STATEMENT ON TITLE II OF THE BANKING BILL OF 1935

(S. 1715)

By

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Before the

Committee on Banking and Currency

of the

United States Senate

on

May 10, 1935

In discussing the proposed Banking Bill of 1935 before your Committee, I should like to present a statement of some of the fundamental issues that are raised by the proposed legislation, and then to outline the proposals in Title II of the bill, section by section, with such modifications as I should like to recommend in the text as introduced.

Character of proposed legislation

The amendments to the Federal Reserve Act proposed in this bill are important and are urgently needed at the present time. Their general objective is to improve the administrative machinery of the Federal Reserve System, to determine more clearly the distribution of authority and responsibility between the Federal Reserve Board and the Reserve banks, and 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.

The proposals made in this bill are definite and limited in scope and arise out of the experience of the past twenty years. They are not revolutionary; they do not alter the fundamental character of the Federal Reserve System, or the regional nature of its organization, and they do not, as has been asserted by critics, make the Federal Reserve System a football of party politics, or an engine of inflation.

Need for public control of monetary policy

The most widespread criticism of the bill has come from those who see in it an attempt to subordinate the Federal Reserve System and, through it, the country's banking system, to political control. On this subject there appears to be much misinterpretation of what the present bill provides, coupled with a lack of clear understanding of existing law and of the proper relationship between the Reserve System and the Government. This bill aims to clarify the powers and responsibilities of the Reserve Board in matters of national monetary policy, and at the same time preserves and increases the regional autonomy of the Reserve banks in matters of local concern. There is nothing in this bill that would increase the powers of a political administration over the Reserve Board.

That matters of national credit and monetary policy should be under public control has been recognized since the System was first proposed. For example, in the report of the Senate Committee on Banking and Currency, in 1913, on the original Federal Reserve legislation there is a statement to this effect: "The function of the Federal Reserve Board in supervising the banking system is a Governmental function in which private persons or private interests have no right to representation, except through the Government itself. The precedent of all civilized governments is against such a contention."

The statement by President Wilson before the Congress in joint session on June 23, 1913 is even more decisive. On that occasion President Wilson said: "The control of the system of banking and of issue which our new laws are to set up must be public, not private; must be vested in the Government itself, so that the banks may be the instruments, not the masters, of business and of individual enterprise and initiative."

The necessity of placing the regulation of monetary policy under Government control, which was clearly recognized by the proponents of the Federal Reserve Act in 1913, is the guiding principle of the legislation which is now under consideration by your Committee. The need for public control of the function of supplying the medium of exchange to the people of the United States, both by issuing currency and by regulating the volume of bank deposits, seems to me to be almost a non-controversial matter. It is in direct recognition of the constitutional requirement that Congress shall coin money and regulate the value thereof. In delegating this power, Congress has chosen, and in my opinion always will choose, to delegate it not to private interests, but to a Government body like the Federal Reserve Board created by Congress to serve as its own agency in discharging its responsibility for monetary control.

I might quote in this connection a statement by the late Paul Warburg, who said on November 12, 1910: "The management of the central reservoir must be absolutely free from the dangers of control by politics and by private interests, singly or combined."

<u>Public -- not political -- control</u>

The necessity of public control, as I have said, can hardly be questioned. Apprehension can only be expressed against the dominance in the Federal Reserve System of political, and particularly of partisan, control as distinguished from public control. On this point I wish to emphasize that the bill, far from proposing an increase in the powers of a political administration over the Federal Reserve System, contains provisions intended to increase the dignity and independence of the Federal

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I notice that the House of Representatives did not adopt our recommendations for an increase in the salaries and for pensions for Board members. I believe that these provisions are an essential part of the bill. They are an important means of increasing the Board's independence, as well as making the positions on the Board more attractive in the future to outstanding men who may not have independent means.

Reserve Board. For this purpose the bill provides that members of the Board shall be well qualified by education or experience, or both, to participate in the formulation of national economic and monetary policies. I recognize that the requirement of such qualifications cannot insure that only qualified men will be appointed to the Federal Reserve Board, but it is a step in the direction of strengthening the tradition that members of the Federal Reserve Board must be qualified to carry the responsibilities which their duties entail. The bill also provides for more adequate compensation for Board members and for pensions when they retire. These provisions would further add to the independence of the Board members.

