For release on delivery

Statement of J. L. Robertson, Vice Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions

of the

Senate Banking and Currency Committee

on

S. 714, S. 965, and S. 966

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On behalf of the Board of Governors, let me express our appreciation, Mr. Chairman, for the actions you have taken to assure prompt consideration of three of the Board's legislative proposals. Two of the three bills you have introduced and scheduled for this morning's hearing are identical with drafts submitted by the Board and passed by the Senate in the last Congress. These are S. 966, which would modernize the laws relating to borrowings by member banks from the Federal Reserve Banks, and S. 965, which would facilitate Federal Reserve operations in foreign currencies by permitting investment of such currencies in obligations of foreign governments. The third bill, S. 714, incorporates another of the Board's recommendations--also passed by the Senate in 1965--concerning loans by member banks to their executive officers, as well as other provisions relating to Federal credit unions.

Advances by Federal Reserve Banks (S. 966)

S. 966 would eliminate provisions of the Federal Reserve Act that now require imposition of a "penalty" rate of interest where a member bank borrows from a Reserve Bank on collateral other than U.S. obligations, and the security--even though it is fully acceptable to the Reserve Bank--does not meet obsolete and complex eligibility requirements specified in the statute. In such cases, the Act authorizes the Reserve Banks to extend the credit, but the rate of interest must be one-half per cent higher than the regular discount rate applicable to advances secured by "eligible paper."

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Naturally, member banks wish to borrow at the regular discount rate rather than a rate one-half per cent higher, and consequently the question repeatedly arises whether paper offered as collateral for such advances actually does comply with the eligibility tests.

Under the Federal Reserve Act as originally enacted member banks could borrow from the Reserve Banks only by discounting eligible paper, consisting essentially of "notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes." Paper eligible for discounting was also generally restricted to that having a maturity at the time of discount of not more than 90 days. The statutory requirements as to eligibility for discount have remained substantially unchanged since 1913. The limitations in the Act were imposed on the assumption that the legitimate needs of the economy for bank credit would always be exactly reflected in the volume of these short-term, self-liquidating loans. Thus an automatic control mechanism over discounting was provided, insuring (it was thought) that the amount of reserves created in the process would vary directly with the needs of the economy.

This concept was found inadequate relative to needs as early as 1916, at which time Federal Reserve Banks were authorized

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to make advances to member banks on their promissory notes secured by direct obligations of the United States. Again in 1932 conditions made it necessary to relax further the narrow restrictions on discounting. At that time section 10(b) was added to the Act, making it possible for member banks to borrow on their own notes secured to the satisfaction of the Reserve Bank, but only at a rate of interest at least one per cent above the "regular" discount rate. In 1935 this mandatory differential was reduced to 1/2 of one per cent, which is the requirement in the present law.

Both substantive and operational problems have developed in the implementation of the so-called "eligible paper" concept. As the economy has grown, increasing needs for bank credit have developed which are wider in scope and longer in duration than those which may be satisfied within the definition of eligibility. These are largely the result of the growing capital investment needs of a mechanized agricultural and industrial society. For example, farmers today make much greater use of expensive equipment; a modern combine represents a big investment and requires longer-term financing. In filling these needs, member banks make many loans which are as sound and acceptable as short-term commercial loans but which are not eligible as collateral for Federal Reserve credit at the usual discount rate. In other words, credit needs now exceed the supply of short-term, self-liquidating loans classified as "eligible" and vary for the most part independently

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of changes in that supply. Experience has also demonstrated that the provision of a given type of collateral does not necessarily indicate the use to which the member bank will put the credit.

Aside from these substantive shortcomings, the eligible paper concept poses practical problems for the Reserve Banks, for member banks, and perhaps to a certain extent for banking customers. The Reserve Bank must analyze each instrument presented to it, not only for its soundness and acceptability, but also for its eligibility under the narrow and complex standards specified by the Federal Reserve Act. The member bank also must make this analysis when it contemplates borrowing on the security of commercial paper, and may at times, depending on the extent to which it must use eligible paper to obtain Federal Reserve credit, tailor its lending practices to these standards. When a member banks finds it necessary to so alter its lending policy, hardship--or at least inconvenience--can result for some of its credit-worthy borrowers.

These problems did not cause any great difficulties for Reserve Banks or member banks in the immediate post-war years, largely because banks then held ample supplies of U.S. Government securities. For two decades, the bulk of the credit provided through the discount window has been collateralized by such securities. However, in recent years non-Federal debt has increased far more rapidly than Federal debt, and bank portfolios have reflected this development. Furthermore, bank holdings of

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Government securities available for use as collateral at the discount window have been curtailed by the rise in the level of public deposits which typically must be secured by a pledge of these same assets.

