Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 2, 1938

To Chairman Eccles

Subject: Statement re Patman Bill.

From Mr. Wyatt, General Counsel

URGENT

There is attached a tentative draft of a statement regarding the Patman Bill, which is to be the subject of a discussion at a special meeting of the Board tomorrow (Thursday) afternoon. I was asked yesterday morning to prepare it and have a copy in the hands of each member of the Board this afternoon in order that he might read it tonight.

It has been very hastily prepared and is not a finished document, but I hope it will serve as a basis for discussion.

Because of limitations of time and other engagements, it was impossible to collaborate with other Divisions of the staff in preparing this draft.

Respectfully,

Walter Wyatt,
General Counsel.

Attachment

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CONFIDENTIAL March 2, 1938.

TENTATIVE DRAFT

(Prepared very hurriedly as a basis for discussion)

STATEMENT REGARDING H.R. 7230

The Board of Governors of the Federal Reserve System is opposed unanimously to the enactment of the bill H.R. 7230. The reasons for this opposition are indicated by the following analysis and discussion.

ANALYSIS

Considering the five declarations of policy in section 1, together with the substantive provisions, the purposes of the bill may be summarized as follows:

1. To provide for Government ownership of the Federal Reserve banks;

2. To prevent injurious expansion and contraction of credit and currency;

3. To stabilize and maintain a dollar having uniform purchasing power from generation to generation;

4. To permit all insured banks to enjoy all rights and privileges of the Federal Reserve System;

5. To encourage sound local banking;

6. To provide that net earnings of the Federal Reserve banks shall be covered into the Treasury;

7. To eliminate the requirement that member banks shall subscribe to stock of the Federal Reserve banks;

8. To require any nonmember insured bank to carry its reserves with a Federal Reserve bank so long as it chooses to enjoy the rights and privileges of the Federal Reserve System;

9. To enlarge the power of the Board of Governors to change the reserve requirements of member or affiliated banks;

10. To enlarge the membership of the Board of Governors to fifteen members, including the Secretary of the Treasury, the Comptroller of the Currency and the Chairman of the Federal Deposit Insurance Corporation;

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11. To have Federal Reserve bank directors appointed by the President and confirmed by the Senate, and to prevent any of them from being officers, directors, employees or stockholders of any bank;

12. To abolish the Federal Advisory Council;

13. To provide that the Board of Governors shall constitute the Federal Open Market Committee;

14. To place all positions in the Federal Reserve banks, except those of directors and officers, in the classified civil service;

15. To provide that no officer, director, or employee of any Federal Reserve bank or of the Board of Governors shall receive an annual salary in excess of $25,000;

16. To provide that examinations of member and affiliated banks of the Federal Reserve System by any Federal agency shall be made without charge or assessment for costs thereof against such banks.

For convenient discussion, all of these points may be grouped as follows:

(1) Those relating to the objectives of monetary policy;

(2) Those relating to the ownership and management of the Federal Reserve System; and

(3) Those relating to the extension of the benefits of the Federal Reserve System to nonmember banks.

OBJECTIVES OF MONETARY POLICY

The bill states two objectives of monetary policy: (1) "To prevent injurious expansion and contraction of credit and currency" and (2) "to stabilize and maintain a dollar of uniform purchasing power for the purpose of assuring the kind of dollar which a generation hence will have the same purchasing and debt-paying power".

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The Federal Reserve System is already charged with the duty of preventing injurious credit expansion or contraction, and the bill adds nothing to its power to accomplish this objective except to remove the present limitations upon the power of the Board of Governors to increase the reserve requirements of member banks. Theoretically, this may be desirable; but the grant of such power at the present time and under present circumstances might have very undesirable effects. It would create in the minds of member banks apprehension as to possible requirements for increased reserves, which would discourage them from extending credit more freely and might seriously retard the efforts which are being made to promote business recovery.

With respect to the proposed objective of stabilizing the purchasing power of the dollar, there is attached a statement entitled "Objectives of Monetary Policy", which was adopted unanimously by the Board of Governors of the Federal Reserve System under date of July 30, 1937 and which contains a complete statement of the Board's views with respect to all such proposals.

OWNERSHIP AND MANAGEMENT OF FEDERAL RESERVE SYSTEM

The proposed changes in the ownership and management of the Federal Reserve System are unnecessary, would serve no useful purpose, would impair public confidence and would have many other harmful effects.