There is in the bill a much misunderstood provision which was introduced for the purpose of making the position of Governor of the Federal Reserve Board more attractive to competent men with banking experience. This provision states that when the Governor is no longer designated as Governor by the President, he shall no longer be a member of the Federal Reserve Board and shall be considered to have served out his term. This would make it possible for a Governor, if he be drawn from the banking field, to reenter the banking business without having to wait for two years when he is no longer designated as Governor.

There has been a great deal of discussion about the fact that this makes the Board a more political Board. You know, gentlemen, as well as I do that no man would stay on the Board if the President of the United States wished to appoint someone else in his place. The present act provides that the President shall designate one of the appointive members as Governor of the Board and this has been consistently interpreted to mean that the Governor serves as such at the pleasure of the President. It seems to me to be immaterial whether a Governor has or has not a technical right to stay on the Board, if the President prefers to have someone else as Governor, because no person who is qualified for that position would choose to remain in these circumstances.

The bill as reported in the House has modified this provision so that the Governor could retain his position on the Board, if he were not redesignated, but if he resigned, he would be permitted to resume his banking connection without the two years' delay.

Recognition of the fact that control over money is a matter of national concern that must be retained by the sovereign power or delegated by it to an agency of its own creation is as old as Government itself. The change that has occurred in the past quarter of a century has been in the nature of adaptation of an ancient idea to modern conditions. The change has arisen out of a growing recognition of the fact that monetary control must not be confined to control of currency because, to an ever increasing extent, the bank check has taken the place of currency. In this country fully nine-tenths of all payments are made by check rather than in cash. Control over the supply of money, therefore, involves under existing conditions a control over the volume of bank deposits and bank credit.

The statutes of all the newer central banks of the world recognize the necessary relationship between the Government and the central bank. That it is not clearly recognized in the charters of some of the older central banks is due primarily to the fact that the relationship between central banking, commercial banking, and the money supply has been a gradual development and the responsibility of public control over deposit banking has only been gradually appreciated. There is in the world today no central banking institution, whatever the facts as to stock ownership or the legal provisions of its charter, which is not subject to control by Government. This is just as true of the Bank of England, which is commonly cited as as example of a completely independent central bank, as it is of any other central banking system.

The necessity of Government control arises from the fact that governments are largely instruments for the formulation and execution of economic and financial policies. Since changes in the supply of means of payment, both in the form of currency and in the form of deposits, are an important and at times a determining factor in economic changes, a central bank, if it chose to pursue an antagonistic policy, could greatly hinder a government in achieving its objectives. Since central banking institutions derive their power from the government - are in fact creatures of the government - they do not, and in the nature of things, cannot work at cross purposes with the government, particularly at times of emergency. Hence, in one form or another there must be cooperation between the government, which determines economic policies, and the bank of issue which determines monetary policies.

Limitations and objectives of monetary control

Recognition of the importance of monetary control and of cooperation between the government and the bank of issue is not based on the belief that all economic ills can be cured by monetary action alone.

It has been asserted that the proponents of this bill, and I in particular, hold such a belief. Speaking for myself alone, I am keenly aware of the limitations of the influence of monetary measures on economic conditions. I realize that without a properly managed plan of Government expenditures and without a system of taxation conducive to a more equitable distribution of income, monetary control is not capable of preventing booms and depressions. The volume and cost of money are important, however, and are the particular responsibility of the Federal Reserve System. That is the reason why our immediate concern in this legislation is to make the machinery of regulating the volume of money as efficient as possible so that the system may exert its influence towards the achievement of the desired objective.

This objective, in my opinion, should be more clearly defined than is the case in existing law. For the somewhat indefinite phrase of accommodating agriculture, commerce and industry I would suggest the substitution of a definite mandate that the Federal Reserve System shall exert such powers as it has towards promoting business stability and moderating fluctuations in production, employment, and prices, in so far as that can be accomplished within the scope of monetary action and credit administration. This objective, which is similar to the one recently adopted for the Bank of Canada, states the aims that must guide the Federal Reserve Board in the formulation of its policy and at the same time clearly recognizes the limitations of its power. I believe that the Federal Reserve Board will be in a position to exercise its powers more effectively if it is given a more definite indication by Congress of the broad objectives of monetary policy. It will also increase the Board's power to resist political pressure for the use of its authority for purposes inconsistent with the maintenance of business stability.

