Form No. 131

Office Correspondence

FEDERAL RESERVE BOARD

111.2-40

Date February 9, 1935.

To Governor Eccles

From Walter Wyatt, General Counsel.

Subject: Reasons for and against amendments contained in Title II of the Banking Act of 1935.

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Dear Governor Eccles:

I am handing you herewith for your information a memorandum which I prepared very hurriedly Thursday night at the request of Mr. Szymczak, which states reasons for and against the amendments contained in Title II of the Banking Act of 1935.

I did all of this in about five hours and, therefore, it necessarily is not a very thorough or satisfactory job. However, it may be of some use to you. I am sending a copy to Dr. Goldenweiser.

Respectfully,

Walter Wyatt,
General Counsel.

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February 7, 1935.

Mr. Szymczak

Mr. Wyatt, General Counsel.

Reasons for and against amendments contained in Title II of the Banking Act of 1935.

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Dear Mr. Szymczak:

In accordance with the request contained in your memorandum of this date, I am handing you herewith a "list of reasons" for and against the amendments to the Federal Reserve Act proposed in Title II of the Banking Act of 1935.

I had so many interruptions during the day that it was impossible for me to start on this until after dinner tonight; and, in view of the fact that you want it by tomorrow morning, the time is so limited that I could not do a very thorough or satisfactory job. However, I sincerely hope that this will serve your present purposes and that, if you desire something more elaborate, you will not hesitate to call upon me for it.

I understand that this is for your personal use only; and, for reasons which are obvious, I shall appreciate it if you will not quote it as expressing my views one way or the other. It is not intended to represent my views but only to indicate the principal arguments which, in my judgment, could be made for or against each proposed amendment.

Respectfully,

Walter Wyatt,
General Counsel.

Attachment.

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Feb. 7, 1935

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ARGUMENTS FOR AND AGAINST AMENDMENTS TO
FEDERAL RESERVE ACT CONTAINED IN
TITLE II OF THE BANKING ACT
OF 1935

(Note: The various amendments are discussed by topics in the order in which they occur in the mimeographed summary of Title II.)

1. FEDERAL RESERVE BANKS

Abolish the office of Federal Reserve Agent and combine the offices of Chairman of the Board of Directors and Governor at the Federal reserve banks, appointments to be made annually by the Directors of each bank subject to approval by the Federal Reserve Board. The Governor to be the chief executive officer of the bank, Chairman of the Board of Directors, and a Class C director. A Vice Governor to be selected in the same manner and to perform the executive functions of the Governor in his absence. The Vice Governor may also be a Class C director and may be appointed as Deputy Chairman of the Board of Directors (Sec. 201, pp. 38-40).

Arguments for the Proposal

This proposal would increase the efficiency of the organizations of the Federal Reserve banks, by doing away with the present dual organization (under which the responsibility for the bank's operation is divided between the Governor and the Chairman) and substituting a single

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executive head who will be responsible for all of the operations of the bank and for its personnel, and would also have the power and responsibilities of the Chairman of the Board of Directors. It would serve the interest of economy by eliminating one of the highest salaried officials. It would be in line with the intent of the original Federal Reserve Act, which contemplated a single executive head of the bank in the person of the Federal Reserve Agent. By requiring the Governor to be appointed annually and making his appointment subject to approval by the Federal Reserve Board, the Board's control over the actual operations of the banks would be strengthened. The arguments in favor of a Vice Governor to perform all of the executive functions of the Governor in his absence are obvious.

Arguments Against the Proposal

The proposal would weaken the control of the Federal Reserve Board over the Federal reserve banks; because it would deprive the Board of its own representative, the Federal Reserve Agent, who is appointed by the Board alone and who is now required by law to maintain an office of the Board on the premises of the Federal reserve bank, to make regular reports to the Board, and to perform such other functions as the Board may require. Being initially selected by the directors of the Federal reserve bank, the Governor would be more subservient to the other directors than he would to the Federal Reserve Board, which only would have the power to approve or disapprove his appointment. Moreover, by requiring the Board to designate as a

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Class C director the person selected by the directors as Governor if he is approved by the Board for that office, the amendment would deprive the Board of the power to appoint one of the three directors now appointed by the Board. Moreover, if the Vice Governor be designated by the Federal Reserve Board as a Class C director, the Federal Reserve Board would be represented on the Board of Directors by only one Class C director who is not selected initially by the other directors.

