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August 18, 1937

Honorable Robert F. Wagner, Chairman,
Committee on Banking and Currency,
United States Senate,
Washington, D. C.

My dear Mr. Chairman:

This refers to your letter of June 22, 1937, in which you request an opinion as to the merits of the bill S. 2680 which would amend section 19 of the Federal Reserve Act so as to permit member banks for a period of five years after August 23, 1937, to pay interest on demand deposits made by savings banks or on demand deposits of public funds of States or political subdivisions thereof or demand deposits of trust funds, if the payment of interest with respect to such deposits of public funds or trust funds is required by State law.

It will be recalled that prior to the enactment of the Banking Act of 1933 the law contained no prohibition against the payment of interest on demand deposits by member banks and contained no provision relating to the regulation of the rate of interest payable on time or savings deposits. The Banking Act of 1933 authorized the Board of Governors to regulate the rate of interest payable on time and savings deposits by member banks and prohibited member banks from paying interest on any deposit payable on demand, except that this prohibition did not apply to deposits made by mutual savings banks or to deposits of public funds made by or on behalf of any State, county, school district or other subdivision or municipality with respect to which the payment of interest was required under State law. The Banking Act of 1935, enacted August 23, 1935, rewrote the language of this exception to the prohibition on the payment of interest on demand deposits, and as thus amended the law now provided in effect that until August 23, 1937, but not thereafter, a member bank may pay interest on any demand deposit made by a savings or mutual savings bank, on any demand deposit of public funds made by or on behalf of any State, county, school district or other subdivision or municipality, or on any demand deposit of trust funds, if the payment of interest with respect to such deposits of public funds or trust funds is required by State law.

In enacting the Banking Act of 1935, it was the evident policy of Congress to eliminate the several existing exceptions to the prohibition on the payment of interest on demand deposits by member banks after a temporary period ending August 23, 1937. No reason is apparent why the policy of Congress, as thus prescribed, should now be altered, as is proposed in S. 2680. There has been no change in the conditions existing at the time of the enactment of the Banking Act of 1935 which would seem to make desirable a reconsideration of the policy in this regard.

The prohibition upon the payment of interest on demand deposits was enacted by Congress in order to eliminate detrimental competition for deposits among banks, and there is equally as much opportunity for such competition with respect to deposits of the kind now excepted from the prohibition as with respect to any other class of demand deposits. In fact, deposits of public funds of States, counties and municipalities are of a kind with regard to which competition among banks has been most active. Moreover, such public deposits are not infrequently withdrawn from banks in large amounts without notice and with possible disastrous consequences. It is believed that no justification exists for giving these classes of deposits privileges which other deposits do not have. This is especially true in view of the fact that payment of interest by member banks on demand deposits of public funds of the United States and Territories, Districts and possessions thereof not only is not permitted but is specifically prohibited by the law as amended by the Banking Act of 1935.

In considering this question, it should be remembered that a two-year period has been provided by Congress in which the necessary adjustments to conform to the Federal law might be made. A number of States have amended their laws so as to meet the situation and the passage of S. 2680 would, in effect, not only penalize those States which have already acted but would also encourage States to adopt legislation establishing interest requirements on demand deposits of public funds.

The Federal statutes and the regulations of the Board of Governors provide for the placing of funds in member banks on a time deposit interest-bearing basis; and it is believed that it would be feasible for a substantial proportion of the funds which will be affected by the change which automatically takes place on August 23, 1937, to be placed in member banks as time deposits, in which event, of course, they may draw interest at a rate not exceeding that prescribed by the regulations of the Board.

For the reasons stated, the Board of Governors does not favor the enactment of S. 2680.

Sincerely yours,

M. S. Eccles,
Chairman.