Increased regional autonomy

An important feature of the proposed legislation is that it clarifies and increases regional autonomy of the Reserve banks in matters of local concern. This is contrary to the contention of critics who allege that the bill would abolish local autonomy and inaugurate completely centralized control over the Federal Reserve System. In its proposals along this line the bill follows the principles laid down in 1913 by the House Banking and Currency Committee in its report on the original Federal Reserve legislation, in which it was stated:

> "Local control of banking, local application of resources to necessities, combined with Federal supervision, and limited by Federal authority to compel the joint application of bank resources to the relief of dangerous or stringent conditions in any locality are the characteristic features of the plan as now put forward."

Recognition of the necessity of striking the proper balance between national and regional considerations in the organization and operation of the Federal Reserve System, therefore, dates back to its origin. The principle is that responsibility for policies of national scope and purpose shall be lodged in the Federal Reserve Board and that actual banking operations and all activities or policies of local concern shall rest with individual Reserve banks, subject only to the necessary degree of coordination.

The proposed bill, as already stated, strengthens the regional autonomy of the Reserve banks. At present the Reserve Board appoints three directors of each Federal Reserve bank, including the chairman. Under this bill the Board will appoint at the most two and possibly only one director. The governor, who will be a Class C director, and the vice-governor, who may also be a Class C director, will be appointed by the local directors, subject only to the Federal Reserve Board's approval. In the bill as introduced, annual approval by the Board is prescribed. I believe that one approval of the governor for the period of his three-year term as a Class C director would be sufficient, and I consequently recommend such a change in the bill.

At the present time the Reserve agent is by law the Board's representative at the Reserve bank, and maintains an office of the Reserve Board on the premises of the Reserve bank. Not only is he himself directly appointed by the Board, but the appointment of his entire staff, including bank relations and economic services, is subject to approval by the Board. Under the proposed bill the agent's department would be abolished and its functions and personnel brought directly under the governors of the Reserve banks. The proposed change concerning eligibility requirements for discount and the proposed elimination of the collateral requirements for Federal Reserve notes will likewise increase local discretion and autonomy. The Reserve banks will under these provisions have increased responsibility in dealing with member banks. The power of the Federal Reserve Board to delegate some of its functions to its representatives will also enable the Board to authorize Reserve banks to handle many administrative matters, which under present law must be passed upon by the Federal Reserve Board as a whole. These matters may include passing on applications for membership, granting of voting permits for holding companies, and many others.

It is apparent that the present proposals will not destroy the regional character of the System, but, on the contrary, will carry to its logical conclusion the principles which were in the mind of President Wilson and of proponents of the original act, namely, the granting of wide discretion and autonomy to the Reserve banks in local matters and the concentration in the Reserve Board of authority over national monetary policies.

Summary of reasons for proposed changes

Perhaps the best way to explain the reasons for the changes proposed in this bill is to ask you to consider what kind of a system would be devised, if a plan for such a system were to be formulated at the present time. It would be considered desirable that all banks carrying deposits subject to check be members of the system. It would also be deemed desirable that the banks be supervised, but in a country the size of ours it would be undesirable to centralize in Washington all operations pertaining to individual banks. What would be done is to provide for regional reserve banks with a large degree of local autonomy in dealing with their local member banks. It is equally clear that national monetary policies would have to be under public, not private or banker, control. Such policies would be placed under a body appointed by the President and confirmed by the Senate. Provision would be made to insure as far as possible

that the controlling body be composed of the best talent available and that it be in a position to resist pressure to pursue policies for un-
desirable
~~deniable~~ purposes. To this end both authority and responsibility would be concentrated in that body; its members would be made financially independent; high qualifications for membership and an objective toward which policy should be directed would be laid down. That body would be entrusted with sufficiently effective instruments of policy to make the System responsive to changing conditions, and would be given discretion in the regulation of bank operations.

The system, which I have ventured to suggest would be established if a new plan were now being formulated, differs little from the Federal Reserve System with the changes proposed in the Banking Bill of 1935. We propose to facilitate entrance of nonmember banks into the Federal Reserve System. We propose to increase the regional autonomy of the Reserve banks in matters pertaining to local credit administration. We propose to increase the authority and responsibility of the Federal Reserve Board in matters pertaining to national monetary policies; to lay down new qualifications for future Federal Reserve Board members; to grant to future members pensions and higher salaries. In these ways we hope to make a position on the Board more attractive to outstanding men. We suggest a specific objective of monetary policy. We propose that the System's organization be made more amenable to Federal Reserve Board policy; that the banking system be made more responsive by making it safe for the banks to meet the changing nature of the community's requirements for loans, and by liberalizing the provisions in respect to real estate loans; and, finally, we propose the removal of various impediments to effective policy, such as collateral requirements for notes.