2. SERVICE OF FEDERAL RESERVE BANK DIRECTORS

No member of the board of directors of a Federal reserve bank, except the Governor and Vice Governor, shall hold office for more than six consecutive years. (Sec. 201, p. 40, lines 17-22.)

Arguments for the Proposal

By providing for rotation in office, this proposal would bring fresh ideas and fresh viewpoints into the management of the banks from time to time and would prevent any one viewpoint or any one interest from obtaining too strong a foothold. It would furnish an easy means of eliminating without embarrassment directors who have outlived their usefulness but would not prevent the re-appointment of especially able directors after they had been off of the board for at least a year.

Argument against the Proposal.

This amendment would deprive the Federal reserve banks of some of their most experienced and desirable directors, who have remained on the boards of directors for many years because of their deep interest in

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the affairs of the Federal Reserve System and their devotion to its service. It would make for less stability and continuity in the bank's management and would weaken the adherence to high ideals and sound principles which is incidental to the long service of men of high character.

3. QUALIFICATIONS OF MEMBERS OF THE BOARD - TERM OF OFFICE OF GOVERNOR

Change qualifications of future appointive members of the Federal Reserve Board by providing that they shall be well qualified by education or experience or both to participate in the formulation of national economic and monetary policies. Make the present geographical limitations inapplicable to the selection of future Governors. Provide that the Governor's membership on the Board shall expire when he is no longer designated as Governor by the President. (Section 203 (1), pages 41, 42; Section 203 (3), page 43.)

Arguments for the Proposal.

The present requirement that, in selecting the six appointive members of the Board, the President shall "have due regard to a fair representation of the financial, agricultural, industrial and commercial interests, and geographical divisions of the country" is improper because it indicates that the Board members are expected to represent special interests or special parts of the country, whereas they should represent the entire country. The present law contains no requirements as to qualification by education or experience, which is believed would be more appropriate than the requirement that the Board members represent certain special interests.

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In selecting the Governor the President should be free to select the best man from the entire country and should not be prevented from appointing the man of his choice because he happens to be from the same district as another member of the Board.

The Governor should serve at the pleasure of the President, in order that he might always be in sympathy with, and responsive to, the needs of the administration.

Arguments against the Proposal.

The proposed new qualifications of the members of the Board are of no importance because they are vague and will not prevent the President from appointing anyone he chooses to appoint.

With only five other appointive members on the Board, the President always has seven Federal reserve districts from which to select a Governor, and, from this wide field, should always be able to select the proper kind of man to serve as Governor of the Board.

To have the Governor of the Board serve at the pleasure of the President would make him distinctly a political appointee and would make it more difficult to induce successful men of independent judgment to accept the position of Governor. It would make the Board less independent and less biased in its decisions and would make it less like a "Supreme Court of Finance", which it was intended to be, and more like a politically minded department of the Government. It would increase the danger that the Board's decisions on important economic and financial questions affecting the entire country would be influenced by political considerations.

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4. SALARIES AND RETIREMENT OF BOARD MEMBERS.

Increase the salaries of future appointive members to $15,000 per annum, with compulsory retirement at seventy on a pension of $12,000 per annum. Make present members eligible for retirement at seventy. Allow proportionate pensions for those who have served for more than five or less than twelve years or whose terms expire after they have reached the age of sixty-five and who are not re-appointed. (Sec. 203 (2), pp. 42,43).

Arguments for the Proposal.

Increasing their salaries and providing retirement pay for Board members would make it easier for the President to obtain the services of persons of ability and high character whose personal fortunes are not sufficient to enable them to live in Washington in dignity and comfort on the present salaries of Board members. It would make them more independent and more willing to make a life-time career out of being members of the Board. Compulsory retirement at seventy would prevent members from continuing to serve after they have outlived their usefulness.

Arguments against the Proposal.