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The present situation

The Federal Reserve System is not a private banking system and is not operated for profit. On the contrary, it was created by Congress as an instrumentality of the Government to perform certain public services and is operated solely for the purpose of serving the public.

Although the member banks own all of the stock of the Federal Reserve banks, they do not enjoy the rights and privileges usually incident to such ownership. They do not acquire such stock because they choose to but because they are required to do so by law, and they cannot sell or hypothecate it. The dividends which they receive are limited to 6 per cent per annum and all remaining net earnings of the Federal Reserve banks are paid into a surplus fund which will become the property of the Government whenever the Federal Reserve banks are liquidated.

Even the right to elect directors is strictly circumscribed by legal restrictions which limit each bank to one vote, regardless of the number of shares it owns. Each bank is permitted to participate in the election of only two of the nine directors. The banks are divided into groups according to their size and the large banks, the medium size banks and the small banks each elect two directors. The remaining three directors are appointed by the Board of Governors of the Federal Reserve System, which is an establishment of the Federal Government and all of the members of which are appointed by the President and confirmed by the Senate.

The powers of the directors of Federal Reserve banks are limited

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to the management of local affairs subject to the regulations and general supervision of the Board of Governors in Washington. The appointment of the President and First Vice President of each Reserve bank and the compensation paid to every officer and employee is subject to approval by the Board of Governors in Washington. Every director and officer of the Reserve banks is subject to removal from office by the Board of Governors.

The final control in all actions of the Federal Reserve System affecting national credit policies is already vested in the Government. The power to approve or disapprove discount rates of the Federal Reserve banks, to change reserve requirements of member banks, to prescribe margin requirements for security loans, and to regulate the rate of interest on deposits which may be paid by member banks, together with the power to exercise general supervision over the Federal Reserve banks and to prescribe regulations governing their discounts and advances to member banks, and many other details of their operations is vested in the Board of Governors.

The power over the open market operations of the Federal Reserve banks is vested in the Federal Open Market Committee, a statutory, official body consisting of the seven members of the Board of Governors appointed by the President and five representatives of the Federal Reserve banks.

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Under the Federal Reserve System as presently constituted, therefore, we have national management of national affairs and local management of local affairs under strict Government supervision and regulation. Such a division of authority is peculiarly adapted to a country as vast as this with widely varying conditions, habits, practices and needs in various localities.

Effect of proposed changes

The changes proposed in this bill would concentrate the complete ownership of the Federal Reserve banks in the Treasury Department in Washington, concentrate in the Government itself complete control over the management of local as well as national affairs, and make the Federal Reserve System a vast bureaucracy centered in Washington and out of touch with the local needs of commerce, industry and agriculture. Moreover, it would subject the country's banking system to complete political domination, which has always been disastrous.

If this bill were enacted not only would all of the stock of Federal Reserve banks be owned by the Government but also all of their property. Moreover, they would be managed by a board of directors appointed by the Government and supervised by a large Government board, three of whose members would hold office as officials of the Government in other capacities. All net earnings of the banks would go at once to the Government.

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In every sense, therefore, the Federal Reserve banks would be Government organizations. It is reasonable to expect that they would be operated solely as Government organizations. Their operations would be conducted in the interests of the Government as distinguished from business, commerce and agriculture and the public generally. The directorships in the Federal Reserve banks would be sought after as political plums and such appointments would be on a patronage basis. It is true that the appointments would not carry any great emoluments, but the office would be one of considerable influence and power with respect to local credit needs. It would be incumbent upon banks to have on the board of directors of the Federal Reserve bank of their district one or more directors who were friendly to such banks and accordingly it could be expected that the banks, especially the larger ones, would go to great lengths in an effort to obtain their desires in this connection. The directors themselves would, therefore, come to regard their positions as political appointments and would be much inclined to reward their friends by generous extensions of credit, to withhold credit from their political enemies, and to be almost completely indifferent to the needs of smaller institutions.

There would be no substantial check on this development from the Board here in Washington, because the Board itself would be or become at least partly political in character. With one representative from each Federal Reserve district the tendency would be much stronger than in the past for Board members to consider that they represented their respective regions and its interests rather than those of the

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entire nation, and the addition of the Secretary of the Treasury, the Comptroller of the Currency and the Chairman of the Federal Deposit Insurance Corporation would tend to lessen the independence of the organization. While it is difficult to predict what might happen under such circumstances, it is hardly too much to believe that, after the course of a few years, the Federal Reserve System might fail in its purposes, fall into disrepute and meet the fate of the first and second Banks of the United States.