Proposal for a commission

Opponents of this legislation have proposed the creation of a commission of experts which would review the whole field of banking legislation at leisure and would then make a report to serve as a basis for reform. A proposal for a commission is not infrequently made as a means of gaining time in order better to organize opposition to undesired legislation. It is not infrequently advocated by persons who are opposed to a measure and think that the first and easiest step is to prevent its immediate passage by proposing a commission for the study of the subject.

In my opinion the public interest will be best served through the adoption of banking measures in the order of their urgency and in accordance with our capacity to formulate concrete conclusions. The Banking Act of 1933 was such a measure. It did not cover the whole field of our banking problems, but dealt primarily with the specific problems concerning the speculative use of credit and the relations of investments to commercial banking on the basis of our experience in the years immediately preceding the depression. It is gratifying to have this law on our statute books and to feel that there are adequate means at our disposal through that act and the Securities Exchange Act to prevent the occurrence of another speculative orgy like that of 1929.

Similarly the provisions of the present bill are based on the actual experience of the Federal Reserve System for the past twenty years and particularly on its experience during this depression. They were prepared in the light of past events and in consultation with persons who have worked in the System for many years. Statements that have been made to the effect that the bill was hastily drafted without competent advice do not correspond to the facts. The proposals in this bill are simple and concrete; without modifying the essential nature of the Federal Reserve System, they strengthen its power to meet future emergencies and increase the ability of member banks to facilitate recovery.

The argument that an elaborate study should be made before any banking legislation is enacted ignores the fact that committees of both houses of Congress have been studying the subject for years and that there is a vast volume of material available in the hearings and reports of these committees. It also ignores the fact that the Federal Reserve System, commercial bankers, and other agencies have been almost continuously studying the problem in recent years.

It is my conviction that the measures proposed in this bill would not be greatly modified by additional years of study, and that in the meantime the banking system would not be in so advantageous a position for contributing its share towards recovery, and the Federal Reserve System would not be well equipped to cope with inflation if it should develop.

Differences of opinion on the proposals contained in Title II of this bill are not the kind that can be resolved by study. They represent fundamental differences of approach to economic problems. Proponents of this bill are irrevocably convinced of the necessity of public control of national monetary and credit policies. Opponents believe in a minimum of Government supervision and represent two different points of view: one believing that monetary control should be left with the private banks that own the Federal Reserve System; the other holding the opinion that no control at all is necessary, that the free play of natural economic forces will result in the monetary system functioning for the public welfare. These divergent points of view cannot be reconciled by argument, nor can they be clarified by further study. They call for a decision by the Congress of the United States.

Summary of provisions

A brief discussion of the provisions of the bill section by section may be appropriate at this point and may be helpful in indicating what was intended to be accomplished by the proposals.

Section 201 proposes that the offices of governor and chairman of the Federal Reserve banks be combined.

This proposal is in recognition of the situation that has developed in the banks. It gives the governors of the Reserve banks a status in the law and combines their office with that of the chairmen of the boards of directors. It is, of course, essential that the holders of these combined offices be approved by the Federal Reserve Board.

In this proposal there is no encroachment on the autonomy of individual Reserve banks. It merely reestablishes the original plan of the Federal Reserve Act that the Federal Reserve Board, which has responsibility for national policies and for general supervision over the Reserve banks, shall be a party to the selection of the active heads of the twelve Reserve banks. This change will work towards smoother cooperation between the Board and the banks and will establish within the banks a greater unity of administrative control than now exists. It will also result in considerable saving through the elimination of one of the two highest officers in each Federal Reserve bank.

Section 201 also provides that directors of Federal Reserve banks shall not serve more than six consecutive years. This is proposed to avoid the crystallization in the boards of directors of the influence of any one individual or groups of individuals. That such a policy is desirable is evidenced by the fact that it has already been adopted in some of the Federal Reserve districts.

