May 27, 1935

Mr. Robert S. Lovett
Brown Brothers Harriman & Company
59 Wall Street
New York City, New York

Dear Mr. Lovett:

Reference is made to your letter of May 1 in regard to two suggested amendments, described below, to the Federal Reserve Act in connection with consideration of the proposed Banking Act of 1935.

These proposed amendments would (1) authorize any Federal Reserve bank to receive deposits from nonmember banks and bankers which are subject to examination and regulation under State or Federal law, and which are expressly permitted under State law to include balances with the Federal Reserve banks as reserves, and (2) to permit member banks in estimating their required reserve balances to deduct amounts due from private banks and bankers from their gross demand deposits.

As stated in the preamble of the Federal Reserve Act, one of the purposes of the Act was to establish a more effective supervision of banking in the United States, and to accomplish what the law contemplates the Federal Reserve System obviously should include in its membership as large a portion as possible of the country's banking resources. To grant substantial privileges to nonmember banks and bankers without subjecting them to requirements corresponding to those imposed upon member banks would not tend to bring about an increase in the System's membership and would not, in the opinion of the Board, be in the best interests of the Federal Reserve System.

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Banks which are members of the System are required to submit to examination, to comply with the rulings and regulations of the Federal Reserve Board, and to confora to certain statutory provisions regarding their operations. These provisions should, in the opinion of the Board, apply to all banks which are granted any of the substantial privileges of membership. Section 21 of the Banking Act of 1933 provides that private bankers receiving deposits must be subject to examination and regulation under State or Federal law, but there is no provision giving either the Board or the Comptroller of the Currency any authority to require correction of unsound banking practices which may be found to exist. It is for this reason that a provision is included in Section 303b of the Banking Act of 1935 (H.R.7617) repealing this requirement. The power to examine is of little, if any, value and may at times create a wrong impression with the public if it does not carry with it the power to require correction of banking practices which are inimical to the best interests of the public.

Member banks are required to maintain certain minimum balances on deposit with the Federal Reserve banks, whereas nonmember banks and bankers if given the privilege of carrying accounts with the Federal Reserve banks would be under no legal obligation to maintain a specified minimum balance, and would be in a position, should they so desire, to withdraw their balances at any time. Any policy which might result in building up substantial balances in the Federal Reserve banks which could be withdrawn in part or in entirety at the option of the depositors might at

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times seriously impair the System's ability to make effective its general policies. Furthermore, at times like the present, when member banks have substantial excess reserves with the Federal Reserve banks, the building up of deposit balances to the credit of nonmember banks and bankers would not increase in any way the earnings of the Federal Reserve banks, but would increase their expenses. In the light of these considerations, the proposed change authorizing Federal Reserve banks to receive deposits from nonmember banks and bankers does not appear to be one that the Federal Reserve Board could recommend.

The second proposal is that member banks be permitted to deduct their balances with nonmember banks and bankers from their gross demand deposits in estimating their required reserve balances. While the deduction of items in process of collection from gross demand deposits for the purpose of determining deposit liabilities on which reserves are computed would seem fully justified, there is doubt as to the wisdom of permitting the deduction of collected fund balances with any banks. To the extent that deposits are made by one member bank with another, however, the net deposit liability of all member banks as a whole is not changed and, therefore, the privilege of deducting balances due from member banks may be justified. Under the present law and regulations member banks may also deduct balances due from nonmembers in determining the amount of demand deposits subject to reserve. To extend this privilege to balances due from private banks would be a further departure from the sound principle that only items in process of collection (for which immediate deposit credit has been given subject to actual collection) should be deducted in determining net deposit liabilities. Furthermore, it might have a tendency to encourage member banks to carry

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balances with correspondents other than member banks.

Even if the effect of the proposed changes on the business of member banks were negligible, the Federal Reserve Board would find it difficult to justify on principle the extensions to nonmembers of privileges without the imposition of conditions corresponding to those imposed on member banks. The fact that the proposed changes would not enable nonmembers to share all the privileges of members, and that it would not necessarily lead to withdrawals from membership in the System, does not appear to alter the principle involved.

The Board recognizes the fact that many strong and ably managed banks, conducting their business capably, are outside the Federal Reserve System, and it appreciates the spirit in which your suggestion is made; but it does not believe that it would be consistent with its obligations to member banks, nor with the spirit of the Federal Reserve Act, to recommend the amendments which you suggest.

Very truly yours,

Marriner S. Eccles,
Governor.

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