REMARKS OF CHAIRMAN ECCLES AT THE CONFERENCE OF FEDERAL RESERVE BANK EXAMINERS, IN THE BOARD ROOM OF THE FEDERAL RESERVE BUILDING, TUESDAY AFTERNOON, NOVEMBER 1, 1938.

A number of those who attended the conference of Federal Reserve bank examination supervisors, held at the Federal Reserve Building in Washington, October 31-November 2, 1938, have requested copies of the talk given by Chairman Eccles on Tuesday afternoon. This talk was extemporaneous and was not intended for general circulation. However, as stenographic notes were taken, a transcript is available and the Chairman has consented to having it mimeographed for distribution among members of the examining staffs of the Federal Reserve banks, who might be interested in seeing it, with the understanding that it is not for release or for publication.

A copy of the transcript with only minor revisions is attached.

REMARKS OF CHAIRMAN ECCLES AT THE CONFERENCE OF FEDERAL RESERVE BANK EXAMINERS, IN THE BOARD ROOM OF THE FEDERAL RESERVE BUILDING, TUESDAY AFTERNOON, NOVEMBER 1, 1938.

Since I had the pleasure of meeting with this group, which I think was two years ago, a great deal has happened in the field in which you are primarily interested, that is, the field of bank examination as it relates to bank investments and bank loans. It seems to me that in order to understand the general purpose of the recent agreement it may be well to go back somewhat into the history of banking in order to follow the main developments that brought about the agreement.

During the 20's the banks were living in a very different period from the present time. They had the opportunity to loan their funds readily on a profitable basis. The call money market at that time was absorbing something like four to five billions of dollars of bank funds at a very profitable rate of return, and these loans were looked upon as being very liquid and very sound. Surplus funds of this sort also flowed to markets abroad, especially in the short term market in London. When we had in operation what we termed the "gold standard" short term funds would readily seek the market where they could get the best return. During that period we were not surfeited with billions of dollars of foreign funds seeking an outlet in our market. At that time banks were permitted to buy securities without much restriction. They were permitted to underwrite securities and they had security affiliates. Now all that is changed. We are familiar with the collapse after 1929. By this time we should recognize that our great desire to get liquidity by putting pressure on the banks to dispose of what we termed their unsound securities, and other pressures that were brought because loans appeared to be less desirable as the depression proceeded, only accentuated the process of deflation; that many banks which were closed, had they been able to carry through, would be solvent today because of the recovery that was brought about; that the treatment as "loss" of depreciation in securities in a depression and the effort to collect loans when the national income was cut in two brought about terrific bank losses and only accentuated further bank difficulties and deflation.

The Reserve system at that time was unable to do very much about it. In loaning to banks we were limited to what was termed "eligible paper" and there was a comparatively small amount of such paper in the banks. Therefore, it became very difficult for the Reserve system to stop the process of deflation that was going on, and the Reconstruction Finance Corporation, as you will recall, was set up in order to make direct loans to the banks on non-eligible paper and in order to provide capital stock, etc. By the time of the bank holiday, we discovered that despite pressure to bring about liquidity in the banking system, everything was completely frozen. But when the President went on the radio and told the public that the banks could pay them because they could go to the Reserve banks and borrow on any sound securities they had, and when the people found they could get their money, they didn't want it. The very fact that the Reserve system was permitted to provide liquidity at that time by making advances upon any sound assets immediately provided a liquidity that all of the examination procedure and liquidity pressures in the world could not provide for.

Now, I think we should have profited by some of the lessons of the 20's, as well as by what happened during the period of the depression. It seems to me that there are two things that stand out; one is that the banks used to have a very much broader field for outlet for their funds than is the case today. This was particularly true prior to some of our recent changes. Another thing that seems to me to stand out is that to apply restrictive bank investment and bank examination policies in a period of depression accentuates deflationary processes and thus helps to undermine the loans and investments that the banking system has. Thus loans and investments which would be perfectly good if the economic conditions prevailing at the time the loans and investments were made had continued become bad when the national income is greatly reduced. To exert pressure to collect loans and liquid investments at such a time only makes matters worse and helps to destroy the very loans and investments upon which the solvency of the banking system rests. It is useless to try to enforce liquidation when the market is not only limited, but is practically non-existent as is the case in a period of deflation. The place for liquidity is in the Reserve system.

