July 2, 1935

MEMORANDUM ON SENATE SUB-COMMITTEE DRAFT OF TITLE II OF THE BANKING BILL OF 1935

The principal objectives to be achieved by Title II of the Banking Bill of 1935 are: (1) to improve the administrative machinery of the Federal Reserve System; (2) to concentrate in a single public body authority and responsibility for national credit and monetary policies; (3) to eliminate unnecessary restrictions on the Reserve banks and the member banks that have proved to be ineffective in preventing disaster and are now hampering economic recovery; and (4) to make it clear that it is the duty of the Federal Reserve System to contribute what it can to the restoration of prosperity and thereafter to use its influence towards the maintenance of stability in business and employment.

The sub-committee substitute for Title II would fail to accomplish these purposes. By retaining the chairman of the board of directors and providing by law for another person to be the chief executive of the Reserve bank, to be known as its president, it continues the existing dual and clumsy organization; by failing to make it clear where the responsibility for monetary policy lies, since some of the powers are left in the banks, some in the board, and some vaguely in the proposed Open Market Committee, the sub-committee bill fails to fix clear-cut responsibility. It also fails to give the System a broad objective toward which it must use its powers. Finally, the sub-committee does not go far enough in removing unnecessary restrictions in regard to eligibility and collateral

requirements and in regard to real estate loans to increase effectively the ability of the banking system to contribute its best efforts towards economic recovery.

The proposals and omissions in the Senate sub-committee bill are discussed in more detail in the following paragraphs.

Reserve bank organization

1. The sub-committee's proposal provides that the governors of the Federal Reserve banks shall be known as presidents and that there shall also be vice presidents. Both of these officers shall be elected by the directors of the Federal Reserve banks subject to approval every five years by the Federal Reserve Board. No change in the existing law is proposed in relation to the chairman of the board of directors and Federal Reserve agent.

This provision defeats the object of the proposed legislation because it does not do away with the dual organization of the Federal Reserve banks, with conflicting jurisdiction, duplication of effort, and diffusion of authority between the chairman of the board and the president of the bank.

Rotation of directors

2. The recommendation that directors of Reserve banks be not permitted to serve for more than two consecutive full terms is omitted from the sub-committee bill. The purpose of the provision was to prevent crystallization of interests of particular groups in the directorates. The omission, therefore, is undesirable.

Changes in title and composition of Federal Reserve Board

3. In relation to the Federal Reserve Board, the sub-committee bill proposes to change its title to Board of Governors of the Federal Reserve System. It proposes the elimination of the two ex-officio members and the establishment of a new board of seven members to be appointed by the President. No specific qualifications are proposed for the members except that at least two shall have had tested banking experience; the members are to be selected by the President, as at present, with due regard to the various economic interests of the country, and not more than four shall belong to any one political party. The term of office is fourteen years; the members are not eligible for reappointment; the salary is $15,000; and there is no provision for pensions.

Without commenting on the proposed change in the composition of the Board or in its official title, it may be stated that it would be unfortunate not to provide qualifications for board members along the lines suggested in the House bill, namely, that they shall be qualified by education or experience or both to participate in the formulation of national economic and monetary policies. This qualification would emphasize the character of the duties of the board and would make it more difficult for the President to appoint and to secure the confirmation of unqualified persons. It would be desirable, if two members are to have tested banking experience, that it be specified that it shall be experience in Federal Reserve or in commercial banking.

Ineligibility of members for reappointment is highly undesirable, because it will make it more difficult to have qualified men accept

positions on the board. This is contrary to the recognition of the public importance of having the board consist of men of the highest qualifications. For the same reason pensions for board members should be authorized. If no other pension plan is provided, both present and future Board members should at least be authorized to participate in the retirement plan of the Federal Reserve System, which is applicable to persons of the age of sixty-five.

There is a provision in the sub-committee bill requiring that not more than four members of the Board of Governors shall belong to one political party. This makes the board bi-partisan, whereas it ought to be non-partisan, in order to be non-political. It would serve the public interest better to provide that all the board members shall be qualified for the work they must do rather than that the two political parties shall be adequately represented.