Section 202 would give the Federal Reserve Board authority to waive capital requirements for membership for insured nonmember banks joining the System prior to July 1, 1937, when all insured nonmember banks are required by law to become members of the System. This proposal is for the purpose of making it possible for numerous nonmember banks with small capital to join the Federal Reserve System and thus not lose their privilege of belonging to the Federal Deposit Insurance Corporation. In providing that insured banks must become members of the Federal Reserve System by July 1, 1937, the Banking Act of 1933 took an important step in the direction of unified banking which is universally admitted to be desirable. This provision of the present bill is designed to facilitate the process. I wish, however, to recommend a modification of the section in the bill as it was introduced. I shall include this proposed modification with others that I wish to recommend.

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I should like to call attention to the fact that the bill as reported by the Banking and Currency Committee of the House eliminated from this proposal the limitation that it shall continue in force only up to July 1, 1937. The House Committee also made a change in Title I of this bill and amended the Banking Act of 1933 to eliminate the requirement that all banks that are members of the Federal Deposit Insurance Corporation shall become members of the Federal Reserve System by July, 1937. This change appears to me undesirable. It is generally agreed that unification of banking under national supervision is desirable and that the conflict of jurisdiction and authority over banks which has prevailed has been a source of weakness in the banking system. There ought to be national control of charters granted to banks, and there ought not to be unfair competition between member and nonmember banks in regard to interest on deposits and other matters. In case, for example, the Federal Reserve System should find it necessary to raise reserve requirements, as it has authority to do under the law, the fact that a substantial group of banks would not be affected would be a distinct limitation on the effectiveness of the measure.

For these reasons, it would be in the public interest to bring about as rapidly as possible a unification of the banking system. At the same time it is recognized that there are many small banks that would find it difficult to join the Federal Reserve System even under the liberalized provisions proposed in this bill. For one thing, many of these small banks derive a considerable proportion of their income from exchange charges which they would have to abandon if they joined the Federal Reserve System. It has occurred to me, therefore, that the situation might be met by a proposal that all insured banks with deposits of $500,000 or more shall join the Federal Reserve System within a year after they become members of the Deposit Insurance Corporation. Banks of this size do not have to depend on exchange charges for their earnings and should be in a position to qualify for membership in the Federal Reserve System in other respects. Under this proposal smaller banks would have the option of joining the Federal Reserve System as they wished. I should like, however, to provide that any new bank chartered after the passage of the Banking Bill of 1935 be required to belong to the Federal Reserve System, if it joined the Federal Deposit Insurance Corporation.

I am informed that there are 5,644 State nonmember banks belonging to the Insurance Corporation whose deposits are $500,000 and under, and 2,038 whose deposits are over $500,000, so that roughly three-fourths of the insured nonmember banks would not be obliged to join the Federal Reserve System, if my suggestion were adopted, and only one-fourth, representing the larger banks, would be required to join. This would not deprive the small banks of their earnings from exchange charges. At the same time it would not seriously interfere with the System's monetary policies, because the banks with deposits of over $500,000, which would have to join the System, hold 77 per cent of the total deposits of all insured nonmember banks.

Another important advantage of this proposal, as compared with the House proposal, would be that the larger banks that are now members of the Federal Reserve System would not be free to retain the benefits of deposit insurance and at the same time to leave the System whenever it suited them. That is a matter of vital importance, because the right of member banks to free themselves from regulation by the System by giving up membership might at any time limit the System's ability to make its monetary policy effective.

Section 203 deals with qualifications for membership on the Board, provision for a more adequate salary and a pension system, and also with the matter of the Governor's appointment, which I have already discussed.

Section 204 would authorize the Board to assign duties to designated Board members or its representatives and thus would enable it to be relieved of a mass of administrative detail and to give its time to the study of policy matters.

Section 205 of the bill would provide for an open market committee to consist of the Governor and two 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. It would be the duty of this committee to formulate the System's open-market policies, which would be binding on the Federal Reserve banks. The committee would also make recommendations about discount rates.

A change in the provision about open-market policy is necessary in order to place definite responsibility on a national body with a national viewpoint.

