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OF STATE BANKS
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BY

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"THE DUAL SYSTEM OF BANKING"

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THE DUAL SYSTEM OF BANKING

When your President, Mr. Perry, wrote to me in July inviting me to attend this annual convention of your Association, he told me that he wished to build the program around this central theme:

"In the wartime and postwar eras, how far, and by what means, is it desirable or possible to preserve the dual system of banking?".

That is an important and challenging subject. It implies that there are two sides to the issue. It implies that you are willing to hear both sides. I could, of course, be politic and say only what I think you would prefer to hear, but I doubt that your invitation to me was based upon the assumption that I would appear here as a champion and defender of the dual system. On the contrary, I imagine that you expected me to play the role of the devil's advocate, though, of course, as I see it, I am on the side of the angels. On one thing, however, we can agree. As public officials responsible for banking regulation, we all want a strong and successful banking system. It cannot be strong unless it is successful. We all favor what we believe to be in the public interest. And what, in fact, best serves the public interest will survive in the long run.

As a one-time banker and then as a sharer of the numerous supervisory headaches with which you are all familiar, I have known a good many of the State supervisors well and favorably, despite their tendency to differ with my views. So far as I am aware, I have never succeeded in converting any of them to my viewpoint, notwithstanding the cogency of the arguments on my side of the case. So I will be neither surprised nor disappointed if in this session you are not won over to my side. Nor is there cause for alarm lest your commissions be swept suddenly away, for this is a most venerable issue, this question of the dual banking system, and the related issue of branch and unit banks. In all probability we, or our successors, will still be debating these issues far into the post-war world. Economic forces and modern needs, rather than what may be said here, will ultimately determine the character and functions of our banking system.

In what I have to say I can speak only for myself. I am well aware that the division of opinion on questions of unification and branch banking extends beyond State boundaries into the Federal banking agencies, including the Board of which I am but one member. But I am confident that the cordial and cooperative relationships which have existed between the Federal Reserve and the State banking authorities will not be marred because I happen to believe in a unified banking system and in well-regulated branch banking limited to trade areas.

Our banking structure has had a piecemeal growth throughout our history. It reflects the cumulative efforts of public authorities, State and national, to meet recurrent emergencies and to deal with specific problems and competitive conditions. It has not been developed in accordance

with any comprehensive plan based on the country's banking needs taken as a whole. As the country expanded, its need for money and credit grew. In order to supply those demands, banks were formed in the quickest and easiest manner possible, with little or no direction or regulation, until abuses and difficulties arose. We all know that the history of banking in this country is filled with crises and disasters, with fulminations and fumbings for reform. What has developed hardly justifies the term "banking system". Although we can now have far more confidence in the soundness of our banks than at any time in the past, further improvements are urgently needed. They will come about, no doubt, in the future as in the past by gradual steps. To those who believe, as I do, that it is not in the best interest of the public or of the private banking system to maintain things as they are, the process will seem painfully slow.

The first duty of the Government, as I see it, is to create a climate and a condition conducive to a maximum of sustained private production and employment. Its next obligation, inescapable in the modern world, is to provide the opportunity for employment, in a way that will stimulate and not impede private enterprise, at such times as deflationary forces endanger economic stability. Conversely, its powers must be used to offset inflationary developments at the other end of the cycle. In other words, Government can and should be an economic balance wheel, helping to keep the economy going ahead on an even keel.

The most important governmental powers affecting economic stability are fiscal and monetary. Most of us recognize that it is essential in wartime to have close coordination between Government policies and those of the banking system. The banking system fully subscribes to the objective of financing war costs, not covered by taxation, by borrowings from nonbank sources. It is clearly recognized that the banks should finance only that residue of war costs which cannot, or at least are not, met by taxing and borrowing from the public. There is general acceptance both of the policy of maintaining approximately the present pattern of interest rates and of limiting Government obligations purchased by the banks to certain types and maturities of issues. Central banking operations have at the same time supplied the banking system with such additional reserves as are necessary to effectuate these policies.

