans and investments. This policy has been a factor in the creation of the existing

large volume of deposits in the hands of business enterprises and of individual and corporate investors. The large volume of deposits in the hands of the public and of reserves in the possession of banks, together with a relatively limited opportunity for the use of these funds, has resulted in reducing interest rates to the lowest level in history. It has been reflected in a decline in the carrying charges on mortgage debt for farmers and urban householders, enabled many corporations to refund their debt at lower rates, and lightened the cost of current financing to commerce, industry, and agriculture. While there has not been an expansion in business activity fully sufficient to absorb the unemployed and to produce a national income adequate for the country's needs, the policy of monetary ease has contributed to the progress made in this direction.

Nor is there any immediate reason for considering a reversal of this policy. There is nothing in the present monetary or banking situation that would point to proximate danger of injurious credit expansion. It is in such a period as this, however, when there is no call for quick action to meet emergency situations, that the possibilities of future developments and the adequacy of existing regulatory machinery need to be reviewed.

Approaching the problem from this point of view it is apparent that the Federal Reserve System lacks effective powers to cope with an injurious credit expansion if it should develop. We have now \$3,000,000,000 of actual and a great amount of additional potential excess reserves. The System's powers to diminish these excess reserves are limited to a further advance of one-seventh in existing reserve requirements from 175 to 200 percent of the statutory amounts,

which would absorb perhaps \$800,000,000 of reserves, and to such sales out of its portfolio of \$2,635,000,000 of United States Government obligations as may be feasible and expedient to make. It is clear that these powers would not be sufficient to control an expansion if it got under way. There would be enough reserves left at the disposal of the banks, after the System's powers were exhausted, to provide the basis for a serious credit inflation.

The course that such an inflation takes is familiar. There develops an increase in applications for loans for new or enlarged business operations; later there begins to develop speculative activity in commodities, inventories, securities, or real estate. There is also an increase in the use of existing deposits, which increases their rate of turnover. These activities spread and feed on themselves, because prices begin to rise and even conservative business men decide to increase their stocks of raw materials and semi-finished goods before prices advance further and before their competitors gain an advantage by providing for their needs. These business demands, piling up, result in further price advances, accumulation of forward orders, duplicate orders, and competitive bidding for a limited supply of goods. Shortages of some classes of goods and some classes of labor develop. This in turn results in a further rise in prices, and the process is likely to continue till some link in the chain breaks and a reverse, or deflationary, movement develops whose violence is likely to be proportionate to the rate of the previous advance and the level of prices and speculative intensity previously reached.

This sequence of events is facilitated if banks throughout the period of expanding activity have idle reserves in excess of requirements and are free and tempted to grant large extensions of credit of an unsound or speculative



kind, or even to extend a large volume of loans that may be individually sound from the point of view of the credit risk but may nevertheless in the aggregate result in dangerous expansion both of loans and of deposits. Deposits created by perfectly sound loans, as they pass from hand to hand at a constantly growing rate of speed, may create excessive demand for some class of values, or for all classes of value, which aggravates and drives to new heights the process of credit expansion. Such developments are not necessarily far removed or slow in getting under way. On the contrary, they may start at any time and develop with breath-taking rapidity.

Monetary authorities when they are properly equipped can moderate and sometimes prevent the development of this pattern of inflation and deflation, of booms and depressions. They cannot do so, however, unless at an early stage of the boom they succeed in putting the banks in debt through open-market operations. When the banks are in debt they become subject to the discipline of the discount rate and of such direct powers over a borrowing bank's operations as are vested in the Board by different sections of the Federal Reserve Act. But if the banks are out of debt - they are largely out of reach of the System's regulatory powers.

Another aspect of the situation is that, when funds are abundant, interest rates are low - which in an inflationary situation encourages unsound undertakings. When the Federal Reserve authorities have the power to put the banks in debt and to raise the discount rate, they also have the power greatly to influence the going rate for money. Banks become more reluctant to increase the interest charges on such loans as they make. This also tends to restrain speculative expansion.