The small increase in salary proposed is not sufficient to make the position more attractive to men of the right kind and the salary is not enough to enable a member of the Board to live in Washington in a manner commensurate with the dignity and importance of

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his position. While the pension would be some added inducement and comfort to men without dependents who desire to devote their lives to service on the Board, it would provide no protection to the wife or other dependents of such member. Some men render their best service after passing the age of seventy and the compulsory retirement provision would prevent such men from giving their best years of service to the Board.

5. DELEGATION OF POWERS.

The Board shall be empowered to delegate specific powers and duties to designated members of the Board or officers of representatives of the Board, but shall not delegate the power to determine any national or system policy or to make rules and regulations or any power which is required to be exercised by a specified number of members of the Board. (Sec. 204, pp. 43, 44).

Arguments for the Proposal.

This proposal would enable the Board members to divide up among themselves the performance of many routine duties or to delegate such duties to members of their staff or to representatives at the Federal reserve banks, thus leaving each member of the Board much more time to give consideration to the more important questions of national and System policy which desérve careful thought and thorough study. It is contemplated that the powers so delegated would be exercised in accordance with general regulations or policies laid down by the Board,

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so that the only thing which really would be delegated would be the power of applying the Board's general policies to the facts of specific cases. The Board would formulate all national or System policies but would be relieved of the burden of passing on individual cases.

Argument against the Proposal.

Congress created a Board because many of the powers and duties under the Federal Reserve Act are too important to be entrusted to single individuals; and the proposed amendment would enable the Board to delegate many very important powers to individual members of the Board or even to employees or representatives of the Board, who are not appointed by the President or confirmed by the Senate. The Board might become a mere figure head under this arrangement.

6. OPEN MARKET COMMITTEE

Amend section 12A of the Federal Reserve Act so as to provide for an open market committee consisting of the Governor and two other members of the Board elected annually by the Board, and two Governors of the Federal reserve banks elected annually by the Governors of the Federal reserve banks. Give this committee the power to determine the open market policies of the Federal Reserve System and make such policies binding on the Federal reserve banks without approval by the Federal Reserve Board. All open market operations of the Federal reserve banks would be subject to regulations prescribed by the Federal Reserve Board.

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The committee would make recommendations regarding discount rates; but the power actually to fix such rates would be left in the directors of the Federal reserve banks, subject to the review and determination of the Federal Reserve Board as at present. (Sec. 205, pp. 44,45)

Arguments for the Proposal.

The present machinery, which provides for an open market committee consisting of representatives of each of the twelve Federal reserve banks whose recommendations must be approved by the Federal Reserve Board before they become effective is too slow and cumbersome. The proposed new bommittee would be more efficient and could act more promptly, because it would be a small committee and its decisions would be final. While the final authority would be transferred from the Federal Reserve Board to a committee consisting of three members of the Board and two representatives of the Federal reserve banks, it would be consistent with the principle of the original Federal Reserve Act that there should be a central body in Washington charged with the duty and given the power to co-ordinate the activities of all twelve Federal reserve banks for the purpose of carrying out credit policies affecting the country as a whole.

Arguments against the Proposal.

This proposal would deprive the Federal Reserve Board of its most important function and would greatly reduce the Board's power and prestige. Having a majority of the committee members of the Board would

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not correct this difficulty; because (a) the three members of the Board who are on the committee might vote for a policy which the other five members of the Board are opposed to, or (b) conceivably, one Board member and the two bank representatives might put into effect a policy which the other seven members of the Board would be opposed to.

Since the final power to fix discount rates would remain with the Board, this might lead to a situation where the Committee would be striving for one result through open market operations, while the Board as a whole would be striving to prevent the same result through its rate policy.

Giving the Committee the power to determine open market policies but leaving the Board the power to prescribe regulations governing the open market regulations might lead to hopeless conflicts of authority.

Moreover, a committee such as that proposed could not be as independent or unprejudiced, or as well equipped, as the Federal Reserve Board to reach final decisions on matters of such tremendous importance to the entire country.