Essential as it is in the national interest to have this high degree of coordination in fiscal and monetary action in wartime, it is equally important from the standpoint of national economic welfare to continue it in peacetime. Looking to the future, the Federal Government is destined to play a crucial role in the maintenance of economic stability. It is difficult to see how its basic functional powers can be effectively employed to this end so long as the nation's banking machinery is a hodgepodge of some fifty-two different jurisdictions, laws, and supervisory agencies, so long as approximately half of the banks of the country are subject to uniform central banking policy and half are not, so long as

these multiple agencies, State and Federal, with their differing philosophies, divided and conflicting policies, dominate the banking picture. While coordination is extremely difficult, admirable efforts have been made in this direction. They are in reality an admission of the need for unification of banking regulation and for clearly fixing responsibility where those who bear it can be effective and be held accountable.

The sovereignty of Government over the nation's money supply is beyond challenge. It is clearly recognized and declared by our Constitution. Demand deposits, as you all know, have become in the past sixty years the major part of our money supply. Control over their expansion and contraction should reach to all banks that are in a position to create them. Banking reserves which limit the money supply are thus crucial. It follows that reserve requirements should be made applicable to all banks of deposit. It is inequitable as well as ineffective that only the member banks of the Reserve System are subject to changes in such requirements while those banks which elect to remain outside the System, or those which are now members and which choose to withdraw, can escape sharing in what is a national responsibility.

While it is true that some States voluntarily set the same reserve requirements for nonmember State banks that are fixed for member banks, the State banks are permitted to count vault cash and to carry their reserves as deposits with other commercial banks. This has a very different monetary effect from carrying these reserves with Federal Reserve Banks. Reserves carried with Federal Reserve Banks are entirely unavailable for lending, but only twenty per cent or less of reserves carried with member banks are unavailable. This makes for a heavy dilution, but not for effective control.

Likewise, bank examination policy, with its direct influence upon bank lending and investment, which are money-creating operations, needs to be closely coordinated with national monetary policy. Notwithstanding the degree of coordination sought by the agreement among the three Federal bank supervisory agencies in 1938 and subscribed to generally by the State authorities, the result is at best a compromise and not a real solution.

Almost every aspect of banking regulation and supervision is made more difficult and less effective by the existing structure. I need not recount to you the innumerable conflicts, discriminations, divided and overlapping authorities; that characterize the banking picture in this country. As the Federal Reserve Board declared in its Annual Report for 1938, "The banking picture emerges as a crazy quilt of conflicting powers and jurisdictions, of overlapping authorities and gaps in authority, of restrictions making it difficult for banks to serve their communities and make a living, and of conditions making it next to impossible for public authorities to apply adequate restraints at a time and in conditions when this may be in the public interest." That report suffices to show the need for modernizing

and streamlining the banking structure of this country as modern business and industry in almost every conceivable line of endeavor have been modernized and streamlined. Attempts at coordination, commendable as they are, reflect, but are not a practical solution of the problems.

Now all of this, you may say, is just my philosophic approach. I am trying to sketch it in because it is my basic reason for believing that the dual banking system, as now constituted, is outmoded and that economic forces -- not mere debate -- will compel its adaptation to the financial needs of modern economic life.

It is not long ago, as time is measured, that we were pre-dominantly an agricultural nation. Local communities were relatively self-sustaining. Industries were largely locally owned and comparatively small. As the great railroad systems of the nation developed with the westward march, new towns and villages sprang up along the way. Each had its local, more or less self-contained economic life, its stores and its banks. This was in a day of a relative scarcity of capital. Interest rates were high. Too often banks took the risks and the losses that should have been borne by risk capital and not by bank stockholders and depositors. This era of rapid, steady expansion faded out with the advent of the large mergers and consolidations in the industrial world, with the development of modern transportation and distributive systems. Attempts to halt this march of progress by anti-trust, anti-chain store legislation or other statutory pains and penalties have largely been in vain. It requires no gift of prophecy to foresee that the same economic forces will in time compel the banking system to follow a parallel pattern.

