

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 10, 1938

Mr. Eccles

Subject: _____

From A. B. Hersey

A.B.H.

Attached is a draft of comments on the legislation proposed

by the Federal Home Loan Bank Board.

Ellis
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February 10, 1938

COMMENT UPON DRAFT LEGISLATION
PROPOSED BY THE FEDERAL HOME LOAN
BANK BOARD, JANUARY 25, 1938

The Acting Director of the Budget addressed a letter to the Chairman of the Board of Governors on February 3 requesting comments on a proposed bill "To amend the Federal Home Loan Bank Act, the Home Owners' Loan Act of 1933, the Federal Reserve Act, Title IV of the National Housing Act, and for other purposes" prepared by the Federal Home Loan Bank Board. Following are comments on the general effect of the proposed bill and on several of the individual sections of the bill.

Certain sections of the bill, intended "to strengthen the reserve of home-mortgage credit in the Federal home loan banks" would either affect the operations of the Federal Reserve System or would call for the further issuance of obligations fully guaranteed by the United States. These sections are considered undesirable from the point of view of monetary control and of general financial and credit policy.

In addition, it appears that (1) the declaration of findings of fact and of policy of the United States which constitutes section 1 of the proposed bill unduly emphasizes the part played by building and loan associations in financing residential construction and exaggerates the need of giving further encouragement to these associations, that (2) the sections of the bill intended "to promote, organize and develop" Federal and other associations would tend to modify the present character of such associations as "local mutual or cooperative thrift and home financing institutions", and that (3) the sections of the bill intended "to increase the home-financing facilities of local mutual thrift and home-financing institutions by the insurance of such savings" will have effects far beyond their stated purpose.

It is to be noted that certain parts of the proposed bill would improve the supervision and regulation of building and loan associations by the Federal Home Loan Bank Board and its related agencies and would remedy technical defects in the law.

The Board of Governors is directly concerned with the proposed amendment to section 13 of the Federal Reserve Act which would make Federal Home Loan Bank obligations eligible as collateral for 15-day advances by the Federal Reserve banks to member banks, the proposed amendment to paragraph (b) of section 14 of the Federal Reserve Act which would permit the Federal Reserve banks to buy and sell in the open market obligations of the Federal Home Loan Banks, the proposed amendments to sections 11 and 15 of the Federal Home Loan Bank Act which would provide for a full guarantee by the United States of obligations of the Federal Home Loan Banks, and the proposed amendment to subsection (n) of section 4 of the Home Owners' Loan Act which would make available to the Home Owners' Loan Corporation an additional bond issue of \$300,000,000 for the purchase of obligations of Federal Home Loan Banks.

Amendments to section 13 of the Federal Reserve Act are unnecessary, since the member banks are now permitted under section 10(b) of the Federal Reserve Act to borrow from the Federal Reserve banks on any sound assets.

The addition of obligations of the Federal Home Loan Banks to those which the System is authorized to buy and sell is undesirable. The primary purpose of the open-market operations of the Federal Reserve System is to increase or decrease the reserves of member banks and thereby to expand or contract the available base for member bank deposits, which are the

principal element in the nation's supply of money. If the System is authorized to use in its open-market operations various types of securities which may at times be in need of support, this will result in pressure on emergency occasions to make purchases for the sake of the market standing of these securities. Such purchases are likely to conflict with the main objectives of open-market operations. In recent years open-market operations of the System in securities have been conducted entirely by the purchase and sale of direct obligations of the United States. This matter was discussed at greater length in a letter of the Board of Governors to the Acting Director of the Budget dated June 7, 1937.

The proposed amendments to give a full guarantee by the United States to the obligations of the Federal Home Loan Banks are undesirable at the present time. The opinion of the Board of Governors remains as stated in their letter to the Acting Director of the Budget dated June 7, 1937, commenting on a proposal to authorize a further issue of guaranteed bonds of the Home Owners' Loan Corporation to purchase obligations of the Federal Home Loan Banks.