Federal Reserve authorities, however, in order to exercise such a restraining influence must - as an essential condition - be able to put member banks in debt. This power the System does not possess so long as member banks can continuously and rapidly expand their operations on the basis of reserves that they already have and are under no necessity to borrow at a Reserve bank. Consequently, the System's inability to place banks into debt, caused by excessive volume of their actual and prospective volume of reserves - makes it impossible for the System to discharge its responsibility for exercising its influence toward the maintenance of economic stability and the moderation of booms and depressions.

It is for these reasons that the Board deemed it its duty to point out to Congress the present and prospective reserve position of our banking system and the limitations on the System's present powers to regulate it.

#### Reserves of nonmember banks

In the foregoing paragraphs there has been indicated why the Federal Reserve System for the discharge of its responsibilities needs to have adequate powers to regulate bank reserves. It should be pointed out also that power over the reserves of member banks alone would not be sufficient for effective monetary regulation. While nonmember banks control only one-sixth of total deposits of commercial banks, they number 9,000 as compared with 6,300 member banks. Developments in so large a proportion of banks, even though they may control only a fraction of total deposits or loans and investments, may start an inflationary movement that might endanger the entire banking system as a whole, including both member and nonmember banks.

More important still is the consideration that membership in the Federal Reserve System is voluntary, since State member banks are free to give up their

membership at any time on six months' notice, and national banks can leave the System by giving up their national charters and take out State charters instead. It is true that banks hesitate to do so and that instances of this sort have not been numerous in the past. One reason for this, however, has been the very fact that in view of the voluntary nature of membership the Federal Reserve System has been reluctant to adopt rules or requirements for member banks that would place them at a disadvantage in competition with nonmember banks.

If a situation should develop when a restrictive action on credit expansion through modification of reserve requirements should become necessary in the public interest, Federal Reserve authorities might find themselves in a difficult dilemma. They would either have to refrain from taking necessary action in order not to create a discriminatory situation against member banks, or else take such action and have member banks in large number escape the effects of the regulation by abandoning membership. Not only would such a situation not be equitable to member banks, but it would result in a gradual diminution and ultimate loss of control by the Federal Reserve System.