The sub-committee bill omits the power of the Federal Reserve Board to delegate some of its authority to individual members or other representatives. This is an undesirable omission because it would prevent the board from relieving itself of a mass of routine duties which could be as well or better performed by individual members or by the regional banks.

Chairman of the board

4. The sub-committee bill provides that the Chairman and Vice Chairman of the Board of Governors be appointed by the President for four-year terms.

This is undesirable because at the expiration of the four years, which might or might not coincide with the term of office of the President of

the United States, the chairman would run the risk of not being reappointed, would in that case usually not want to stay on the board, and yet would not be permitted to engage in the banking business for two years.

It would be extremely difficult under these provisions to secure capable executives for the position of chairman of the board. It would be preferable to have the designation of the chairman of the board be at the pleasure of the President, as it is in effect under existing law. If the Secretary of the Treasury and the Comptroller of the Currency are not to be members of the board, the President should be in a position to have as chairman a man who is in general sympathy with his economic program. The President, in choosing a chairman, should not be hampered by the restrictions that not more than one member may come from one Federal Reserve district. The prohibition against accepting positions with the member banks for two years after leaving the board should also be made inapplicable to the chairman, as is proposed in the House bill.

Publicity

5. The sub-committee bill provides for publication in the annual reports to Congress of the Board of Governors of the Federal Reserve System of all records kept with respect to all questions of policy determined by the board. This provision is too sweeping, since it would be impracticable to publish all records on the great variety of policy decisions made by the board in the course of a year. The requirement for publication should be confined to the record of decisions on national credit or monetary policies.

Eligibility provisions

6. The sub-committee bill proposes in effect the continuance of the so-called section 10(b) of the Federal Reserve Act, which permits advances by Reserve banks on satisfactory assets, at a penalty rate, when the banks' eligible paper has been exhausted.

It is not an acceptable substitute for the proposal in the House bill, which was intended to remove the unnecessary distinctions between classes of paper based on form and maturity. If the banks have to demonstrate that they have no eligible paper and are obliged to pay a penalty rate on advances on ineligible paper, this will not serve the purpose of making banks feel more ready to extend longer-time credit with the assurance that the Federal Reserve banks will come to their assistance in case of need, so long as their assets are sound.

The sub-committee bill eliminates the requirement that the circumstances under which ineligible paper might be used as a basis of borrowing must be "exceptional and exigent." The elimination of this language, however, would not be sufficient to encourage the banks to be more willing to contribute to business recovery.

Experience has demonstrated that technical provisions do not protect the banking system from disaster. What the House bill proposes is that the Reserve banks look to the substance rather than the form of paper and that they recognize their obligation to prevent banks with sound assets from being obliged to close their doors. The sub-committee bill is a half-hearted gesture in that direction and is not an adequate substitute for the original proposal.

Open-market proposal unsatisfactory

7. The sub-committee provisions on the Open Market Committee are absolutely unsatisfactory. The committee is to consist of the board of seven members and five representatives of the Reserve banks, selected by the twelve presidents. This results in an even number, which is bad, and in a poor distribution of the membership, because the five bank representatives, with the assistance of one board member, would be able to tie up proceedings.

Worse than that, the committee would have no authority whatsoever except to issue regulations. The central purpose of the legislation, which is to concentrate authority and responsibility for monetary policy in one body, would be defeated by the sub-committee proposal. It is not clear what is intended to be the procedure, but it would seem that the Reserve banks would retain their authority to do as they please about open-market operations, subject to regulations by the committee.

However the committee may be constituted, it should have clear-cut powers of determining the System's monetary policies; otherwise responsibility for these policies would continue to be diffused.

The sub-committee bill gives the Open Market Committee no authority whatsoever over the other two instruments of monetary policy, changes in reserve requirements and in discount rates. This would make it possible for a situation to arise where the Open Market Committee was attempting to pursue one credit policy and the board and banks nullified that policy by the use of one or both of the other instruments. For example, the Open Market Committee might decide to ease credit by recommending purchases of

securities, and the board and the banks might decide to tighten it by raising reserve requirements or discount rates. Under such a set-up it would be difficult to achieve a national policy. It is no improvement over the existing situation, which it is the purpose of the proposed legislation to correct.