7. ELIGIBILITY FOR REDISCOUNT

Subject to such regulations as the Federal Reserve Board may prescribe, make any commercial, agricultural, or industrial paper eligible for rediscount by Federal reserve banks and authorize Federal reserve banks to make advances to their member banks on their promissory

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notes secured by any sound assets of such member banks. (Sec. 206, pp. 45, 46).

Arguments for the Proposal.

The present eligibility requirements are theoretical, impractical and entirely too technical. Much of the paper that is technically eligible for rediscount is not good from a credit standpoint and much paper that is not technically eligible for the rediscount is perfectly good from a credit standpoint. The result has been that Federal reserve banks frequently discount eligible paper of doubtful value and take ineligible paper as additional collateral. This is a senseless procedure which has made the Federal reserve banks appear supertechnical and sometimes ridiculous.

The changes in our economic life and in our method of doing business which have taken place since the Federal Reserve Act was passed have greatly reduced the amount of eligible paper in the country; and many member banks do not have enough eligible paper to enable them to obtain reasonable credit accommodations from the Federal reserve banks. Moreover, in 1932 it became necessary to make any asset of a member bank eligible as security for a loan from the Federal reserve bank in time of emergency and the Reconstruction Finance Corporation made many of the loans to member banks which the Federal reserve banks should have made.

If this amendment is enacted, the Federal reserve banks could perform their functions much more effectively than they can under existing laws and it would not be necessary to enact special legislation

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to meet an emergency. If their directors and officers continue to be as capable and conservative as they have been in the past, the Federal reserve banks will not acquire enough slow assets to effect their liquidity to any appreciable extent.

Arguments against the Proposal.

The proposal is inconsistent with the theory of the original Federal Reserve Act that the reserves of member banks should be invested only in short term, self-liquidating, business paper growing out of current business transactions, so that the volume of Federal reserve credit in the market would automatically expand and contract in response to the changing needs of business. Furthermore, it would make it possible for the Federal reserve banks, if poorly managed, to tie up the reserves of the member banks in slow assets which could not be liquidated if the need arose. If it is improper for banks of deposit to tie up demand deposits in slow loans and capital assets, it is much more improper for the reserve banks to tie up the reserves of commercial banks in such assets. If this should happen, the next depression might wreck not only all of the member banks but the Federal reserve banks as well.

8. PURCHASE BY FEDERAL RESERVE BANKS OF OBLIGATIONS GUARANTEED BY THE UNITED STATES.

Amend Section 14 of the Federal Reserve Act so as to make eligible for purchase by Federal reserve banks, without regard to the

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six months' maturity limitation of the present law, all obligations which are fully guaranteed by the United States as to principal and interest. (Sec. 207, p. 46).

Arguments for the Proposal.

Inasmuch as bonds and notes which are direct obligations of the United States are now eligible for purchase by Federal reserve banks without regard to their maturities, it seems inconsistent and unnecessary to permit obligations which are fully guaranteed by the United States as to principal and interest to be purchased by Federal reserve banks only when they have maturities from the date of purchase not exceeding six months. The credit of the Government is pledged for the latter just as much as for the former.

Arguments against the Proposal.

Federal reserve banks ought not tie up their funds in long term investments; and this amendment simply adds to the evils of the present law by enlarging the class of long term securities which the Federal reserve banks may purchase.

9. FEDERAL RESERVE NOTES.

Abolish altogether the present requirement that Federal reserve notes must be secured at all times by the specific pledge of gold certificates or eligible paper with a face value not less than the amount of Federal reserve notes outstanding; repeal the prohibition against

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one Federal reserve bank paying out the notes of another; and abolish many of the present technical provisions regarding the issue, redemption and retirement of Federal reserve notes. (Sec. 208, pp. 46-48).

Arguments for the Proposal.

The present requirement that Federal reserve notes be secured by not less than a like amount of gold certificates or eligible paper adds nothing to the value of such notes; because they are also obligations of the United States and constitute first liens on all of the assets of the Federal reserve banks. The Federal reserve banks would always receive something of equal value for all Federal reserve notes paid out and the holders of the notes would have a lien on these and all the other assets of the Federal reserve banks without the needless red tape of the Federal reserve banks pledging collateral with the Federal Reserve Agent. Moreover, this requirement and the accompanying technical provisions regarding the issue and retirement of Federal reserve notes involve a lot of red tape which results in delay and much needless expense. The prohibition against one bank paying out the notes of another is of no practical value and involvew much useless labor and expense.