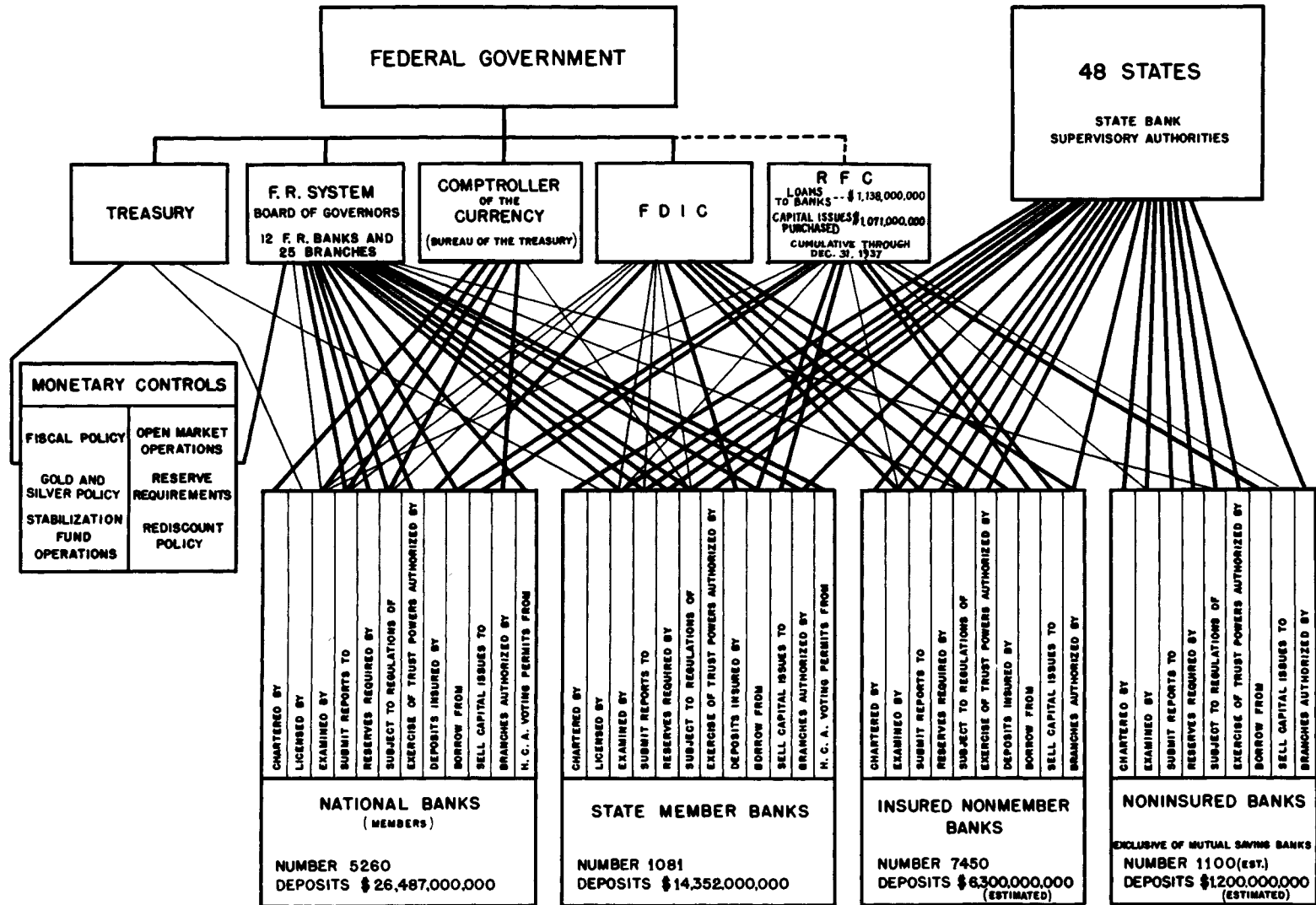
PROBLEM OF BANK REGULATION AND SUPERVISION

In the field of bank supervision, as well as in the field of monetary regulation, our financial mechanism needs strengthening. Bank supervision and regulation differ materially from State to State and as between banks that are chartered by States and those that are chartered by the Federal Government. Even within the Federal Government there is a considerable diversity, overlapping, and confusion of jurisdiction in the regulation and supervision of different groups of banks. The chart indicates the various lines of supervisory relationship as between different Federal Government agencies and the forty-eight States as they apply to the four main groups of banks: national banks, State member banks, insured nonmember banks, and noninsured banks.

(Chart)

From 1863 to 1913 Congress had jurisdiction only over national banks. Since 1913 many of the Federal laws and regulations have been made applicable to State-chartered banks belonging to the Federal Reserve System, as well as to national banks. Since 1933 some of the Federal laws and regulations have been applied to all banks that are members of the Federal Deposit Insurance Corporation, which includes all members of the Federal Reserve System and most other State banks as well. Very few Federal regulations apply to banks that are not insured. The list below shows the character of regulations that are applicable to the different classes of banks:

# PRINCIPAL BANK SUPERVISORY RELATIONSHIPS



———— MAJOR SUPERVISORY RELATIONSHIPS  
 ———— INCIDENTAL SUPERVISORY RELATIONSHIPS

NUMBER AND DEPOSITS AS OF DEC. 31, 1937.

COMPARISON OF FEDERAL STATUTORY PROVISIONS REGULATING AND  
RESTRICTING THE BUSINESS OF DIFFERENT CLASSES OF BANKS

I. Applicable to national banks only.

Restrictions on real estate loans.  
Regulations governing exercise of trust powers.  
Restrictions on acting as insurance agent.  
Restriction on acting as real estate loan broker.  
Prohibition against holding "other real estate" for  
more than five years.  
Limitation on indebtedness which bank may incur.