"We consider it important that no further authorization to issue bonds fully guaranteed by the United States be made at the present time. The bulk of the outstanding guaranteed bonds were issued for emergency lending purposes with the expectation that they would automatically be retired from repayment of the loans thus financed." "...permanent participation of the Government in the financing of the Federal Home Loan Banks...seems to us undesirable and contrary to the Administration's policy of retiring as fast as possible from credit operations that should in normal times be carried on by private agencies".

"Two views may be taken of the functions of the Federal Home Loan Banks; (1) They may serve as reservoirs of funds for the temporary accommodation of their member institutions;(2)

they may pursue a permanent and "normal" policy of supplying their member institutions with funds to be used to increase their earning assets and thus to pyramid their earnings and their debts... Any developments tending to encourage savings institutions to assume as a normal thing large short-term liabilities of the nature contemplated ought to be resisted in the interests of sound financial and economic conditions in the future... Should the function of the Federal Home Loan Banks be interpreted...as a reservoir of funds for temporary and emergency accommodation, there is possible some question as to whether that System possesses the requisite powers for carrying out this function in a long-continued period of disturbance. This, we believe, is a problem to be faced on its own merits in the future. At such a time there should be thorough reconsideration of the operations of this and other Government credit agencies."

In view of the fact that the Federal Home Loan Banks floated \$78,000,000 of their consolidated debentures at very favorable terms during 1937, it appears that measures to ensure marketability of these obligations in times of stress may safely be postponed for consideration at a later date.

The proposed amendment to make an additional bond issue of \$300,000,000 available to the Home Owners' Loan Corporation for the purpose of acquiring obligations of the Federal Home Loan Banks would create a revolving fund for this purpose totalling \$600,000,000. It is especially undesirable to prepare now for future emergency conditions affecting the Federal Home Loan Bank System through use of an agency created for the entirely different needs of a previous emergency period.

Ever since the enactment in 1932 of the Federal Home Loan Bank Act there have been efforts, in part successful, to expand the scope of operations of associations under Federal supervision. Although it is no longer recommended, as in 1937, that the Home Owners' Loan Corporation be empowered to take over shares in Federal savings and loan associations in exchange for its own assets in liquidation, the proposed bill attempts

to make additional funds available to Federal associations by opening the way to purchases by the Federal Home Loan Banks of creditor obligations of the associations, by making shares of the associations lawful investments for national banks and for fiduciary and public funds under the control of the United States, and by providing insurance above the usual \$5,000 limit for shares of associations held by governmental and non-profit organizations. Moreover, the bill would again broaden the definition of a "home mortgage" as was first done in the Act of May 28, 1935, it would enable the Federal associations to expand their holdings of non-residential mortgages and of security investments, and it would permit member associations for the first time to obtain advances from the Federal Home Loan Banks on non-home mortgages. All of these amendments are inconsistent with the character of Federal and other associations as "local mutual or cooperative thrift and home financing institutions".

The insurance of share accounts in building and loan associations by the Federal Savings and Loan Insurance Corporation, created by Title IV of the National Housing Act, and especially the amendments now proposed, appear to involve an assumption that such shares are or should be the equivalent of bank deposits. The effect of one of the proposed amendments is to permit the Corporation to pay its insurance liabilities in cash in full. Under existing law only 10 percent of any such liabilities may be paid in cash. This amendment is undesirable because it would result in conferring the same degree of liquidity upon investors' shares in building and loan associations, which generally pay dividends of 4 percent, as is now conferred upon insured bank deposits bearing no interest or bearing interest not in excess of 2 percent or at the most $2\frac{1}{2}$ percent.

The desirability of reducing the annual premium charge upon insured institutions from $1/8$ to $1/12$ of one percent, the same rate as that payable by insured banks, is also to be questioned. It is believed that the present rate of the Federal Savings and Loan Insurance Corporation is too low rather than too high, for two reasons: first, because the risks of holding shares in building and loan associations are inherently greater than those of holding bank deposits, as indicated by the higher rates of dividends paid to association shareholders; second, because the Federal Savings and Loan Insurance Corporation does not receive the same large proportion of premium payments based on the uninsured excess of accounts over \$5,000 as the Federal Deposit Insurance Corporation receives in premium payments based on deposits over \$5,000.