Under the present law open-market policies are formulated by the Federal Open Market Committee, which consists of the governors of the twelve Federal Reserve banks. The recommendations of the committee have to be approved by the Federal Reserve Board, and the boards of directors of each Federal Reserve bank retain the authority to refuse participation in the policy adopted. It would be difficult to conceive of an arrangement better calculated than this for diffusing responsibility. ~~and creating an elaborate system of obstructions.~~

In my opinion, however, the proposal in the bill would not be a satisfactory solution of the problem. I wish to recommend, instead, a provision clearly vesting in the Federal Reserve Board full power and responsibility to initiate, adopt and enforce open-market policies for the Federal Reserve System, after consulting with an advisory committee consisting of five representatives of the Federal Reserve banks selected annually by the governors of the twelve Federal Reserve banks. The Board should be required to consult this committee before adopting an open-market policy, a change in discount rates, or a change in member bank reserve requirements.

Such a provision would eliminate conflicts of jurisdiction and policy and at the same time would preserve the participation of Federal Reserve bank governors in the deliberations leading to the adoption of open-market policies. Open-market operations might be initiated by either the committee of the governors or by the Board, but the ultimate responsibility for making a final decision and the power for adopting and carrying out national policies would be centralized in one place and in one body, as they should be.

Open-market operations as a means of credit control in this country are a post-war development. They were not regarded as a major instrument of policy when the original Federal Reserve Act was passed. From small informal beginnings, whose significance was not fully appreciated, open-market operations have gradually come to be recognized as the principal instrument of credit control. At first the individual operations of the separate Reserve banks were designed merely to equalize the earnings of these banks in periods when rediscounts were diminishing; then, as their effect on bank reserves and the volume of member bank credit was realized, operations were conducted at first by a self-appointed committee of the governors of the eastern Reserve banks and later by the same committee after approval by the Reserve Board. Owing largely to the circumstances of their origin, these operations, though they have come to be the most important features of our monetary policy and are definitely national rather than regional in purpose and in effect, still remain chiefly under the control of the regional Reserve banks.

Local, or regional, control of open-market policy is, in fact, impossible, because the effects of such policy cannot be restricted geographically. Local control has been tried and voluntarily abandoned. The question, therefore, is merely where the national control shall be lodged. In my opinion it should be lodged in the Federal Reserve Board, which has the responsibility for other instruments of monetary policy through discount rates and changes in reserve requirements.

I am recommending an amendment to the bill to carry out this proposal.

Section 206 proposes that the Federal Reserve banks, under regulations by the Federal Reserve Board, be authorized to make advances to member banks on the basis of any sound asset. This proposal arises out of the experience of the Federal Reserve System.

The view on which the original eligibility provisions of the Federal Reserve Act were based was that bank assets should be self-liquidating. This view rests on the theory that member banks should engage in purely commercial banking; such a view, however, is not realistic in a situation where only 8 percent of bank assets consist of presumably self-liquidating paper. The banking system cannot subsist on the 2 billion dollars of eligible paper that is available; particularly since this paper is largely concentrated in the financial centers. Furthermore, in an emergency it does not remain self-liquidating. The banking troubles of this country in 1919 to 1921 were based to a considerable extent on the frozen condition of this type of asset.

In an emergency no type of bank asset is liquid, and it is the function of the central banking institution to provide such liquidity, subject only to the requirement that the assets shall be sound. There is not and can never be a substitute for soundness, which must be based upon the competent exercise of banking judgment. The present provision would introduce into the Federal Reserve Act for the first time the express requirement of soundness of assets as the fundamental and single requirement for eligibility for borrowing from the Reserve banks. If the Reserve banks are to give genuine assistance to the commercial banks, they must serve in an emergency as an agency for liquefying all sound assets. During the depression many banks were forced into bankruptcy not because their assets were bad but because they could not meet the narrow and essentially unrealistic eligibility requirements, and it became necessary, by the Glass-Steagall Act of February 1932, to pass emergency legislation permitting the member banks to borrow from the Reserve banks on sound assets.

It has been suggested that the proposed amendment would impair the assets of the Reserve banks themselves. The implication is that the Reserve banks would lose their judgment of the soundness of bank assets. That this fear is fanciful would seem to be indicated by the fact that under the Glass-Steagall Act the Reserve banks made loans of this character amounting to over $300,000,000 and that of this amount all but about $1,500,000 has now been repaid.

<u>Section 207</u> makes provision for placing securities guaranteed as to principal and interest by the United States Government on the same basis in regard to eligibility for purchase by the Reserve banks as direct obligations of the United States Government. There seems to be no reasonable ground for discrimination against these guaranteed obligations.