II. Applicable to all member banks, but not to nonmember insured banks.

Restriction on loans to executive officers.  
Restrictions on dealing with directors.  
Prohibition against paying preferential rate of  
interest on deposits of directors, officers, etc.  
Restrictions on interlocking directorates between  
bank and other banks.  
Restriction on interlocking directorate between  
bank and securities companies.  
Prohibition against securities affiliates.  
Prohibition against acting as medium or agent in  
connection with loans to dealers in securities.  
Prohibition against affiliation with other corporations.  
Limitations on loans to affiliates.  
Limitations on investment in bank premises.  
Minimum capital requirements.  
Prohibition against loaning on or purchasing own stock.  
Restrictions on withdrawal of capital and payment of  
unearned dividends.  
Prohibition against impairment of capital.  
Requirement that reserves specified in Federal Reserve  
Act be maintained.  
Prohibition against making loans or paying dividends  
while reserves deficient.  
Restrictions on purchase of investment securities and  
stock.  
Limitations on acceptance powers.  
Limitations on loans to one borrower.  
Limitations on loans secured by stocks or bonds.  
Minimum capital for branches.

III. Applicable to member banks and to nonmember insured banks (standards  
not necessarily uniform).

Restrictions on establishment of branches.  
Restrictions on payment of interest on deposits.  
Prohibition against loans or gratuities to bank examiners.

This list indicates the extent to which the different classes of banks are subject to the various Federal laws. It is clear that there is considerable diversity which not only creates an unfair competitive condition as between the different classes of banks, but also diminishes the effectiveness of many of the regulations designed to influence the soundness of the banking structure and the continuous flow of bank deposits. It should be recalled once more in this connection that the establishment of uniform, fair and workable standards of soundness for banking is not merely a matter of equity to the investors in the banking business, but also a matter of public concern in relation to the functioning of our monetary system.

An important example of diversity under present law is found with regard to requirements about capital. National banks and also State member banks must have a prescribed minimum capital in accordance with the size of town in which they are located. Other insured banks are not subject to Federal law as to minimum capital, except that in general their capital must be adequate. There are also substantial differences in capital requirements in connection with the establishment of branches.

The chart indicates that there are a number of matters on which regulatory measures are the joint concern of two or more agencies. The Board of Governors is authorized to formulate regulations on a number of matters affecting national banks, as well as State member banks, such, for example, as payment of interest on deposits and loans to executive officers. The enforcement of these provisions as they affect national banks, however, is entrusted to the Comptroller of the Currency, and the determination of limitations on interest paid on deposits by

nonmember insured banks is in the hands of the Federal Deposit Insurance Corporation. There is confusion also with regard to the exercise of trust powers; the granting of authority to exercise such powers by national banks as well as the formulation of a regulation on this matter is in the hands of the Board of Governors, while the supervision of the use of these powers is the responsibility of the Comptroller of the Currency. The Comptroller of the Currency determines what constitutes investment securities permissible for purchase by all member banks, both national and State, but the enforcement of the regulation so far as it relates to State member banks is in the hands of the Board.

The overlapping of responsibilities and diversity of regulations relating to banks, together with the ability of the banks to shift from one jurisdiction to another, have resulted over the decades in a tendency among the different authorities to relax regulations and standards of supervision in order to discourage the banks from leaving their jurisdictions. ?

An outstanding example of overlapping of responsibilities and powers is found in connection with the examination of banks. In addition to the forty-eight State bank supervisory agencies, there are four Federal agencies authorized to examine banks. National banks are subject to examination not only by the Comptroller of the Currency, but also by the Reserve System and, with the consent of the Comptroller, by the Federal Deposit Insurance Corporation. In case the national bank has sold preferred stock to the Reconstruction Finance Corporation, it is also subject to examination by that agency. In practice, the effects of these conflicting authorities have been minimized by agreement by which the agencies accept each other's examinations, but the authority, nevertheless, exists and can and sometimes is used.