In the recent emergency, the Federal reserve banks found themselves without sufficient eligible paper to secure their Federal reserve notes at a time when the country was faced with a drain on its gold, and it was necessary for Congress to pass an emergency law authorizing

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the Federal reserve banks to pledge Government bonds as collateral for Federal reserve notes. A repetition of such an emergency could be avoided by eliminating the collateral requirements.

On the whole, this amendment would greatly simplify and expedite the issuance and retirement of Federal reserve notes and would eliminate much needless trouble and expense without impairing in any way the soundness or security for the Federal reserve notes.

The proposed amendment would retain the requirement of existing law that the Federal reserve banks maintain a reserve of 40 per cent in gold certificates against the amount of Federal reserve notes in actual circulation, and this is the only check needed against an over-issue of Federal reserve notes.

The Federal reserve banks can now issue Federal reserve bank notes against which they are required to maintain no reserves whatever but only a redemption fund of 5 per cent.

Arguments against the Proposal.

By eliminating the requirement that Federal reserve notes be secured by eligible commercial, agricultural and industrial paper, we would abandon the theory of the original Federal Reserve Act that this requirement causes the volume of notes outstanding to expand and contract automatically in such a way as to accommodate itself to the needs of legitimate business. This amendment, together with the amendment abolishing the restrictions upon the classes of assets which Federal reserve banks may discount or accept as security for loans, would make it possible for the Federal reserve banks during a speculative era to issue a large volume of Federal reserve notes in return for loans on

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speculative securities or mortgages on speculative real estate; and the collapse of such a speculative boom might find the Federal reserve banks without means of redeeming their notes.

Much argument against the proposed amendment could also be based upon the abolition of the redemption fund and much of the machinery for the redemption of Federal reserve notes; but provisions for redemption are meaningless under the present law, as amended by the Gold Reserve Act of 1934, because Federal reserve notes are now redeemable in any other kind of lawful money, which simply means exchanging one kind of currency for another.

10. INCREASING OR REDUCING RESERVE REQUIREMENTS.

Amend the sixth paragraph of section 19 of the Federal Reserve Act as amended by the Thomas Amendment so as to permit the Federal Reserve Board (without the approval of the President and without declaring the existence of an emergency) to decrease the reserve requirements in order to prevent injurious credit contraction as well as to increase the reserve requirements in order to prevent undue expansion of credit. (Sec. 209, pp. 48, 49).

Arguments for the Proposal.

This amendment merely clarifies and makes more logical and workable a provision of existing law which was added to section 19 by the Thomas Amendment. It is a very important safeguard against inflation, because it gives the Federal Reserve System a means of absorbing

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the large amount of excess reserves now possessed by the member banks and thus placing itself in a position to exercise a restraining influence on any tendency toward credit inflation. While the present law authorizes the Board to increase or decrease the reserve requirements, it authorizes it to do so only when an emergency exists "by reason of credit expansion"; whereas a decrease in the reserve requirements might be the remedy for an undue credit contraction but would only add to the possibilities of undue credit expansion. The removal of the requirement that the President approve such action on the part of the Board would relieve the President of much political embarrassment if it should become necessary to increase the reserve requirements in order to check inflation.

Arguments against the Proposal.

It could be argued that, instead of increasing the Board's power in this respect the present provision of law on this subject should be repealed; because it is too drastic and gives the Board more power over the economic welfare of the country and the private property rights of the member banks then ought to be entrusted to any body of men except Congress with the approval of the President.

11. ADMITTING INSURED BANKS TO MEMBERSHIP WITHOUT REGARD TO CAPITAL REQUIREMENTS

Until July 1, 1937, authorize the Federal Reserve Board to admit insured nonmember banks to membership in the Federal Reserve System without complying with the capital requirements of the Federal Reserve Act, but require such banks to comply with such requirements within such

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period or periods after admission as in the Board's judgment shall be reasonable in view of all of the circumstances. (Sec. 202, p. 41).