Before discussing the Banking Act of 1935, I would like to say something about the Securities Act of 1933 and Securities Exchange Act of 1934 and what those Acts did to the banking system. The banks were prohibited from underwriting; the banks and their securities affiliates were divorced; any offerings of securities made to the public were required to be registered with the Securities Exchange Commission; the Comptroller of the Currency issued a regulation that in effect prohibited banks from purchasing any securities except those which were not only registered but were also widely distributed, and had a high rating. Now, what was the effect on the ability not only of the banks to loan and provide a market, but also on the ability of commerce and industry to get credit? The large business concern that needed to borrow millions of dollars could go to the capital market because it could afford to have its securities registered and because it could get a rating which made its securities eligible. But the little business was placed at a great disadvantage. Prior to the elimination of bank underwriting and securities affiliates industry as a whole throughout the country had ready access to credit, but when an important credit channel was closed when this legislation was passed and these restrictions were put in by the Comptroller, no alternative was provided. This worked a particular hardship on the small and medium-sized business which could no longer issue local unregistered securities, whereas the big business could still tap the capital market with its large, registered issues. So that there will be no misunderstanding, I want to emphasize that I am discussing the practical effects and not questioning the merits of the legislation which was necessary to correct flagrant abuses.

As for the banks, they could no longer find an outlet in the call loan market; they could no longer go out on their own account through a securities affiliate or through bond underwriting and develop any security business. Yet they were loaded with excess funds and there was no place to put those funds except in the Government market. At the same time, the Government, through the Reconstruction Finance Corporation and other agencies, undertook to provide the credit which the banks were unable to provide because of the various restrictions and conditions which existed.

We started out to correct some of those situations in the Banking Act of 1935, and I am going to read here part of my testimony with reference to that Act.

> "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.
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> "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.
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> "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."

This was the background of the Banking Act of 1935. I want to lead up to the history of examinations.

> "This then is the dilemma that faces the banks. If they go into the longer term lending business, they run the risk of depreciation and the inability to realize quickly upon their assets in case of need. If they do not go into this business, they cannot find an outlet for their funds. Their earnings will suffer and the justification for their existence diminishes. How can this dilemma be solved? It is proposed in the bill to solve it by removing the problem of liquidity as such from the concern of the banks, by bestowing liquidity on all sound assets through making them eligible as a basis of borrowing at the Reserve banks in case of need. This will enable the banks to concentrate their efforts on keeping their assets sound and to pay less attention to their form and maturity.

"Reliance on the form of paper as a guide to soundness and eligibility has not protected the banking system from disaster. We wish to divert bankers' attention from the semblance of paper to its substance, to emphasize soundness rather than liquidity. To require that a real estate loan shall be repaid in five years, as the present law requires, does not improve liquidity but rather, through the excessive strain it places on the borrower, acts to promote foreclosures and insolvency.

"What we are proposing is that the problem of liquidity shall cease to be an individual concern and shall become the collective concern of the banking system. A single bank which adopts a policy calculated to pay off all of its deposits at a moment's notice, even though the national income is cut in two, cannot adequately perform its duty of serving its community. Since good local loans go bad when a depression sets in, the bank's portfolio would have to consist of super-liquid open-market paper. What we want to accomplish is to make it possible for banks, without abandoning prudence or care, to meet local needs both for short and for long time funds. We want to make all sound assets liquid by making them rediscountable at the Reserve banks, and then to use the powers of monetary control* in an attempt to prevent the recurrence of national conditions which result in radical declines of national income, in the freezing of all bank assets whether they are technically in liquid form or not...."

I could go on here because there were extended discussions and hearings on this whole question, but I merely want to give you that much of the background and approach to this problem. Although we obtained legislation, as you know, which permitted more real estate lending and changed the whole eligibility basis of the Federal Reserve System, nothing at all was done about changing our bank examination program to harmonize with the changed conditions that the legislation had recognized. We did nothing toward changing our approach to the new banking

*Other portions of Mr. Eccles' testimony emphasized that monetary authority must be exercized in conjunction with other Federal powers and policies that affect the national income.

and credit problems but we largely continued, not only in the Reserve system but in our other agencies also, to pursue the same rules and regulations governing loans and investments, just as though we had had no collapse and no legislation in the interim, including the Securities Exchange legislation and the Banking Act of 1935.

