Chairman Eccles' views with regard to eligibility are set forth in the following extracts from his summary of statements which he made before the House Committee on Banking and Currency March 4 to 20, 1935, when testifying on the Banking Act of 1935.

Section 206 Eligibility for Discount

It is proposed to give the Federal Reserve Board authority by regulation to determine the character of paper that may be eligible as a basis for borrowing at the Federal Reserve banks. This is particularly important at this time because it would encourage member banks to pay less attention to the form and maturity of paper that is offered by would-be borrowers and to concentrate their attention on the soundness of such paper. At present many banks are unwilling to extend loans to borrowers who have assets that are unquestionably sound because they lack assurance that in case of a withdrawal of deposits they would be able to liquefy these assets at the Federal Reserve banks.

In times of emergency it has been necessary to remove existing legal restrictions and to give discretion in the matter to the Federal Reserve authorities, as was done under the Glass-Steagall Act of 1932. This act, however, was passed after a great many banks had gone to the wall at least partly because of lack of eligible paper and its provisions, in so far as they relate to borrowing from the Reserve banks, expired on March 3, 1935.

What is proposed is not, as has been sometimes alleged, a policy of opening the doors of the Federal Reserve banks to all kinds of paper, regardless of its soundness. On the contrary, it is proposed to place emphasis on soundness rather than on the technical form of the paper that is presented.

Experience under emergency laws shows that the Federal Reserve banks and the Federal Reserve Board have exercised caution and, though they have extended credit on ineligible assets to the extent of $300,000,000, all but $1,500,000 of this has been paid back and the banks have suffered no considerable losses. It would appear safe, therefore, to intrust discretion in the matter to the Federal Reserve Board, which is always in session and, therefore, is in a position to consider emergencies promptly without being under the necessity of proclaiming them by an appeal to Congress and thereby aggravating the situation, and without being obliged to wait for Congress to be in session and to act on the matter.

The eligibility requirements of the existing law do not meet present-day banking conditions which differ from conditions at the time the Federal Reserve System was established. The amount of eligible paper now held by banks is a small part of the total resources of the banks. Even in 1929, it was only slightly over 12 per cent of their loans and investments, and today it is less than 8 per cent. The total amount of the paper which would be considered eligible by the banks themselves is only about $2,000,000,000 at the present time and was only about $4,000,000,000 in 1929. While this amount is sufficient in the aggregate to provide access to the Federal Reserve banks, there are many individual banks that do not possess sufficient eligible paper.

During the depression, the banks did not have eligible paper to meet the withdrawal of their deposits, which was brought about by the general liquidation of bank loans and by hoarding; in order to avoid closing, they were forced to liquidate in the market such bonds as they had and could sell without too large a loss; they were also forced to bring pressure for payment of all loans which came due and to refuse new credit, so that they might have as large cash reserve as possible and be as liquid as possible. The attitude of the banks throughout the nation was largely due to the fact that they lacked eligible paper in sufficient quantities for their required accommodation at the Federal Reserve banks.

As a consequence, in an effort to remain liquid, they froze themselves so completely that they finally closed the entire banking structure. In the final analysis, there can be no liquidity during a depression, except liquidity created by the Federal Reserve banks through their power of issue. It was finally recognized that it is not necessary to have rigidly defined eligibility for paper for discount.

This rigid eligibility was finally changed, but only after a great deal of damage had been done, after thousands of banks had been closed unnecessarily, after millions of individuals and institutions had been forced to the wall through the lack of available credit or through pressure to pay existing debts, and after millions of depositors had lost hundreds of millions of dollars through the closing of banks.

It seems to me only realistic to recognize that the Reserve banks, subject to rules and regulations made by the Reserve Board, should have the power to meet emergencies by loaning to member banks upon sound assets, rather than to see unnecessarily drastic liquidation forced upon the community.

This provision does not mean inflation. Before the banks today, as a whole, would have occasion to borrow from the Reserve banks, they would have to extend billions and billions of dollars of credit, because of the excess reserves they now possess. But, if the provision exists, it may make the banks feel altogether differently about extending credit today. It will make them realize that, in order to have access to

Reserve bank credit, they do not have to have specified types of ninety-day or six-month paper, the supply of which is limited.

In a period of timidity like the present, the banks tend to refrain from making loans, except on paper eligible for discount at Federal Reserve banks. This is even now a factor causing liquidation in many communities and preventing adequate expansion of credit in others. There is ample credit today, but, without a change in the eligibility features, there will be great hesitancy on the part of the banks to loan on other than short-term commercial paper or Government bonds. If the bill is adopted, banks will be willing to loan existing funds on longer terms than they otherwise would.