The answer to the theme question of this session is not hard to discern as you look back at the fate of thousands upon thousands of the small unit banks which once thrived. By 1921 we had more than thirty thousand commercial banks in this country. More than twenty-two thousand of them were State banks, while some eight thousand were national banks. As of last June thirtieth, the number of State banks had shrunk from twenty-two thousand to about nine thousand, and there were about three thousand fewer national banks. There has been no banking mortality remotely approaching this sad record in any other nation on earth. The disappearance of more than thirteen thousand State banks and three thousand national banks as well -- whether it be through failure, through merger, or through voluntary liquidation -- is eloquent proof that something was fundamentally wrong with a system that permitted so large a number even to come into being.

We have expended more in time and money on bank examination and supervision, conducted by at least 52 separate State and Federal agencies, than any nation in the world. It involves unnecessary waste of manpower at a time like this. It did not and could not of itself protect the depositors, stockholders or customers of the thousands of banks that went to the wall, even during the so-called prosperous Twenties. Aside from voluntary liquidations or absorptions, nearly ten thousand State banks, with aggregate deposits of

close to five billion dollars, folded up in the Twenties and early Thirties. At the same time more than two thousand national banks, with deposits of only slightly less than two and a half billions, went to the wall. Most of these were independent unit banks. Banks that survived the Twenties and then weathered the economic disaster of the early Thirties were necessarily the strong and not the weak. What saved them in the end was the avalanche of money poured out by the Federal Government -- the billions in loans and capital supplied directly to the banks by the RFC and the additional billions furnished to others through the RFC, the Farm Credit Administration and the Home Owner's Loan Corporation, which made it possible to liquidate the frozen and defaulted credits held by the banking system.

As you in this audience know, bad management and other human defects were minor and not major reasons for the epidemic of failures. The mortality was greatest through the Twenties among the smaller institutions in the agricultural regions. They were the victims of depressed agricultural conditions. Thousands that managed to come through in the country and in the cities only to succumb in the early Thirties, were likewise primarily the victims of economic distress and disaster with which they could not cope individually and from which the most diligent supervisory and examination policy could not save them. Since the bank holiday, the rising price level has made good the assets of numerous banks that were closed then and of many that would not have been reopened had strict examination policy been uniformly applied. The rising price level, not deposit insurance, has reduced bank mortality to a minimum.

The record of bank failures in this, the richest country on earth, might have been much better -- it could hardly have been much worse -- had examination and chartering policy been more restrictive in boom times and if, especially during depression, runs had been averted by deposit insurance. However, deposit insurance, which I strongly favored at a time when most of my banking contemporaries regarded it as a scheme for making good banking pay for the mistakes of bad banking, cannot cure the basic weaknesses. The attempt to do so at this stage by making chartering and examination policy increasingly restrictive, would lead only to depriving the public of needed banking services in innumerable communities. This, in turn, would lead to demands upon Government to furnish through its agencies the credit services that the banks would otherwise supply. It would mean additional Government encroachment upon the field of private banking enterprise.

Even today, during the greatest of all war booms and despite the enormous growth of deposits, many of the smaller banks are having difficulty in making a living. It is difficult to attract new capital into the banking system. Moreover, the process of contraction in number of banks is continuing -- fortunately through voluntary liquidation of existing units unable to operate successfully, and through mergers and consolidations, rather than through the disastrous process of failures.

The solution is not to be found in more and more restrictions applied to a basically faulty structure. The solution lies in a unified system with branch banking. We alone among the leading nations have failed to develop such a system. We alone have deposit insurance. We need it as long as the basic faults of our banking structure remain uncorrected, but the need for it would disappear, and bank failures would be as rare in our country as they are in other great nations, if we would deal with the causes instead of continuing to deal with the effects of the basic weaknesses in our system.

Merely to unify the banking system under one regulatory authority would not be a sufficient remedy. As I have sought to stress, the problem is basically an economic one. The question is, can the small independent unit banks expect better earnings in the future? Or, of greater importance, can they provide their communities with adequate credit facilities and bank services at costs as low as those prevailing elsewhere? In this vast country there are many so-called creditor areas which have a surplus of savings over local credit and investment needs, and others, debtor areas, where the demand for funds exceeds the local supply. But we have a banking system which requires for the sake of liquidity that banks in the debtor areas send funds to the creditor areas, whereas the reverse should be the case. Farmers and home owners and small businesses are demanding better and cheaper credit facilities, while banks in their communities hold idle balances in large city banks or buy low interest-bearing bonds. But to protect their depositors they cannot afford the risk of having all their assets invested at home. Is there any wonder that borrowers come to Washington, in times of business contraction, and ask for new Government credit agencies? I am opposed to Government subsidized competitive agencies taking away business from the banks. But is the widespread outcry against farm credit agencies really based upon a fear of socialized credit and does it really attack the cause of the trouble?