The banking system, due to its failure to recognize these changes; our examination agencies, due to their failure, were gradually driving the private banking system out of business. Farm credit was largely provided by the Production Credit Corporation, through the sale by the Intermediate Credit Banks of Intermediate Credit debentures to the banks. The installment finance companies were providing consumer credit directly at rates as high as ten per cent or more, and banks were buying the finance companies' paper at one-half or one-fourth of one per cent. The Federal Savings and Loan Associations were gradually absorbing more of the savings funds of the country; the Postal Savings and the sale of Baby bonds were attracting still more of the surplus funds of the banking system, and the Reconstruction Finance Corporation was called upon more and more to provide credit for direct loans to industry.

I took an active interest in setting up the Federal Housing Act in order to make the banks secure in making the type of real estate loans that the people needed to build homes. Many banks have not availed themselves of that opportunity in spite of the fact that the Government didn't loan the money, but set up a separate agency whereby the loans would be guaranteed at a return of five per cent to the banks. Last year the agitation for twelve regional banks to provide intermediate credit was a most potent force, and it took a good deal of diligence and effort on the part of some of us to prevent that sort of legislation from going through. Now, we cannot, as a Reserve system, or as a Board here, expect to keep the Government from setting up agencies to provide credit for industry unless (and this is to protect the banking system which we certainly want to do) - unless, first, the banks are going to recognize that the day of commercial loans on any extensive scale is over with, and unless they recognize that they have the dual function of investing ten billion dollars in the savings field as well as providing check money through their commercial banking functions. Unless they recognize that, then I haven't very much hope for the profitable future of the banking system and with it of the Reserve system. The Board has been conscious of this condition that has existed, and last year when it issued a press statement covering Regulation A, which was the regulation governing advances to be made by the reserve banks to member banks, it had this to say:

> "In establishing rules which in effect make all sound assets of member banks eligible as a basis for advances by the Federal Reserve banks the Board has in mind the fact recognized by Congress in the Banking Act of 1935, that under our banking system member banks carry time deposits as well as demand deposits, and since these banks are custodians of the funds representing the savings or capital accumulation of the people, they properly invest a part of their funds in long-time paper. Consequently, provision should be made whereby such paper may be used in case of need as a basis for advances from the Federal Reserve banks.
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> "The principles underlying the new regulation are the same as those underlying recent modification of the Federal Reserve Act. Experience has demonstrated that the solvency of banks is better safeguarded by careful regard to the quality of the paper which they acquire than by strict observance

"of the form that this paper takes, and that greater emphasis on soundness and less emphasis on form is a sound banking principle. The Board was also guided in its determination of eligibility requirements by the recognition of the fact that at a time of a deflationary development it is important for the Federal Reserve System to lend with the greatest freedom consistent with safety. At such times technical limitations on the character of eligible paper endanger rather than protect the safety of the banking structure."

Despite all this, as I said a while ago, there was not an adequate recognition on the part of the bank examining agencies of the changed conditions. We had no uniformity, even within the Reserve system; there were no two reserve banks where an identical examination policy and procedure was carried out; our own situation was just as unprogressive as that of others, the Federal Deposit Insurance Corporation or the Comptroller's office, in recognizing some of these fundamental circumstances. And certainly without a better coordination how could we expect coordination and cooperation between the three separate agencies? It was in an effort to correct this situation that conferences were held and the revised program was finally adopted.

You will recall that the recovery program of last spring provided for desterilization, and resulted in a request that the Reserve system cooperate by reducing the reserve requirements -- not that there wasn't an ample amount of excess reserves but rather as a gesture that the Reserve system was favorable to the easiest possible credit conditions and wanted to do everything possible to bring about an expansion and stop the progress of the credit deflation. The Board felt that this program would not serve any purpose, no matter what amount of excess reserves were added to the System, either through desterilization or reducing the reserve requirements, unless there was a modification of bank examination policy and of the investment regulations of the Comptroller's office. I am going to read the statement which I made in a letter to Senator Vandenberg, right along that line.

"In my judgment, one reason why bank credit is not flowing adequately into productive business channels is because the banks are under too severe restrictions in their lending and investing operations. This is due both to Federal and State bank examination policies and to the Regulation of the Comptroller of the Currency governing investments by member banks. As to loans, many would-be borrowers cannot get deserved accommodation by the banks, not because the bankers are necessarily at fault, but because of the restrictions imposed upon them. While larger units of business can obtain ample bank credit, there are numerous cases where sound local businesses need working capital or fixed capital on longer terms than the banks can make without being criticized by most bank examiners who have been trained in the school which identifies liquidity with soundness. Similarly, the Comptroller's Regulation in effect confines permissible bank investments to registered securities that are given approved ratings by recognized rating firms and that have a wide and active market. Thus many local industries of small and medium size, which cannot stand the costs of registering and issuing securities for general public offering but which are perfectly sound risks, are denied access to that type of credit which is available to larger business units through the purchase of their securities by banks. Without questioning the necessity for regulations in the field of investment securities, I am confident that it is a mistake to prohibit member banks from purchasing sound securities of local businesses. I have urged that the Comptroller's Regulation be revised so that bank lending and investment policy can meet changed conditions and present day requirements of business and industry. In a recent address, I stated: 'Bankers cannot justly be held responsible for such restrictive governmental banking policies as confuse soundness with liquidity or true worth with current depressed market values. I favor modernization of these practices and regulations, to encourage the bankers to meet changed credit conditions and needs within their own communities, and thus to discourage the alternative which is multiplication of governmental agencies set up to provide credit accommodation that the banking community could and should in normal times be adapted to extend to the public.'"

Now you have all read the Regulations that were in the Bulletin in July, the revision of bank examination procedure and the new investment securities regulation of the Comptroller of the Currency. I am just going to read an excerpt or two from that statement which is an expression of the Board's view of the amended regulations:

> "The program adopted is expected to be of benefit both now and in the future in two important respects; first, in broadening the opportunity for small and medium-sized business concerns to obtain credit from the banks on a sound basis, and, second, in relieving pressures that tend to reduce outstanding credit or prevent extension of new credit to sound borrowers.
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> "Under the new designations, the principle is clearly recognized that in making loans, whether for working capital or fixed capital purposes, the banks should be encouraged to place the emphasis upon intrinsic value rather than upon liquidity or quick maturity.
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> "Similarly, the revised examination procedure recognizes the principle that bank investments should be considered in the light of inherent soundness rather than on a basis of day to day market fluctuations. It is based on the view that the soundness of the banking system depends in the last analysis upon the soundness of the country's business and industrial enterprises, and should not be measured by the precarious yardstick of current market quotations which often reflect speculative and not true appraisals of intrinsic worth.
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> "A primary purpose of the program is to encourage the private banking system of the country to adapt its lending and investment functions to present day requirements of commerce, industry, and agriculture. It is designed to afford the banks a broader opportunity for service to the community and for profitable outlet for some of their abundant, idle funds. As the banks avail themselves of the opportunity, the necessity will be diminished for creation of government agencies to furnish credit facilities which the banks should provide.
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> "The program is based upon sound banking principles. The banks will be required to continue the present practice of charging off losses and of establishing and maintaining adequate reserves against doubtful and speculative loans and securities."

It is encouraging, after an effort of something like five years, to have a recognition of these changed principles in the banking field by the banking and supervisory agencies and particularly by the private banking system. I was much interested in getting a report on term loans issued by Reserve City Bankers Association, at a meeting in Chicago recently. I am going to take occasion to refer to one or two highspots in that report because it seems to recognize the changed principles in the banking field. I think we have made considerable progress when a group which largely represents a most conservative viewpoint, adopts a report of this sort.

> "The banking system has been described truthfully as a handmaiden to the nation's industry and commerce. In fulfilling this role, banks must be ready to modify their services to conform to changing industrial conditions."
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> "One reason why many banks have refused to embark upon the making of term loans as a recognized and regular part of their business has been the critical attitude adopted by Federal and State regulatory authorities towards such loans, which were generally classified by examiners as 'slow' or worse. To remove this obstacle to the making of long term bank loans, a revision of bank examination procedure has been promulgated by the Comptroller of the Currency, with the agreement of the Secretary of the Treasury, the Board of Governors of the Federal Reserve System and the directors of the Federal Deposit Insurance Corporation.
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> "The examination procedure now adopted abandons both liquidity and marketability as the sole ultimate criteria of the soundness of bank loans, and considers primarily the assurance of ultimate repayment."

That brings us pretty well up to date. The Reserve system, of course, cannot be expected to assume responsibility for the examination and investment policies of the entire banking system in view of the limited scope of the System's authority. However, I felt it was important at this time that you get the background of this entire development; that only in that way can we here expect your full, your constructive and your sympathetic acceptance of some of these changes, and your full cooperation in carrying out not only the letter of the changed agreement and approach, but the spirit of it in every detail.

In order that I may not be misunderstood, I should like to add that it is my conception that the bank examiner, the man who goes into the bank, should report the findings and that the supervisors -- you who are represented here -- should be the ones to do the interpreting; you are the ones who should apply the rule of reason.