The fields of examination activity of each of the three Federal agencies are sharply defined. Generally speaking, national banks are examined only by the Comptroller of the Currency. The Federal Reserve System examines State member banks and no others, and State member banks are not examined by either the Comptroller of the Currency or the Federal Deposit Insurance Corporation. The Federal Deposit Insurance Corporation examines insured State banks which are not members of the Federal Reserve System. The Federal Deposit Insurance Corporation seldom exercises the power to examine national banks and State member banks which it can do with the permission of the Comptroller of the Currency and the Board of Governors. Such examinations are generally made only when there is a serious situation and the Federal Deposit Insurance Corporation may be called upon for financial assistance. State banks belonging to the Federal Reserve System or the Federal Deposit Insurance system may be examined by a Federal as well as by the State authority, but this duplication is generally avoided by joint or alternating examinations.

Although duplication in actual examination among Federal agencies is largely avoided by cooperative arrangements, difficulties arise in the overlapping of responsibility. The attempts that have been made informally and formally to coordinate examination policies involve time and trouble which might more profitably be spent on other things. Even after an agreement is reached, there may be, and in fact there are, differences of interpretation of the procedure, formula, or policy agreed upon. Another difficulty arises in connection with cases where banks are in trouble and a merger or consolidation involving a national bank, a State member bank, and an insured nonmember

bank, or any combination of such banks, would be helpful. Action in such cases is frequently delayed and sometimes made impossible because of differences between the various Federal supervisory agencies. In such cases, where speed of action is frequently required, conflicts of jurisdiction are a great source of delay - with consequent loss to the banks and the communities. There is also much duplication of analysis and review among the various agencies.

A voluntary agreement between the agencies in connection with examination policy was reached last spring, but the effectiveness of this agreement depends in the first place on the continuance of cooperation between the agencies and in the second place on the nature of interpretation placed on the agreed principles of examination by the different agencies. A similarity of interpretation is difficult to attain because the agencies have different responsibilities and, therefore, different approaches to the problem. The Board of Governors is primarily responsible for national credit and monetary policies and is interested in a supervisory policy that is in conformity with these policies. The Comptroller's office is primarily a supervisory and examining agency and is interested principally in safeguarding the depositors of individual banks. The Federal Deposit Insurance Corporation is primarily an insurance agency and is, therefore, primarily concerned about the protection of the insurance fund, which depends upon the solvency of the banking system. While in a broader sense all of these lines of approach in the end translate themselves into the maintenance of sound banking and an unimpeded flow of money, the emphasis that is likely to be placed on different points of view by the various agencies is and must necessarily be different.

RELATION BETWEEN SUPERVISORY AND MONETARY POLICIES

From the point of view of the Federal Reserve System, a more important matter even than the inconvenience and confusion that results from multiple supervisory jurisdictions, is the fact that policies pursued with regard to examination or other supervisory rules may at times interfere with national credit policies. The question sometimes has been raised whether there should be a relationship between supervisory and monetary policies. It is contended by some that bank examination should determine the facts about the condition of each bank, detect violations of law, and determine the adequacy of assets in relation to liabilities. Such an audit or examination, it is claimed, has no relationship to monetary policy and should in no way differ in character with changes in business conditions. While this position may sound plausible at first glance, upon analysis it is entirely untenable. So far as examiners determine violations of law, or merely count the cash in the vaults of the banks, these are presumably matters of objective fact that have no particular relationship to business conditions or credit policies. So far, however, as the examiners and supervisory authorities analyze and criticize loans and investments made by banks, the principles followed and actions taken may have broad consequences upon the banking system, which are definitely related to national credit policies.