A bank that conducts its business on the theory of having only such assets as can be disposed of at will in times of crisis, when the national income has been cut in two, cannot serve its community adequately. Such a bank would confine its operations to the purchase of the most liquid open-market paper, with the consequence that it would neglect its local responsibilities and would find it difficult to earn enough from the low returns on such paper to cover expenses. The banks should be in a position to meet the needs of their communities for all kinds of accommodation, both short- and long-term, so long as the credits are sound, and they ought to have the assurance that all sound assets can be liquified at the Federal Reserve bank in case of an emergency.

The proposed revision of eligibility requirements is one of the most important features of legislation at the present time. It will tend to do more towards inducing recovery through credit expansion than any other feature of the bill. The banking System must be made to provide the money and credit required, if it is going to justify its existence. At the present time, credit is provided largely by the Government.

The Government is lending to individuals and corporations through the various Government lending agencies, of which the three most important are the Home Owners' Loan Corporation, the Farm Credit Administration and the Reconstruction Finance Corporation. The banks have been liquidating their private loans, and the Government has been taking them over, and the banks have been providing funds through the purchase of Government bonds or of bonds guaranteed by the Government. If this is continued, it seems to me that the banks will have great difficulty in justifying their existence.

If the banks do not utilize their funds in the direct field of lending in place of the Government, they will find that the Government will have taken over the banking business, not because the Government wanted to, but because the banks forced it.

I think the emergency measures were very effective, because they stopped banks from closing. When people can get their money, they do not want it. Instead of the Reserve banks being required to make loans to member banks, money which had gone into hoarding tended to come back into the banks. That enabled the banks to repay their borrowings to the Federal Reserve banks, so that the amount of member bank borrowings from the Reserve banks today, is negligible; whereas, in 1933, it was very large.

It was section 10(b) of the Federal Reserve Act, as amended by the emergency banking act, which provided that, under exigent circumstances, member banks may borrow from Reserve banks on their time or demand notes secured to the satisfaction of the boards of directors of the Reserve banks. There was some use made of that provision, but not very much, because it was necessary for a bank when it applied for credit under the terms of the provision, to admit that it was in great distress and in exigent circumstances and that it required special treatment by the board of the Federal Reserve bank; this meant that a bank would use the borrowing privilege only as a last resort. Furthermore, this law came too late, after numerous banks had been obliged to close.

It is not proposed in the bill to make real estate loans eligible for discount. The bill would authorize Federal Reserve banks, subject to the regulations of the Board, to discount for a member bank all commercial, industrial or agricultural paper, and to make advances to a member bank on its promissory notes secured by any sound assets, which would include real estate loans, collateral loans, bonds, or any other sound assets. Real estate loans have not been eligible as collateral for advances from the Federal Reserve bank except during an emergency and then could be used as collateral for an advance only as an emergency matter. In a depression, only the Federal Reserve banks can liquify assets, and real estate loans do not differ from other types of assets. In a great depression, there is no other place for a bank to go for advances on such assets as real estate loans, loans on collateral, or investments in bonds. When the market is severely depressed, as it was for a period of several years, it means bankruptcy for any bank to liquidate its assets on the existing market.

It has been asked whether the difficulties of banks in meeting their demand obligations were the result of a scant supply of actual currency. The answer is no. The banks found that they were unable to meet their deposit liabilities in currency because of the lack of assets which the Reserve banks would accept. That reduced the amount of currency that they were able to pay out, and the very fact that many of them were unable to meet that demand created a general demand to convert deposits into currency. As soon as the Emergency Banking Act of 1933 permitted the banks, both member and nonmember, to get credit in the form of currency from the Reserve banks upon all of their sound assets, the people of the country no longer wanted their deposits in currency. The currency began to come back into the banks and deposits in banks increased.

Many of the assets considered eligible and held to be liquid were less sound than other assets held by banks which could not qualify for rediscount or as security for borrowing from the Reserve banks.

An asset that may be considered sound and liquid when business is active and there is a high rate of employment and national income is large, may become frozen and unsound if the national income diminishes. Liquidity and soundness are not determined merely by the substance of a loan or asset at the time the asset is purchased or the loan is made; they depend upon the state of trade and business which follows.