These Federal agencies, as has been said, were "born of pitiless and inexorable necessity" in a time of adversity when the banks could not meet desperate agricultural needs, and at the time were welcomed by the banks as they were by farmers. Many of the credits they extended were not bankable loans. But even if they could be abolished over the opposition of organized agriculture today, which I very much doubt, that would hardly mean the difference between profitable and unprofitable banking operations.

You have only to look at the unprecedented and still growing volume of bank deposits created as a result of war financing to realize that relief cannot be expected to come through a rising interest rate structure after the war. The command over the interest rate structure which governments have exercised during the war will not, in my opinion, be relinquished afterward. In view of the huge debt-refunding operations that the Government will have to carry on and the disruptive effects of a falling bond market, or, otherwise stated, of a rising interest rate on

these operations, it is hardly likely that the responsible authorities would fail to exercise their undoubted powers of control to prevent any such wide fluctuations in interest rates as would afford the banks a hope of rising returns from this source.

Moreover, the vast volume of funds that have already come or will come into existence before the end of the war presents a competitive situation that is hardly designed to result in increased rates and earnings by the banks. These deposits are owned by insurance companies, mortgage companies, finance companies, building and loan associations, business and industry, as well as by many other potential lenders, individual and corporate. I have recently seen funds advertized for lending in the mortgage field for as long as forty years at but four per cent. Banks must face the necessity of adapting themselves to meet such competition and at the same time, through diversification and sound management, safeguard the interests of their depositors and stockholders.

I recognize that a banking structure that may best serve one part of the country may not be adapted to another part. Generally speaking, in the Eastern States, where larger diversified banking units predominate and distances are relatively short, there is no such public need for trade-area branch banking as is the case in those sections of the country where distances are great and where the banking units are necessarily smaller and far less diversified in their lending and investing activities -- indeed, often they are too reliant upon conditions in one or only a few lines of agriculture or industry.

I have long felt that limited branch banking is the practical solution of the banking problems confronting those areas where unit banks cannot succeed. I have never favored nation-wide branch banking, or its extension over wide areas. I do feel, however, that it should be permitted within limited trade areas, in no case exceeding the limits of the immediate area served by the head office or by a branch of a Federal Reserve Bank. I believe that the independent unit bank should be protected, however, by a statutory provision prohibiting establishment of any branch in a community already served by a unit bank or by a branch of another bank. The banking authorities could, of course, permit establishment of another bank in a community if the need for it existed, but under the provision I have in mind, a branch could only come into the community by acquiring a unit bank which had been in existence for at least five years. Such an acquisition would have to have the consent of the bank supervisory authorities in order to prevent monopolistic tendencies. Under such provisions, a market would be provided for the stock of a unit bank in case the stockholders desired to sell because of unprofitable operations or for any other reason. At present the owners of the smaller unit banks are greatly handicapped in having no opportunity, in most cases, to dispose of their investment, if they wish to do so, at anything like a satisfactory price.

The smaller unit banks face many difficulties and disadvantages as compared with branch banks. The smaller units are so limited in their lend-

ing capacity that more and more, as business, industrial and agricultural enterprises have enlarged, they have had to turn to the banks with large resources for their financial requirements. The smaller units do not have the opportunities afforded the larger institutions to diversify their lending operations and thus spread the risks. They cannot afford to employ the specialized management in the various lines of lending and investing activity that can be employed by the larger banks. They are not able to offer the variety of credit and other services, and they lack stability and continuity in management, as compared with larger banks with branches. Accordingly, I see in a branch banking set-up such as I have outlined a practical and logical solution of the problem, both from the standpoint of providing needed banking services for the public in many communities and from the standpoint of the interest of the unit banks themselves.

