July 3, 1935

MEMORANDUM ON TITLE II OF THE BANKING BILL OF 1935 AS REPORTED BY THE SENATE BANKING AND CURRENCY COMMITTEE

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 concentrate in a single public body authority and responsibility for national credit and monetary policies; (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 and maintenance of as full employment of labor and of the productive capacity of the nation as can be continuously sustained.

The bill as reported to the Senate would fall short of accomplishing these purposes. By retaining at the Reserve banks the chairman of the board of directors and providing by law for another person to be the chief executive, to be known as president, it continues the existing dual organization. The bill also fails to place full and clear-cut responsibility for the three instruments of monetary policy, discount rates, reserve requirements, and open-market operations, in one body responsible to the public. Neither does the bill give the System a broad objective toward which it must use its powers. Finally, the bill does not go far enough in removing unnecessary restrictions in regard to eligibility, collateral requirements, and real estate loans to increase effectively the ability of the banking system to contribute to economic recovery.

The proposals and omissions in the Senate bill are discussed in more detail in the following paragraphs:

Reserve bank organization

1. The Senate bill provides for chief executives of the Federal Reserve banks to be known as presidents and also for vice presidents. The presidents will take the place of the governors of the banks, who are not specifically provided for in the Federal Reserve Act, but are in fact the chief executives of the banks. The presidents and vice presidents would be elected by the directors of the Federal Reserve banks subject to approval every five years by the Board of Governors of the Federal Reserve System. No change in the existing law is proposed in relation to the chairman of the board of directors and Federal Reserve agent.

This provision does not correct the defects in the existing organization of the Federal Reserve banks, with its conflicting jurisdiction, duplication of effort, and diffusion of authority between the chairman of the board and the president of the bank.

Rotation of directors

2. The recommendation that directors of Reserve banks be not permitted to serve for more than two consecutive full terms, the purpose of which was to prevent crystallization of interests of particular groups in the directorates, is omitted from the Senate bill.

Changes in title and composition of Federal Reserve Board

3. The Senate bill proposes to change the title of the Federal Reserve Board to the Board of Governors of the Federal Reserve System. It

would eliminate the two ex-officio members and establish a new Board of seven to be appointed by the President within 90 days. No specific qualifications are provided for the members except that at least two shall have had tested banking experience; the members are to be selected by the President, as at present, with due regard to the various economic interests of the country, and not more than four shall belong to any one political party. The term of office is fourteen years; the members are not eligible for reappointment; the salary is $15,000; and there is no provision for retirement or pensions.

No comments are offered on the proposed changes in the composition and title of the Federal Reserve Board.

The Senate proposal that two members of the Board shall be persons of tested banking experience is desirable, but it is suggested that Federal Reserve or commercial banking experience be specified. It would also be an improvement to provide for qualifications for Board members along the lines suggested in the House bill, namely, that they shall be qualified by education or experience or both to participate in the formulation of national economic and monetary policies. Such a requirement would emphasize the character of the duties of the Board and would make it more difficult for a President to appoint and to secure the confirmation of unqualified persons.

The provision against reappointment of Board members would be contrary to the public interest because it would make positions on the Board less attractive to men of the highest qualifications.

For the purpose of further strengthening the Board, provision should be made for compulsory retirement of members at the age of seventy and for authority for the members to participate in the Federal Reserve retirement system which is applicable to persons at the age of sixty-five.

The requirement that not more than four members of the Board of Governors shall belong to one political party would make the Board bi-partisan, whereas it ought to be non-partisan, in order to be non-political. It would serve the public interest better to provide that all the Board members shall be qualified for their work rather than that the two political parties shall be adequately represented.

The Senate bill omits the power of the Board to delegate some of its duties 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.

<u>Chairman of the Board</u>

4. The Senate 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 engage in the 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 under existing law, particularly if the Board is no longer to have ex-officio members. Also, in choosing a Chairman the President should not be hampered by the restriction that not more than one member may come from any one Federal Reserve district.

In the interest of attracting the best available men, the prohibition against accepting positions with the member banks for two years after leaving the Board should be made inapplicable to the Chairman.

Publicity

5. The Senate bill provides for publication in the annual reports of the Board of Governors of the Federal Reserve System of all records kept with respect to all questions of policy determined by the Board. This provision is too sweeping, since it would be impracticable to publish all records on the great variety of policy decisions made by the Board in the course of a year. The requirement for publication should be confined to the record of decisions on national credit or monetary policies.

