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February 20, 1935

Dear Senator Fletcher:

Having been out of the city for several days, I have been delayed somewhat in answering your letters of February 14.

I appreciate your expressions of interest in my address to the Ohio Bankers' Association, and I am especially glad to know that your long experience in banking legislation has led you to substantially the same conclusions that I voiced last week in Columbus. I am also glad to have you raise the points that you do about bank loans on real estate and about Government securities held by the Federal reserve banks and other banks.

First, as to your inquiry about bank holdings of Government obligations.

(insert)

Now as to the provisions in the proposed Banking Act of 1935 relating to real estate loans, in regard to which you refer to the editorial in the Washington POST of February 14 and to the letter of February 11 from your friend in Jacksonville.

I quite agree with you that we shall be confronted with many arguments against these real estate loan provisions, and that we should be prepared to make any modifications that may be required to strengthen these provisions after due consideration of constructive suggestions having that end in view. This whole question of mortgage lending by banks, however, is one on which there has been much loose thinking as well as loose practice, and it is therefore not surprising that the changes now proposed have been hastily criticised and widely misinterpreted.

The objections to the proposed changes fall into two main classes. There is first the view that commercial banks should not be permitted to make long-term investments because the liabilities of such banks are payable on demand. This is the crux of the argument made by the Washington POST. The second class of objections is predicated on the assumption that to enlarge the mortgage-lending power of our banks, in the manner now proposed, would be to disregard the experience of the recent past and to invite a repetition of

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practices that have proved disastrous.

As to the segregation of short-term and long-term lending functions in distinct types of institutions, it seems to me that this is by now plainly an academic theory that is impossible of practical application. Under the Federal Reserve System, our banks have been engaged in both types of lending for twenty years with the full sanction of law. They have also engaged, with the full sanction of law, in savings banking as well as in commercial banking. The time deposit and the long-term investment functions are inseparable under our economic system, and the segregation of the long-term from the short-term lending function, in distinct types of institutions, would therefore involve also the segregation of the time and the d mand deposit functions.

I need not tell you that such a step would be politically impossible of accomplishment even if it were desirable on financial grounds. But as a matter of financial policy it would be equally impossible. It would disrupt our banking system as a whole, and would leave the vast majority of our banks without enough business of either the short-term or the long-term type alone in their communities to make possible their continued existence.

As a matter of fact—a fact that I have stressed in the statements that I have made thus far on the new banking bill—a vital practical problem now confronting our banks is that of increasing their earning assets and thereby justifying, on the one hand, their existence as business enterprises, and, on the other, their continued support by the communities that they are organised to serve. This is the immediate reason for the proposal to enlarge their powers and to encourage their activities in a field where an abundance of sound loans is now available, but where lending is discouraged by the present undue concern of the banks over the question of liquidity.

The error that the objectors to these proposed enlarged powers fall into is that of considering only the section of the new banking bill relating to real estate loans. That section cannot be considered as standing alone. In the first place, it must be considered in relation to the provision that would enable the Federal Reserve Board to make any sound asset available for borrowing at the Federal reserve banks. This is a sufficient answer to the objection

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that sound real estate mortgages become frozen assets in an emergency. In the second place, it must be considered in relation to the deposit-insurance law, which is in itself an insurance against the kind of emergency—a run on the banks—that is the chief occasion for concern over liquidity.

The essential question, then, is whether the proposed new provisions look toward sound loans. It seems to me plain that the present provisions do not. They limit to a period of five years a type of loan that is essentially of a long-term character. They do not look to the capacity of the borrower to liquidate the loan and do not require the loan to be regularly curtailed. They encourage the perpetuation of mortgage debt and impose on the borrower the unwarranted costs of periodic renewals. They virtually force the borrower to resort to second-mortgage financing with its prohibitive costs.

These are practices that the proposed new provisions are designed to end; and I am sure you will agree with me that they should be ended in the interest of banks and borrowers alike, and for the protection of the real estate and mortgage markets as a whole. I believe that the new provisions, if enacted, would go a long way toward restoring to real estate mortgages the place that they have traditionally occupied as prime investments.

Yours very sincerely,

JMD/mmm

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