The present branch banking laws discriminate unfairly against national banks. While Federal law permits a national bank to have branches in those States where State law permits branch banking, the Federal law requires the same capitalization for each branch of a national bank as for establishment of a new national bank. Most State laws impose no such capital requirements. If both State and national banks were put on an equal footing with respect to branches and the independent unit banks were protected as I have suggested, it seems to me that it would be in the interest of all concerned.

The public interest and public needs will, I am confident, determine in the end the pattern that will be followed. It is not the public which has opposed branch banking. As Senator Glass said when the subject was being debated in the Senate some years ago -- and he has had more legislative experience with banking problems than any man in public life in our times --

"The plea against branch banking comes from bankers and not from people who transact business, not from people who want to borrow money, not from people who want to buy credit. It comes from bankers who want to exclude from their peculiar communities anybody else who wants to sell credit."

And you will perhaps pardon me if I recall to your mind that the same Senator is the author of the statement that "the curse of the banking business of this country is the dual system".

Now, I have not advocated abolishing State chartering and supervision because I have felt, or at least hoped, that a sufficient degree of unified policy and action could be brought about, short of so drastic a change, by requiring that State banks, like national banks, be members of the Federal Reserve System, by a consolidation of Federal regulatory and supervisory authorities, and by development of branch banking as I have indicated. Nevertheless, I must confess that the cold logic of the situation calls for the more drastic readjustment to modern conditions.

In the earlier days of the Republic when State banks were empowered to issue currency, there was a reason for State chartering and supervision that ceased to exist when State bank notes were taxed out of existence. In the light of the clearly recognized sovereignty of the Federal Government over the issuance of currency, the logic of the case calls equally for ending State authority to charter banks which, in turn, while they no longer issue currency, can create bank credit that has so largely supplanted currency as the country's chief medium of exchange.

As Professor Westerfield of Yale has pointed out;

"It has been seriously argued that the Constitution not merely permits but requires that the power of the states to charter commercial banks be abolished and control of commercial banking be exercised by the federal government alone, because the Constitution expressly gives Congress control of the monetary system and forbids interference with it by the states, and commercial bank deposits are the principal element of the monetary system."

Having a regard for the antiquity of this issue of the dual system and the controversy which has raged about the subject for so many generations, I have perhaps been more prudent than logical in stopping short of advocating that you gentlemen be legislated out of your present occupations -- but a long line of eminent authorities, who could hardly be charged with indifference to State Rights, have not stopped short. Senator Sherman, of Ohio, that distinguished leader in establishment of the national banking system, concluded nearly eighty years ago that, and I quote, "The whole system of state banks, however carefully guarded, was both unconstitutional and inexpedient and ought to be overthrown".

Daniel Webster, speaking in the Senate on the subject of State bank circulation, said:

"I confess, Mr. President, that the more I reflect upon this subject, the more clearly does my mind approach the conclusion that the creation of state banks, for the purpose and with the power of circulating paper, is not consistent with the grants and prohibitions of the Constitution."

Even so ardent a champion of State Rights as Thomas Jefferson wrote in 1814 that, "The state legislatures should be immediately urged to relinquish the right of establishing banks of discount".

My own approach and viewpoint were well expressed by an editorial in the New York Times of July 23, 1936, emphasizing the fact that "an obvious and pressing need" for fundamental banking reform still existed.

"If the experience of the depression years showed anything," this editorial continued, "it showed the glaring weaknesses inherent in a banking system which is conducted under no less than fifty different sets of Federal and local regulations, with many communities denied by law the services of banking institutions equipped with adequate financial resources. The remedies for these weaknesses are unified regulation obtained through membership of all banks in the Federal Reserve System and an extension of the practice of sound branch banking."

You will not, I trust, accuse me of radicalism or of favoring bureaucracy because I find myself allied in my thinking with so many others who, down through the years, have shared my general viewpoint; some, like Jefferson, being much more drastic than I have been. And you will not, I trust, think that I have any less desire to work cooperatively, closely, and in harmony with you to make the best of our present situation just because I believe that time and economic progress will ultimately bring fundamental changes in the banking structure. I do not care what system, whether dual or unified, prevails, or how many banking authorities there are, if the system, whatever it may be, best serves the public interest and preserves private banking in this nation.