Eligibility provisions

6. The Senate bill proposes in effect the reenactment of section 10(b) of the Federal Reserve Act, which has expired and which permitted advances by Reserve banks on satisfactory assets, at a penalty rate, when the member bank's eligible paper has been exhausted.

It is not a satisfactory substitute for the original proposal 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.

The Senate bill eliminates the requirement that the circumstances under which ineligible paper may be used as a basis of borrowing must be "exceptional and exigent." The elimination of this language, however, would not be sufficient 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 from disaster. The object of the original proposal was that the Reserve banks look to the substance rather than the form of paper and recognize their obligation to prevent banks with sound assets from being forced to close their doors. The Senate bill is not an adequate substitute for this proposal.

Open-market proposal

7. The Senate bill provides that the Federal Open Market Committee consist of the Board of seven members and five representatives of the Reserve banks, four to be elected by the boards of directors of the Reserve banks, respectively, in the East, the South, the Middle West, and the West, and one at large by the twelve presidents.

The committee would thus consist of twelve members, with a possibility of a tie vote, which should be avoided. The banks' representation would also be too large, since their representatives with the support of one Board member could prevent the adoption of a policy.

It is assumed that the Senate bill proposes to give the Federal Open Market Committee power to enforce its policies. The language of the bill, however, is not clear on that point, since it only provides that no Reserve bank shall engage or decline to engage in open-market operations, except in accordance with regulations adopted by the committee.

Since it is essential to the proper functioning of the Federal Reserve System that the committee have authority to have its policies carried out, the language of the bill should be clarified on this point.

The Senate bill gives the Open Market Committee no authority 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 the Reserve banks nullified that policy by the use of one or both 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. Under such a set-up it would be difficult to achieve an effective national policy.

The proposal in the Senate bill that purchases of obligations of the United States Government or guaranteed by it shall be made by Reserve banks only in the open market should be modified to permit the purchase of temporary certificates of indebtedness directly from the Treasury on quarterly income tax dates and on other similar occasions. The prohibition of such purchases would serve no useful purpose and would result periodically in unnecessary, violent fluctuations in the money market.

<u>No objective provided</u>

8. The Senate bill provides for no objective for Federal Reserve System policy. The Federal Reserve Act says that the Federal Reserve banks must accommodate commerce and business. Experience has shown that the Federal Reserve System's responsibilities are much broader. It is not merely its function to provide accommodation to commerce, industry, and agriculture when they desire 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 in the law of this function of the System and of the fact that it must use its powers for the purpose of contributing to the maintenance of full employment would constitute a mandate that would assist the System in the formulation of its policies and would help protect it from political and other special influences.

Operation of the Federal Reserve System as a passive agent of trade, industry, and agriculture would be fatal to a proper discharge of the System's responsibilities.

<u>Collateral for notes retained</u>

9. The Senate bill omits all reference to the proposal in the original 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.

Admission of insured banks to membership

10. The Senate bill omits the section which authorizes the 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.

Changes in reserve requirements

11. The Senate bill limits the authority of the Board of Governors 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 3 to 6 billions of additional excess reserves that could be created through means now in sight, the Board should have the power to protect the country against inflation which might result from the unrestricted use of these reserves.

If it is deemed desirable to provide a maximum limit, a better limitation would be that the Board shall not raise reserve requirements beyond the point where they would absorb, in the aggregate, the vault cash and excess reserves held by member banks at the time. This would afford a safeguard against unreasonable advances in reserve requirements and, at the same time, would provide protection against inflation.

The Senate bill provides that action on reserve requirements shall be by an affirmative vote of at least five Board members. There is no reason why action in this matter should require a particular kind of vote by the Board, when action in regard to other instruments of credit policy, namely, open-market operations and discount rates, can be taken by a simple majority vote.

Real estate loans

12. The provisions in the Senate bill on real estate loans should be modified in two principal respects. First, it should not be required that amortized real estate loans by member banks must be repaid up to 50 percent in ten years, since this would make the burden in the early years unnecessarily heavy for the borrowers. Government agencies are making amortized real estate loans which mature in eighteen years and insurance companies are advertising for amortized real estate loans maturing in twenty years. Secondly, the provision of the original bill requiring State member banks to comply with the same limitations and regulations governing the making of real estate loans as are applicable to national banks should be restored. Its omission would place national banks at a competitive disadvantage. If the Federal Reserve System is to be responsible for promoting sound banking conditions, it should have the power to prescribe regulations applicable to all member banks. The minimum requirement that should 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 expressly permitted by the laws of the States in which they are located.