The proposal in the sub-committee bill that purchases of obligations of the United States Government or guaranteed by it shall be made by Reserve banks only in the open market should be modified to permit the purchase of temporary certificates of indebtedness directly from the Treasury on quarterly income tax dates and on other similar occasions. The prohibition of such purchases would serve no useful purpose and would result periodically in unnecessary, violent fluctuations in the money market.

No objective provided

8. The sub-committee bill provides for no objective for Federal Reserve System policy. The Federal Reserve Act says that the Federal Reserve banks must accommodate commerce and business. This represents a narrow and inadequate conception of the functions of the System. It is not merely its business to provide accommodation to commerce and business when business desires it. It is its function to exercise such powers as it has to influence in the public interest the volume of available means of payment for all the people of the United States. Recognition of this function of the System and of the fact that it must use its powers for the purpose of promoting business stability and full employment is the heart of the proposed legislation.

A reversion by the Federal Reserve System to the obsolete idea that it should be a passive agent of trade, industry, and agriculture would be fatal to a proper discharge of the System's responsibilities.

Collateral for notes retained

9. The sub-committee bill omits all reference to the proposal in the House bill by which the Federal Reserve banks would be freed from the expensive, unnecessary and cumbersome provisions about collateral against Federal Reserve notes. These provisions serve no useful purpose, do not improve the quality of Federal Reserve notes, and yet have dangerously hampered the Federal Reserve System at times when it should have been able to combat deflation. Retention of these provisions is another indication that the sub-committee bill is not in harmony with the understanding of the practical operation of the Federal Reserve System which experience for over twenty years has developed.

Admission of insured banks to membership

10. The sub-committee bill omits the section which authorizes the Federal Reserve Board to waive requirements for admission of insured banks to the Federal Reserve System. This omission is unfortunate because, if the banks are obliged to join the Federal Reserve System, it should be within the power of the board to facilitate this by temporarily waiving capital and other requirements. It is an important step in the direction of unification of banking and ought not to be omitted.

Changes in reserve requirements

11. The sub-committee bill limits the authority of the Federal Reserve Board in regard to changes in reserve requirements by providing as a minimum the maintenance of existing requirements and as a maximum an amount twice as large. The maximum limit is inadequate because in the present situation, with

2 1/2 billions of existing excess reserves and 3 to 6 billions of additional excess reserves that could be created through means now in sight, the Federal Reserve Board should have the power to protect the country against inflation caused by the unrestricted use of these reserves.

If it is deemed desirable to provide a maximum limit, a better limitation would be that the Federal Reserve Board shall not have the authority to raise reserve requirements beyond the point where they would absorb, in the aggregate, the vault cash and excess reserves held by member banks at the time. This would afford a safeguard against unreasonable advances in reserve requirements and, at the same time, would provide protection against inflation. The sub-committee bill provides that action on reserve requirements shall be by a vote of at least five board members. There is no reason why action in this matter should require a particular kind of vote by the board, when action in regard to other instruments of credit policy, namely, open-market operations and discount rates, can be taken by a simple majority vote.

Real estate loans

12. The provisions in the sub-committee bill on real estate loans have two principal defects. First, the provision that amortized real estate loans by member banks must be repaid up to 50 percent in ten years would make the burden in the early years unnecessarily heavy for the borrowers. Government agencies are making amortized real estate loans which mature in eighteen years and insurance companies are advertising for amortized real estate loans maturing in twenty years. Secondly, the omission of any provision requiring State member banks to comply with

the same limitations and regulations governing the making of real estate loans as are applicable to national banks places national banks at a competitive disadvantage. If the Federal Reserve System is to be responsible for promoting sound banking conditions, it should have the power of prescribing regulations for all member banks. The minimum requirement that should be considered in this connection would be that the provisions of the law should apply to all member banks but should not be interpreted as prohibiting such real estate loans by State banks as may be expressly permitted by the laws of the States in which they are located.