<u>Section 208</u> provides for eliminating collateral requirements for Federal Reserve notes. The requirement for segregation of collateral against Federal Reserve notes adds nothing to the quality of the notes, which are a prior lien on the assets of the issuing Reserve banks, and an obligation of the United States Government. Being a prior lien, the notes are secured in effect by the best assets that the Reserve banks have. They cannot be issued except in return for assets that the Federal Reserve banks are permitted and willing to acquire.

The complex machinery of providing for special segregation of collateral behind Federal Reserve notes is not in conformity with the fact that there is nothing more sacred in the note liability than in the deposit liability of the Federal Reserve banks. The deposits are the reserves of our banking system and, therefore, are back of all the deposits of all the depositors in all the member banks. These deposits surely deserve the dame degree of protection as do Federal Reserve notes. The proposal does not go this far but merely places Federal Reserve notes on a basis of equality with deposits so far as collateral is concerned, without making any change in reserve requirements. It would preserve their status as paramount liens on the assets of the issuing banks and as obligations of the Government, and would have no effect either on the quality of the notes or on the elasticity of our currency. It would result in a simplification of the machinery of currency issue and in considerable economy for the Federal Reserve banks.

While these collateral requirements are not a protection for Federal Reserve notes, they have at times been the cause of serious difficulty for the Federal Reserve System. At a time when the System was pursuing an easy money policy through the purchase of Government securities there developed a shortage of eligible paper, with the consequence that it was necessary to impound a large amount of gold as collateral against the notes, over and above the 40 percent reserve requirement. Such a situation prevailed in the early months of 1932, when the Federal Reserve banks, because their gold reserves were impounded behind the Federal Reserve notes, were unable to pursue a policy that would tend to arrest the deflationary process. At that time it became necessary for Congress to pass the Glass-Steagall Act, which authorized the use of Government securities as collateral for Federal Reserve notes. This law has since been extended, but it expires in March 1937.

It is proposed here to do away with collateral requirements altogether. They serve no useful purpose, they are expensive and cumbersome, and at times result in danger to the country's financial structure.

Section 209 is designed to clarify and expand somewhat the power of changing reserve requirements, provided in the so-called Thomas Amendment. It would permit the Board to change reserve requirements without declaring the existence of an emergency and without the necessity for obtaining the approval of the President. This is one of the ways in which the bill would diminish political control over the Federal Reserve Board.

I wish to recommend that the bill be modified so as to limit the power of the Board to change reserve requirements to two groups of banks, central reserve and reserve city banks and all other banks, and not to permit changes for individual Federal Reserve districts. There is urgent need for the authority to change reserve requirements, in view of the large amount of excess reserves now available to member banks and the possibilities of further additions to these reserves.

Section 210 would liberalize the provisions for real estate loans. The modifications here proposed include an increase in the total volume of such loans that a bank may make, an increase in the proportion of the value of real estate that banks may lend, and provision for amortized loans with longer maturity.

Upon further consideration of this matter I wish to suggest that the section be modified to give the Federal Reserve Board power to regulate real estate loans, subject to the limitation that new loans shall not exceed 60 percent of appraised value of the real estate.

As you know, real estate loans are not a new form of investment for our commercial banks. They have been lending on real estate mortgage security for decades. Liberalization of the real estate loan provisions, combined with the broadened eligibility requirements for borrowing at the Federal Reserve banks, may encourage activity in the construction industry, which is essential to recovery.

Criticism of these provisions has come largely from those who believe in the separation of savings banking from commercial banking. Whatever may be said in favor of such a separation as a desirable thing in theory, it is not feasible so long as we have thousands of small banks that cannot make a living on the basis of their demand deposits alone. The member banks have 10 billion dollars of time deposits which represent the people's savings. So long as they have time deposits for which they must pay interest, they of necessity must participate in financing long-term undertakings that will yield enough to pay for doing the business. The law places no limits on what the banks may do in the purchase of bonds or of other long-time paper; there is no reason for singling out real estate loans for special restrictions.

Our banks have been losing a large part of their business to the Government, which has sold its bonds to the banks and has used the funds to make mortgage and other loans, many of which the banks should be in position to make themselves. Unless the banks regain some of the business which has been taken over by the Government credit agencies,