Destruction of Independence

Congress created the Federal Reserve System as its agency through which Congress could exercise part of its constitutional authority to coin money and regulate the value thereof, and Congress sought to make the system directly responsible to it and as independent as possible of any other influence.

In the Banking Act of 1935 Congress sought to increase the System's independence by taking the Comptroller of the Currency and the Secretary of the Treasury off of the Board of Governors, thus removing the Board from the influence of the Treasury.

To have the Federal Reserve banks owned completely by the Treasury would be a step in the opposite direction and would lead to Treasury domination of the entire Federal Reserve System.

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In order to perform properly and in a manner most conducive to the public interest its functions with respect to controlling the volume of currency and credit with a view of accommodating commerce, agriculture and industry and preventing injurious credit expansion or contraction, the System must be as independent as possible of any special influence. Its independence would be completely destroyed if it were placed under the domination of the Treasury Department, which is the largest single borrower from the money market.

At a time when boom conditions were creating large demands for credit and threatening the country with injurious credit expansion, the Reserve System should raise rates and take other actions designed to exert a restraining influence; but it would be embarrassed in doing so if the Treasury were its sole stockholder, because it would be in the interest of the Treasury to keep interest rates low in order to facilitate Government financing. It is unthinkable to subject to the influence of any special interest the instrumentality charged with the regulation of general credit conditions in the interests of the nation's entire economy and which it is essential to keep as independent and unbiased as possible.

Of course the Reserve System in formulating its national credit policies must give due consideration to the problem of Government financing, which is one of the most important factors; but, unlike the Treasury, it must also take into consideration many other factors affecting the national economy and should not permit any one of them to dominate or control its decisions.

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Possible alternatives

If it should be concluded by Congress that ownership of Reserve bank stock by member banks is undesirable, there are other alternatives which are believed to be less objectionable than owernship by the Treasury.

The capital stock could be abolished entirely and the Reserve banks permitted to operate with their surplus funds as their only capital. If this were done, all earnings of the Reserve banks could be paid into the Treasury after the surplus had been increased to an amount commensurate with the responsibilities of the Reserve banks.

Another possible alternative would be to sell the stock to the public with appropriate restrictions on the amount which could be owned by any one person and, if desired, a prohibition against any of it being owned by anyone except an individual not connected with a bank or other financial institution.

If Congress should conclude that the election of Reserve bank directors by member banks is undesirable, it could authorize the Board of Governors to appoint them or provide for their election by representatives of commerce, agriculture and industry.

EXTENSION OF BENEFITS TO NONMEMBER BANKS

The Board is in sympathy with the desire to extend the benefits and protection of the Federal Reserve System to insured nonmember banks; but the provisions of the bill designed for this purpose would tend to destroy membership in the System and remove safeguards designed to promote sound banking.

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Under the provisions of the bill, every member bank could withdraw from the System and thus free itself from all of the regulatory provisions of the Federal Reserve Act except at such times as it might desire to borrow from the Federal Reserve banks or otherwise use the facilities of the Federal Reserve System.

If the benefits of the System were extended to insured nonmember banks without requiring them to become members of the System, this should be done only on condition that they maintain at all times the reserves required of member banks and comply at all times with the provisions of law enacted by Congress for the purpose of providing a sounder banking system.

The smaller banks might be exempted from compliance with any specific requirements of the Federal Reserve Act which are not essential to sound banking and which they would have serious difficulty in complying with.

Incidentally to require all insured banks to carry the same reserves as member banks, as suggested above, would increase the ability of the Federal Reserve System to prevent injurious credit expansion or contraction by changes in reserve requirements.

The provision for examination of member and affiliated banks of the Federal Reserve System by any Federal agency without charge would not materially change the existing situation with respect to State banks, because the Reserve banks already absorb the cost of most examinations of State member banks and the Federal Deposit Insurance Corporation absorbs the cost of examining nonmember insured banks. However, it would

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create a problem with respect to national banks, which are required by law to be examined twice a year by the Comptroller of the Currency. The Comptroller has no funds with which to absorb the cost of examining national banks; and, if the assessments for that purpose were abolished, it would be necessary for him to ask Congress for greatly increased appropriations unless some other means were found of defraying the cost.

CONCLUSION

For the reasons stated above, the Board of Governors is opposed to the enactment of H. R. 7230 or any similar bill.

The consideration of this legislation is extremely undesirable. Its most serious aspects are those which would tend to destroy the independence of the Federal Reserve System and impair public confidence.

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