EAG

July 1, 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 determine more clearly the distribution of authority and responsibility between the Federal Reserve Board and the Reserve banks; (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.

This division not followed in memo. discussion

monetary policy

The sub-committee substitute for Title II does nothing towards accomplishing these purposes. By retaining the Chairman, as well as creating a president of the Reserve banks, 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 on the Reserve banks, in regard to eligibility and collateral requirements, and on the member banks, 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.

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 proposal 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. The Sub-committee bill greatly increases the power of the Federal Reserve Board because it would in addition to retaining the authority to appoint the Chairman of the Board have the power to pass upon the appointment of the president (or Governor). The purpose for which the modification in the existing machinery was recommended would, therefore, not be accomplished and no useful purpose would be served by the proposal. The change in the title of the Governor is a trivial matter but one which would cause unnecessary irritation.

2. The recommendation that directors of Reserve banks do not serve for more than two consecutive terms is omitted in 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.

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 qualifications are proposed for the members, but they are to be selected by the President, with due regard to the various economic interests of the country, with the provision that at least two shall have had tested banking experience. The term of office is for fourteen years; the salary is $15,000; and there is no provision for pensions.

Without commenting on the proposed change in the composition of the Board, 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 training or experience or both to aid 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. The omission of pensions is also regrettable. Board members should at least be authorized to participate in the pension plan of the Federal Reserve System. It would also be desirable to provide that members hereafter appointed shall be retired at seventy years of age.

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 a bi-partisan Board whereas it ought to be non-partisan, and non-political. It would be much 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.

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 return to his 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 in existing law. If the Secretary of the Treasury and the Comptroller of the Currency are not to be members of the Board, the designation of the Chairman will be the only direct link between the President and the Board and he ought to be in a position to have in that post a man who is in general sympathy with his economic program. If it is deemed desirable to increase the independence of the Board from the administration in power, then it would be best to make the Chairman appointed as such for his entire fourteen-year term as member. A man could afford to accept an executive position for a period as long as that while he could not afford to do so for a period of four years, which would be long enough to get out of touch with his private business and yet not long enough to offer an opportunity for continued

public service. The restriction about accepting positions with the member banks should be made inapplicable to the Chairman, as is proposed in the House bill. In fact, the restriction could be eliminated from the law altogether without sacrifice of the public interest because the members of the Board have few opportunities to render services to member banks and the precaution is, therefore, not necessary. It would be much more logical to have that restriction apply to the presidents (or governors) of individual Reserve banks, who are in constant contact with the member banks, but to whom no such restriction applies.

5. 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. It is true that the sub-committee bill eliminates the requirement that the circumstances under which ineligible paper can be used as a basis of borrowing must be exceptional and exigent. But the elimination of this language is not sufficient to meet the situation if it is the intention 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 against disaster. What the House bill proposes is that the Reserve banks look to the substance rather than the form of the 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.

6. 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 presidents 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 presidents, with the assistance of one Board member, would be able to tie up proceedings; but, 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 approval by the Board and regulations by the Committee.

However the Committee may be constituted, it should have clear-cut powers of imposing its monetary policies on the System; otherwise the System would not be in a position to discharge its responsibilities.

The sub-committee bill gives the 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 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. No clear-cut, harmonious, national policy could be achieved upon under this set-up. It is no improvement over the existing situation, which it is the purpose of the proposed legislation to correct.

7. The sub-committee bill provides for no objective for the policy of the Federal Reserve System. 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 its business merely 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 very heart of the proposed legislation.

A reversion at this crucial point to the obsolete idea that the Federal Reserve System should be a passive agent of trade, industry, and agriculture, would be a fatal defect in the bill.

8. 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 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.

9. 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.

10. The provisions in the sub-committee bill on real estate loans are unsatisfactory in two principal respects: First, the provision that amortized real estate loans are eligible at member banks only if the rate of amortization is such as to reduce the principal by 50 percent in ten years would make the burden on the borrowers unnecessarily heavy in the early years. Secondly, the sub-committee bill omits the right of the Federal Reserve Board to prescribe regulations for real estate loans made by State member banks. This is highly undesirable because it perpetuates conflict of jurisdiction. 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 could 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 permitted by the laws of the States in which they are located.

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 5 or 6 billions of additional excess reserves that may 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, it had better 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 excess reserves existing at the time. This would afford a safeguard against unreasonable advances in reserve requirements and, at the same time, would provide protection against inflation.