Consider first investments. In the first place, the character of the investments of all member banks is subject to definition of eligible investments by the Comptroller of the Currency, who has no responsibility for general monetary policy. Yet what the banks can invest in is at times an important factor in the ability of banks to put their funds into active use. Definitions

arising exclusively from the point of view of the protection of depositors of individual banks result in a rigidity of regulation which makes it difficult for banks to find adequate investment and, therefore, places obstacles in the way of making bank funds available for use. Furthermore, it does not always protect depositors, because definitions relating to the temporary market position of bonds are not an adequate safeguard. A bond with a good market rating may easily deteriorate if the business situation changes, and a bond that has a poor rating may advance in value. Definition of investments in terms of the intrinsic quality of the bond on the same basis on which loans are judged is a sounder approach to the problem and more in conformity with monetary policy. Soundness of a bank's investment portfolio should be considered in relation not only to the character of each individual investment, but also in relation to the nature of the bank's liabilities, the diversification of its assets, and the maturity distribution of its security holdings.

As a standard of examination procedure, the market prices of listed or quoted bonds can be more easily determined than other measures of value, and it is simpler for an examiner to insist that the banks carry their securities at the market price. This, however, is not a sound practice either from the monetary or the supervisory point of view. It is not sound from the supervisory point of view, because a high market quotation is not a guarantee of the intrinsic value of a bond which would assure the safety of the depositor. So far as monetary policy is concerned, it is likely to work in a perverse manner. At a time when a business boom is in progress bonds of inferior quality may be quoted above their intrinsic worth, and on a rigid market standard banks may well be encouraged to purchase such bonds as would be likely to decline substantially in case of a

business slump. On the other hand, at the time of a slump, when economic values are on a downward path, market quotations may greatly underestimate the safety of bonds and insistence on the maintenance of market standards may result in forced liquidation which in the aggregate may become a powerful deflationary influence.

With regard to loans, standards are not easily definable, and the examiner is likely to be influenced by past or current conditions in much the same way as the banker and the business man. He is likely to be excessively lenient at the time of a boom, when everything looks propitious and there is no apprehension of danger, and he is likely to be overcautious and consequently deflationary at a time when business is declining and bank liquidation is under way.

Changing economic conditions require changes in policies of banking regulation. Many loans which might ordinarily be made with complete safety by individual banks might, if made in large amounts by many banks at the same time, lead to developments which would make those loans unsafe. There are times, on the other hand, when it is in the public interest not to discourage banks from making loans or purchasing investments which at other times they should be discouraged from holding. In other words, banking supervision must recognize broader considerations than merely the apparent soundness of individual loans and investments as measured by standards of past performance. Examination standards should be flexible and instructions to examiners, and consequently the examiners' recommendations to the banks and to the supervisory authorities, should vary in accordance with the needs of the country for credit.

A bank examiner is not in a position to determine what broader monetary policies should guide him. National authorities should work out for him rules and regulations that set forth as clearly as possible his duties and the standards that should determine the nature of his recommendations. These rules and regulations should be worked out in conformity with broad requirements of monetary policies and should be flexible, subject to modification in conformity with those policies.

For example, at a time when business is in a slump and there is a rush for liquidation, a monetary authority may prescribe lenient rules in connection with bonds and with loans which would relieve the examiner from the necessity of putting pressure on the banks for liquidation. On the other hand, at a time when a boom is in progress monetary authorities may instruct examiners to criticize certain types of loans, even though they may be sound as individual propositions, because there may be evidence of overexpansion in a particular field, taking the system as a whole, or there may be overexpansion in total loans, even though the loans in individual cases appear to be sound. A familiar and telling example of that is the growth of brokers loans between 1925 and 1929. From a strictly examination point of view these loans were good. Few losses were sustained by the lenders. Nevertheless, the rapid expansion of brokers loans to enormous totals contributed to the development of the speculative situation which finally resulted in the collapse of 1929. After that the very fact that those loans were easily collectible through the sale of pledged securities led to a dumping of securities with a consequent deflationary force of incalculable strength which was an important factor in aggravating the deflation and depression that ensued.

The development of clear-cut banking standards uniformly applicable to all classes of banks, together with the development of procedure in the issuance of regulations adjusted to changing economic conditions, is a necessary condition for the effective functioning of our banking system in various phases of the business cycle. A close coordination of supervisory and monetary authorities is, therefore, essential if the banking system is to be a stabilizing rather than a disorganizing force in the nation's economy.