By way of illustration, when German bonds were purchased prior to the war, they were considered the best in the world, and they were sound assets. When wheat was selling at $2 a bushel, it would have been proper to have loaned upon that wheat with a 25 per cent margin, on the basis of a warehouse receipt; the loan would have been considered perfectly sound, and the paper would have been eligible for discount. The same thing is true for any other commodity. I remember when sheep were selling at $16 a head, and when within a six months period you could not sell them at $4 a head; yet a loan for nine months made on sheep at $16, say $8 a head for six months, was eligible for discount; but, before that loan came due, that security was selling for about one-half of the amount of the loan.

Even Government bonds would cease to be liquid at the price at which corporations could not sell them without going bankrupt. The price of Government bonds in 1932 was down, the 3's, I think, to $83. If any substantial amount of those bonds had been sold in that market, the market might have gone to $50 and any bank holding a substantial amount of the bonds would have been ruined. The banks, however, could go to the Federal Reserve banks and borrow on those Government bonds; that was a protection to the market and to the banks, which would not have existed had the banks been obliged to sell those bonds instead of using them as a basis for borrowing at the Reserve bank.

It is up to the banking system in so far as it is possible, to maintain a state of trade and business that will preserve soundness.

To the extent that forced deflation through forced credit contraction is obviated through making available the discount facilities of the Reserve banks--to that extent liquidity is provided. The only liquidity that really exists in a serious depression is the liquidity that is provided through the money-issuing agency, the Federal Reserve banks.

The banking system has excess funds seeking investment of over $2,000,000,000. The excess reserves of the banks are sufficient in amount to enable the banking system as a whole to extend new loans or to purchase additional bonds to the extent of about $20,000,000,000, without borrowing from the Federal Reserve System.

The banking system creates money through its loans and investments. A bank making a loan of a thousand dollars to a customer creates a thousand dollars of deposits. This increase in deposits increases reserve requirements by 10 per cent of that amount. For every thousand dollar increase in deposits the excess reserve decreases by 10 per cent of the increase, so that a loan of a thousand dollars increases the assets of the bank by a thousand dollars and the liabilities, in the form of deposits, by a thousand, and the reserve requirement by one hundred dollars, approximately. Therefore, $2,000,000,000 of reserves in the System as a whole are sufficient to enable the banks, on the basis of ten for one, to extend credit to the extent of $20,000,000,000 without having to go to the Reserve banks and discount or borrow money.

Under the present law, the Reserve banks determine the acceptability of assets or the type of paper which they will take from member banks, subject to the eligibility requirements of the Federal Reserve Act. In the future, if the law is amended to give discretion to the Federal Reserve Board in determining the eligibility requirements, the Reserve banks will have power to loan to member banks, according to rules and regulations laid down by the Federal Reserve Board. However, it would not be mandatory, and it is not mandatory in the present law, that the Federal Reserve banks loan to member banks; they simply have authority to loan to member banks upon what is considered eligible paper.

The policy of the Board in making regulations defining eligible paper under the proposed legislation would depend a great deal upon the conditions that confronted the country. In 1930 and 1931 it would have been in the interest of the banking system and in the interest of the entire country if, in the case of those member banks which had very little or no commercial paper, the Federal Reserve banks had been permitted to loan on any sound assets. The inability of the member banks to borrow from the Federal Reserve banks forced great deflation.

As to the additional specific types of paper which the Federal Reserve Board should class as eligible paper, for rediscount by member banks, I can merely give my personal opinion; I cannot speak for the Board. I believe that very broad rules and regulations should be made with reference to this subject and that broad discretion should be left to the Federal Reserve banks. I think that, in matters of local credit concerning each Federal Reserve district, the Reserve banks should be given discretionary power and that they can be relied upon to make only sound loans.

I would not like to say that, under normal conditions, paper on a bills-payable basis should be taken for longer than a six-months period, because it is always an easy matter to renew the paper. The question of renewal would be up to the Reserve banks.

It would be bad for the banking system as a whole to permit continuous borrowing from the Reserve banks by the member banks. Continuous borrowing from the Reserve banks by the member banks could only mean that the member banks were rediscounting or borrowing and then lending the money because of the difference between the rate that they paid the Reserve banks and the rate at which they loaned.

However, I can well imagine a situation in which there would be a crop failure, drought, or similar catastrophe, when it would be very desirable for the Reserve banks in the affected areas to carry loans for an additional period in order not to force liquidation. Past experience and the attitude of member banks towards borrowing indicate that we can be assured that in ordinary times member banks are not going to borrow from the Reserve banks except for short, seasonal requirements; when an emergency develops, it may be necessary for them to borrow for longer periods of time; and it is such borrowing for which this legislation is proposed.

