July 13, 1935

REC'D IN FILES SECTION
NOV 3 1950
111.2-40

ELIGIBILITY REQUIREMENTS

In section 206 of the Banking Bill of 1935, as originally introduced, it was proposed to substitute for the rigid eligibility requirements that are now in the Federal Reserve Act a provision that any Federal Reserve bank, under rules and regulations prescribed by the Federal Reserve Board, may discount any commercial, agricultural, or industrial paper and may make advances to a member bank on any sound asset.

The principal purposes of the proposal are as follows:

(1) To encourage recovery by making banks more willing to meet the community's requirements for long as well as short-term credit, in the assurance that, in case of need, advances could be obtained from the Federal Reserve banks on any sound asset.

(2) To eliminate from the law rigid limitations on the kind of paper eligible as a basis for borrowing at the Federal Reserve banks. These limitations not only failed to protect the banks from disaster, but contributed to the deflation that swept the country in 1930-32. The fact that banks with sound assets were unable to obtain accommodation at the Reserve banks because their paper was not in eligible form caused many banks to call loans and to sell investments in order to put themselves into a liquid position. This liquidation by the banks caused hardship to borrowers, accelerated the widespread decline in values, and was an important factor in bringing about the general collapse of the banking structure.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

(3) To recognize in the law the fact that the banks cannot perform their economic functions, or make expenses, if they confine their operations to loans on self-liquidating eligible paper. There is only about $2,000,000,000 of this kind of paper available at the present time, or 8 percent of the banks' assets; and there was only $4,000,000,000, or 12 percent of assets, before the collapse in 1929. So long as banks hold $10,000,000,000 of the people's savings, they must be prepared to make long-time loans.

The proposal would not encourage unsound banking but, on the contrary, would lay down the principle that soundness can be achieved only by insisting on the underlying quality of loans rather than on their form.

The proposal in the Senate bill would fall short of accomplishing these purposes because it would preserve the discrimination in the existing law against paper that is not strictly self-liquidating and of short maturity, by providing (1) that such paper could not be used as a basis of accommodation at the Federal Reserve bank until the bank's eligible paper has been exhausted, and (2) that advances made on ineligible paper shall carry a penalty rate of at least 1 percent above the discount rate.

The requirement that eligible paper must be exhausted before accommodation on other paper can be obtained would make a bank hesitate to apply for such accommodation, because this would be giving notice that it has no liquid paper left. This information, furthermore, would be given to the directors of the Reserve bank, who would include three local bankers, possible competitors of the applying bank. The requirement for a higher rate f

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

advances on other than eligible paper would also be an unnecessary discrimination against longer-time paper, though this restriction would be less objectionable in practice than the first.

Since the adoption of the Senate bill with these restrictions would do little to encourage banks to adopt more liberal lending policies or to be more willing to meet the community's need for long-time credit, it is proposed that the bill be modified by eliminating these two requirements.

On another point the Senate bill contains a proposal that has much to commend it. It follows the emergency Glass-Steagall Act of 1932 in providing that accommodation on paper, as defined in the Federal Reserve Act, must be obtained on notes of the member banks secured by satisfactory collateral, and that rediscounts with Reserve banks by member banks of customers' paper shall continue to be subject to existing restrictions. The Reserve banks' portfolios would consequently consist of rediscounted paper, that would conform to eligibility requirements, and of member bank collateral notes secured to the satisfaction of the Reserve banks, which, if experience is a guide, may be depended upon to require adequate security. The maturity of these collateral notes would be in accordance with regulations prescribed by the Federal Reserve Board. If it is thought advisable by Congress, there would be no objection to limiting the maturity to a maximum of 9 months, which is the maximum maturity permitted under existing law for any class of rediscounted paper.

It is believed that, if the Senate bill, with the suggested modifications, were enacted, it would go a long way toward accomplishing the desired objectives.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

July 13, 1935

ELIGIBILITY

(Amendment to Section 203 of H.R. 7617)

Page 149, strike out all of lines 1 to 13, inclusive, and substitute the following:

"Sec. 10(b) Notwithstanding any other provision of law, any Federal Reserve bank, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, may make advances to any member bank on its promissory notes payable on demand or not more than nine months after date, exclusive of days of grace, and secured to the satisfaction of such Federal Reserve bank."

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis