Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 8, 1940

To Mr. Eccles

Subject: Mr. Evans' proposal

From Mr. Morrill's office

In accordance with a request from the Division of Research and Statistics, kindly mark "Confidential" Exhibit C "Proposals to Control Bank Reserves" by Victor M. Longstreet, attached to the memorandum dated November 6 from Mr. Goldenweiser.

November 6, 1940

TO: Board of Governors

SUBJECT: Mr. Evans' proposal

FROM: E. A. Goldenweiser

Mr. John Evans, President of the First National Bank of Denver, has submitted to the Board of Governors and to the Treasury Department copies of the attached memorandum, dated May 7, 1940, entitled The Banks and Government Bonds (Exhibit A, attached). This memorandum outlines a plan providing for (1) cash redemption of Government securities held by member banks and (2) additional member bank reserve requirements in the form of Government bonds.

Also attached are two memoranda that analyze the main features of this plan. The one entitled A Plan to Stabilize Prices of Bank-held Government Bonds (Exhibit B, attached) deals primarily with the cash redemption features of the proposal. The conclusion of this memorandum is that, although the plan would unquestionably accomplish its main aim of reducing the risk of price declines in Government securities, it would do so by requiring the Government to pay a relatively high long-term interest rate on what would be in effect a short-term or demand investment. It would also operate in favor of one particular class of bondholders, namely, the banks.

The memorandum entitled Proposals to Control Bank Reserves (Exhibit C, attached) discusses on pages 11-12 that part of the proposal which requires banks to hold Government securities equivalent to a certain percentage of their deposits. This appears to have been first proposed by Lawrence Seltzer of Wayne University, formerly with the Treasury Department. In our correspondence with Mr. Seltzer, he has agreed that the operation of this plan as a check to credit expansion would be fundamentally the same as the so-called "ceiling reserve plan". The "reserve-bond plan" of Mr. Seltzer and Mr. Evans is of necessity much more complicated than the "ceiling reserve plan" discussed on pages 7-9, involving as it does the additional provisions affecting the bond market, bank earnings, Treasury financing, etc.

E. A. G.

(COPY)

EXHIBIT A

THE BANKS AND GOVERNMENT BONDS

A SUGGESTED SOLUTION FOR A MENACING SITUATION

May 7th, 1940*

Memorandum in reference to United States Government bonds now owned by the Federal Reserve System and its member banks and suggestions concerning a refunding and change in form thereof which would appear to be in the interest of the Treasury, the Federal Reserve System, the member banks, the Federal Deposit Insurance Corporation and the public generally whose money is deposited in the member banks.

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As of December 31st, last, the Federal Reserve System itself and all member banks held, respectively, 2.5 and 11.2 billions of direct obligations of the United States Government. In addition thereto, member banks held 3.1 billions of bonds and notes guaranteed by the United States Government, 2.7 billions of the obligations of states and their political subdivisions and 3.0 billions of other securities.

These vast aggregates totaling 22.5 billions have, when considered as a whole, been acquired within the banking system at extremely high market levels and at excessively low yields.

(Inasmuch as many individual banks may have purchased certain of their securities prior to the advent of extreme easy money, this statement may be challenged by those banks and should be verified by a factual study of actual reports on file of examination of all member banks by the National Bank and Federal Reserve Examiners).

The net working capital of all member banks (i.e., gross capital less capital permanently tied up in bank premises, furniture and fixtures and other non-convertible items) is approximately 4.4 billions. (This total includes a substantial amount of preferred stock owned by the Government and not as yet redeemed).

The United States Government, in public estimation, substantially guarantees the safety of deposits in member banks through its Federal

*(Since this memorandum was prepared statistics have become available as of June 30,1940, and should be inserted. The substitution of later figures would but magnify the problem.)

Deposit Insurance Corporation.

In 1920 when the total Government debt was less than 25 billions of dollars, Fourth 4-1/4% Liberty Loan bonds sold in the middle 80's, approximating a 6% yield to maturity and in the same year the Government offered one year certificates at 6% interest. The net yield of Federal obligations has recently ranged between less than 0% for the shortest maturities and 2¼% for the longest maturities. The return on the latter has fallen to this level from 4¼% in 1932 in the face of the fact that the national debt has substantially doubled since that date.

An advance in the yield on a 10 to 15 year bond selling on a 2½% basis to even a 4% basis would cause its market value to decrease approximately 15%. A 15% decrease in the investment account of all member banks would wipe out approximately two-thirds of their net capital. This net capital must also absorb all losses arising from some 14 billions of loans.

In particular reference to the Government securities now owned by member banks, during the past several years the carrying value of these bonds has in effect been steadily written up through the process of selling one issue for profit and buying another at the same market level and often of substantially the same maturity. Early issues of higher coupon rates have been paid off and issues of progressively lower coupon rates have taken their places. Thus the present carrying values will approximate the existing extremely high market values.

It has been conclusively demonstrated that the market for Government securities promptly disappears whenever any general selling movement occurs except insofar as the Federal Reserve System is willing to support a declining market and by so doing further increase the System investment in Government securities which is already in excess of 20% of the reserve deposits of its member banks.

THE EXISTING HOLDINGS OF 11.2 BILLIONS OF DIRECT UNITED STATES GOVERNMENT SECURITIES CONSTITUTE 23% OF THE AGGREGATE DEPOSITS OF ALL MEMBER BANKS.

In view of the dangers inherent in the situation above outlined, I would recommend for the serious consideration of the Federal authorities that -

1. The Treasury issue and sell at par to the Federal Reserve System account and to all member banks, indebtedness of the United States Government in the form of consols of no maturity in the aggregate amount of 13.7 billions, all for the purpose of refunding the System account of 2.5 billions and the member banks' account of 11.2 billions, i.e., their present holdings of direct United States Government securities. In payment for consols at par the Treasury to accept from the System account and from member banks cash and/or their present holdings of direct United States Government securities at the average daily opening market value of each issue so tendered for a reasonable period immediately preceding the conversion, or from the offering date on issues sold within that period. The said consols to be subject to call at par by the Treasury proportionately from all holders and until called to bear a rate of interest substantially equal to the present yield of the System portfolio, i.e., 1-3/4%. The ownership of consols to be restricted to the Federal Reserve System and its member banks.

2. Concurrently with (1) above the legal reserve requirements of all member banks to be increased by an average of 23%, which increased reserves shall be held in United States Government consols. The said increase averaging 23% shall be proportioned in the same manner and to the same relative degree as cash reserves are now proportioned between Central Reserve City banks, Reserve City banks, and country banks, and between demand and time deposits as follows:

	DEMAND DEPOSITS Central Res. City Banks	Res.City Banks	Country Banks	TIME DEPOSITS All Banks	AVERAGE All Banks
Required cash reserve	22-3/4%	17½%	12%	5%	13%
Required consol reserve	40 %	31 %	21%	9%	23%
Total	62-3/4%	48½%	33%	14%	36%

3. The System account to purchase from each member bank daily at par all consols held in excess of reserves required to be so held and to sell daily at par consols to each member bank sufficient to fill reserves required to be so held. Since consols would be held in safe-keeping by Federal Reserve banks, ownership could be transferred from one member bank to another by book entry.

4. The Treasury to redeem consols at par when total outstanding exceeds 2.5 billion (System account) plus the required reserves of all member banks to be held in consols (i.e., in case of a shrinkage in the total of all deposits in member banks).

5. The Treasury may at its option sell additional consols at par to the System when total outstanding is less than 2.5 billions (System account) plus the above required reserves of all member banks to be held in consols (i.e., in case of an increase in the total of all deposits in member banks.) In case the Treasury failed to avail itself of said option the reserves of member banks required to be held in consols shall be automatically proportionately so reduced.

Under a National emergency and possibly in any event for flexibility, it is possible that the Secretary of the Treasury and the Board of Governors of the Federal Reserve System, acting jointly, should have some discretion, but in any event within definite fixed limits, to increase the consol reserves above 23% (being the % of member bank deposits now invested in the direct obligations of Government.) On the one hand, the Treasury has full authority to redeem consols. It is obvious that if the Treasury and the Board of Governors, acting jointly, had the authority to increase the average consol reserve above the existing 23% average to an average of 25%, it would give the Government a further call upon the deposits of the public in member banks of approximately 1 billion dollars.

6. At such time as the Treasury is retiring the national debt and at its option calls proportionately from all holders all or any part of its then outstanding consols, reducing the total of 2.5 billions (System account) plus the above required reserves of all member banks to be held in consols, to a lesser total, the reserves of member banks required to be held in consols shall first and to that extent be automatically proportionately so reduced and thereafter applied to reduce the System account.

7. The aggregate of consols held within the System in its own and member bank accounts shall not exceed a total which is not covered, as are all other member bank reserves, by 35% in gold or lawful money.

8. Total gold or lawful money required to be held in vaults of System or subject to its sole order would then be as follows:

40% to cover circulation of 4.9 billions	± 2.
35% to cover member banks' cash reserves	± 4.
35% to cover member banks' consol reserve	± 4.
Total gold or lawful money required by System	±10.
Total gold now held by Federal Reserve System	±16.

9. Member banks desiring to do so would be permitted to hold any other United States Government securities but at free market risk in addition to their required reserves in consols.