Arguments for the Proposal.

In view of the prohibition against insuring the deposits of nonmember banks after July 1, 1937, and in view of the fact that thousands of nonmember banks have insufficient capital to make them eligible for membership, this requirement is necessary in order to avoid creating another banking crisis on or shortly before July 1, 1937, as a result of the lapse of the insurance of deposits in such nonmember banks. In fact, without this provision Congress probably could not resist the pressure to amend the law so as to permit nonmember banks to enjoy the benefits of insurance permanently; and this would defeat the object of bringing about a unified banking system, without which we can never have a satisfactory banking system in this country.

Arguments against the Proposal.

One of the causes for the large number of bank failures in the country was the existence of a large number of small banks which were too weak and too poorly managed to survive the vicissitudes of an economic depression. Congress recognized this fact when it increased the minimum capital requirement for the organization of national banks and for the admission of State banks to membership in the Federal Reserve System from $25,000 to $50,000. The proposed amendment would admit to membership in the Federal Reserve System banks with a smaller capital than $25,000 or even with no capital at all; and this would be distinctly a step backward. Instead of strengthening our banking system it would tend to weaken it.

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12. REAL ESTATE LOANS

Amend section 24 of the Federal Reserve Act so as to permit national banks to make real estate loans on an amortization basis for periods not exceeding 20 years and in amounts not exceeding 75 per cent of the value of the property. Repeal the geographical limitation as to the location of the real estate against which national banks may make loans. Change the limitation on the aggregate amount of real estate loans which may be made by national banks so that the aggregate amount of real estate loans plus other real estate (except bank premises) held by any national bank shall not exceed 60 per cent of its time deposits or 100 per cent of its capital and surplus, whichever is the greater. Retain the present requirement that all real estate loans be secured by first liens, but permit second and subsequent liens to be taken to secure loans previously contracted in good faith. Forbid state member banks of the Federal Reserve System to make real estate loans except to the same extent and under the same terms and conditions as national banks are permitted to do so. (Section 210, pages 49 - 51)

Arguments for the Proposal

In order to put bank credit to work, provide employment and stimulate business, it is necessary to liberalize the terms upon which national banks may make real estate loans. On the whole, a twenty-year amortized loan equal to 75 per cent of the value of the property is a sounder loan than a five year loan equal to 50 per cent of the value of

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the property which matures all at one time and which tends to become a permanent loan renewed at each maturity. If a bank's real estate loans were all on an amortized basis, it could, by not reinvesting the proceeds of payments on such loans, gradually reduce its investment in loans of this type, instead of attempting to collect the entire amount of individual loans with consequent hardships on borrowers and demoralization of real estate markets and values.

The proposed increase in the aggregate amount of loans from 50 per cent to 60 per cent of time deposits is not very material and, when other real estate is included in computing such amount, the limitation would be much more effective than that contained in existing law which takes no account of other real estate.

To permit national banks to take second and subsequent liens to secure loans previously contracted in good faith merely recognizes a practice which has long been in effect and which enables banks to protect themselves against loss on loans which are not essential real estate loans where the borrower can give no additional security except second of subsequent liens on real estate.

Making the restrictions and limitations of this section applicable to state member banks is in line with the policy adopted in the original Federal Reserve Act of placing national banks and state member banks as nearly as possible on a basis of substantial competitive equality.

Arguments Against the Proposal

One of the chief causes for the large number of bank failures and for the deflation in real estate values during recent years was the

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fact that banks had invested deposits in real estate loans which they were unable to liquidate when the depositors wanted their money. This forced the banks to attempt to enforce collection on many of the loans, which demoralized the market for real estate, destroyed real estate values, and made it still harder to liquidate other real estate loans. The banks which had too much invested in real estate loans could not liquidate rapidly enough and failed. To liberalize the power of national banks, to make loans on real estate therefore, would perpetuate and increase an unsound practice which contributed very largely to the recent collapse of our banking system. Instead of increasing the authority of national banks to make real estate loans, we should forbid all banks of deposit (except possibly mutual savings banks) to make any such loans whatever.

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