In case of a rediscount, maturity should be based upon what would be considered the period of natural liquidation. For instance, for agricultural and live stock loans the period is nine months, since it is considered that the underlying transactions take that length of time. These loans are rediscountable now. Collateral loans, loans which are not considered rediscountable and are not self-liquidating through the completion of business transactions, such as real estate or collateral loans, would probably be made eligible only in cases of emergency, rather than in the natural course of business. Certainly the Reserve bank should be given the power to enable a bank that has an unusual shrinkage of its deposits and yet has sound assets, to get credit on them so that it can carry out a normal process of liquidation, without closing and without bringing about an undue deflation. That is the purpose of this legislation.

As a general rule, when manufacturing companies, such as sugar companies and other companies, borrow from the banks, they do not want to borrow for a period longer than six months, or even ninety days, because they are constantly reducing the outstanding loans. They do not know exactly by what amount they may be able to reduce loans; and, hence, they do not want to rediscount up to the maximum amount of their financial requirements for a period of nine months. It may be that they can pay a substantial amount in three months and renew the balance. I believe that, even if a nine-months rediscount were permitted in that type of transaction, there would be very few that would use it. If the condition of the company were such that an open line of credit were desirable, if the company were willing to borrow for nine months, and the bank should take its nine-months paper, there would be no reason for preventing the Reserve bank from taking such paper just as they would take live-stock paper.

I think that it has been the member banks rather than the Reserve banks which have held borrowers to a three-months period for borrowing. The member banks prefer ninety-day paper, because in the past they have seen very wide fluctuations in the prices of commodities against which they loan. In loaning for a period of nine months on any commodity, there is more risk from wide fluctuations in prices; and it is my belief that, for its own protection, the member bank passing on the credit will adhere to ninety-day paper and then will renew the loan. After all, even if the member bank borrows from the Reserve bank, it is responsible for the obligation.

It has been suggested that the reason for the gradual decrease in the amount of commercial paper is that many corporations, both large and small, have found that they can get funds through the investment bankers, through the issue of securities.

It seems to me that during the life of the Federal Reserve System our business system has become more concentrated, through consolidation and mergers, into larger and larger units; and that there is today a greater concentration of corporate operations in fewer companies than we have ever had before. The trend in that direction is evidenced by the chain store development and by developments in almost every field of manufacturing activity.

As a result, commercial deposits have tended to be concentrated to a greater extent than formerly in the centers where the headquarters of the various companies are located; and all borrowing on the commercial paper basis, has tended toward concentration in the money market at very low rates; so that the average small bank in the towns with a population of not more than 10,000 or even 25,000, even during the post-war period of great activity, did not have the demand for commercial loans from their local business concerns that they had had previously.

It is true that many of the consolidations and mergers were brought about through the flotation of securities, bonds and stocks, and that, as a result of those flotations, the banks that formerly made commercial loans and short-term loans for the carrying on of business transactions furnished funds through the purchase of bonds or through loans to customers, who purchased bonds or stock. As compared with pre-war days, there was a substitution to quite an extent, no doubt, of bonds and collateral loans for commercial paper in the loans and investments of banks.

And recently, of course, the short-term financing of agriculture has been taken away from the local banks to quite an extent through the Production Credit Corporations, which are a part of the Farm Credit Administration and which get most of their funds, other than their capital which has been furnished by the Government, through the Federal Intermediate Credit Banks by the sale of six-month and nine-month debentures. These debentures are sold in the market; the present rate is about 1 1/2 per cent per annum. The big banks with surplus funds purchase these debentures, thus providing funds through the Federal Intermediate Credit banks to the Production Credit Corporations and the Production Credit Corporations supply the funds to the farmers. This means that the big banks in the financial centers, through Federal credit agencies, are financing agricultural production; and that the eligible agricultural paper is taken away from the banks in agricultural areas.

If you will examine the statements of most of our business concerns, you will find that they have an excess of working capital. One of the difficulties today is that these concerns have large deposits in the banks, which they are not using and are not able to utilize. Even with an improvement in business, the most that could be expected from many of our business concerns would be that they would use the funds that they now have on deposit; and under no circumstances would they be required to borrow. Of course, I am speaking of our business concerns in very general terms. In number there no doubt are a great many business concerns that would be required to borrow; but, measured by the volume of the business which they do, they would represent a small percentage of total business.