This procedure should be desirable from the Treasury viewpoint because it will -

1. Effect a permanent refunding of 32% of the total Federal debt without increasing the total thereof outstanding except as offset by subsequent saving in interest.

2. Reduce present cost of interest to the Treasury on 11.2 billions of direct debt owned by member banks.

(This statement should be verified from reports of Examiners. It is believed that the average coupon rate of member bank holdings exceeds that of the System account).

3. Stabilize the market for all Government issues by removing the constant threat of bank selling of bonds held against demand deposit liabilities. Other holders of balance of public debt such as life insurance companies, corporations, trusts, savings and other individuals are generally investors of term funds not subject to mass withdrawal and therefore more stable holders. Balance of public debt so held as more permanent investment reduced to ±28.5 billions.

4. Natural investment level of premier security of world could be better maintained when freed from threat of mass selling from banks.

5. Protect the deposits of the public and particularly the Federal Deposit Insurance Corporation guarantee.

This procedure should be desirable from the Central Bank or System viewpoint because it will -

1. Increase purely monetary and credit controls.

2. Increase reserve requirements substantially without adversely affecting cash loan or other investment position of member banks <u>as a whole</u>

(Note that the increased requirements of smaller and country banks are much less than of large banks in Reserve cities. See table on page 4.)

3. Will not decrease existing System revenue.

4. Remove member bank speculation in Government bonds - switching, gambling on conversion rights, etc.

5. Remove necessity of supporting markets on totals of 42 billions of United States Government securities to protect 11.2 + 2.5 or 13.7 billions held within the Federal Reserve System.

6. Further justify present gold acquisition policy by requiring that gold be held by Federal Reserve System to secure all reserves of member banks.

7. Best promote interests of agriculture and industry and every other objective of the Federal Reserve System by centering attention on ways and means protecting the member banks and hence the money of the public on deposit therein.

This procedure should be desirable from the individual member bank viewpoint because it will -

1. Eliminate the danger of capital impairment due to market fluctuation of existing Government securities which are at times "frozen" and unsalable.

2. Eliminate the possibility of market manipulation by large holders at expense of small holders.

3. Assure moderate earnings on reasonable proportion of required reserves.

4. Divert banking attention to banking needs of public and away from speculative interest in Government bond markets.

This procedure should be desirable from the public viewpoint because it will -

1. Better protect the money of the American people in member banks, restoring the principle of diversification of risk in all forms of loans and investments which are subject to market fluctuation and risk, when

made with depositors' money largely subject to demand.

2. Increase the courage and confidence of bank management and, free of the threat of capital impairment, encourage freer lending.

3. Avoid further dangerous and destructive extremes of easy money and tend to arrest the diminishing returns on capital.

Condition of All Member Banks
In Billions of Dollars
12/30/39

Loans	14.			Capital Surplus & Undivided Profits	5.5	
State and Municipal Bonds	2.7	19.7				
Other Securities	3.0					
			22.8	Demand Deposits	28.2	
U.S.Gov't.Securities - Direct	11.2			Demand Interbank	8.5	37.4
U.S.Gov't.Securities-Guaranteed	3.1	3.1				
				Demand Foreign	.8	
Federal Reserve Cash - Required	6.4					
		11.6		Time Deposits	11.7	
Excess	5.2					11.8
				Time Interbank	.1	
Vault	.8		19.7 Cash			
Other Banks	5.5	8.1				49.2
In process of collection	1.8					
Miscellaneous assets (Bank premises, bank furniture and fixtures, etc.)	1.1					
	54.8				54.8	

U.S.Gov'ts.(direct) of 11.2 are 23% of member bank deposits;
" " " in System account are 2.5 additional yielding avg. of 1.72%

Federal Reserve notes in circulation are	4.9	40% =	2.0
Member Bank deposits with Federal are	11.6	35% =	4.0
Gold & lawful money now required by System			6.0
Gold now held by System			16.0

Excess Reserves 5.2 Correspondents' balances excessive by 1.8
Loans & other investments of 22.8 could rise 30% before banks would have to rediscount.

19.7 cash + 11.2 Direct Gov'ts. = 30.9 of Cash & Direct Gov'ts. or 63% of total member bank deposits.

Capital Ratio

Should not be between capital & deposits but between net capital & money at risk

1. Net capital=gross capital of 5.5 less misc. bank premises, etc., of 1.1, or 4.4
2. Loans 14.+ State & Munic.Bds. 2.7+other bonds 3.0+U.S. guaranteed's 3.1=22.8=loans & investments placed at risk by member bank management (excluding U.S. Direct)

4.4: 22.8 as 1: 5.2