The declining supply of free Government obligations--that is, holdings not needed as security for public deposits--has led in the past several years to a dramatic increase in borrowing on the basis of eligible paper. The face amount of eligible paper analyzed at the Federal Reserve's discount window increased from about $250 million in 1964 to more than $20 billion in 1966. The number of pieces of eligible paper analyzed increased from 833 in 1964 to 24,345 in 1966. The number of banks using this paper is still small, but also is increasing rapidly (from 20 in 1964 to 82 in 1966). Overall use of the window has shown no such dramatic increases, but it has remained fairly substantial and has grown in the past several years. The above and other data for the last eight years are shown in the attached tabulation.

These increases have resulted in an increasing administrative burden for member banks and Reserve Banks for the reasons cited earlier. And if this rate of increase continues it is only a matter of time before banks begin to face shortages of eligible paper, which represents only a small fraction of their total loans.

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In sum, we feel that all relevant factors argue for elimination of the eligibility standards. It would do away with what are today artificial limitations, originally imposed for reasons which in the light of history have proven not valid or workable, and would thus bring the operation of the discount mechanism more into line with current realities. It would also relieve the member banks and the Reserve Banks of an unnecessary administrative burden, and would enable them to serve the needs of the financial system and the economy more effectively, without being confined by outmoded limitations. The Board, therefore, strongly urges approval of this bill.

Investment of Foreign Currencies Held by Federal Reserve (S. 965)

As a part of its efforts to safeguard the value of the dollar in international exchange markets, the Federal Reserve System has entered into reciprocal currency agreements--the so-called "swap arrangements"--with a number of central banks in other countries. Under these arrangements, the Federal Reserve can obtain a stated amount of foreign currency in exchange for a corresponding amount of dollars. In the event of a drawing--which may be initiated by either party--the balances acquired have to be repaid at the same exchange rate, thus protecting each party against any loss from currency devaluation. The currencies acquired may be sold to smooth out abrupt changes in exchange rates or to prevent fluctuations in U.S. gold reserves or dollar liabilities due to temporary forces acting in the exchange markets.

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A drawing by one party under one of these arrangements puts currencies into the hands of the other party. Balances so acquired may be invested at a pre-agreed rate of interest (the same for both parties). Present law, however, needlessly restricts the means available to us to invest such balances. Under the Federal Reserve Act idle balances of foreign currencies held by the System may be invested in short-term commercial paper in the foreign country or placed in an interest-bearing time account with the same or some other foreign bank. In most countries, however, there is a scarcity of commercial paper for investment, and in some countries time deposit facilities are not conveniently available. Present law contains no authority for the investment of such idle funds in obligations of foreign governments, such as foreign treasury bills. On the other hand, a foreign central bank may--and generally does--invest its excess <u>dollar</u> balances in interest-bearing securities of the United State Government.

S. 965 would authorize the Federal Reserve to buy and sell securities of a foreign government or monetary authority that have maturities of not more than 12 months and are payable in a convertible currency. This would insure that any foreign currencies we acquire in excess of current operating needs may be safely and conveniently invested in income-producing securities. For this reason, the Board recommends enactment of this bill.

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Loans to Executive Officers (S. 714)

Section 22(g) of the Federal Reserve Act prohibits a member bank of the Federal Reserve System from making a loan of more than $2,500 to any of its executive officers, and loans up to $2,500 may be made only with the prior approval of a majority of the bank's board of directors. The section further requires every executive officer to file a written report with his board of directors regarding any loan obtained by him from another bank.

The underlying purpose of these restrictions is unquestionably sound. However, they seem unrealistically severe in the light of changes in economic conditions that have taken place since they were enacted in 1933 and 1935. The President's Committee on Financial Institutions in 1963 recognized the desirability of increasing the $2,500 ceiling on the amount that an executive officer may borrow from his own bank. In addition, it would seem appropriate to provide a considerably higher ceiling on a mortgage loan covering the purchase of an executive officer's home. Under present law, such an officer is compelled to obtain home mortgage financing from another financial institution.

The first section of S. 714 would amend section 22(g) so as (1) to raise the "general" loan ceiling from $2,500 to $5,000, and (2) to permit executive officers to borrow up to $30,000 from their own banks on home mortgage loans. Member banks would be

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prohibited from making such loans on terms more favorable than those extended to other borrowers. Instead of requiring prior approval of such loans by the board of directors of the officer's bank--a time-consuming formality that is unnecessary in view of the other safeguards provided--the bill would require only that the officer report the borrowings to his board of directors. Finally, reports of borrowings from other banks would be required only where they exceed in the aggregate the applicable ceiling ($5,000 or $30,000, depending on the purpose of the loan) on borrowing from his own bank.

The Board believes that these liberalizing amendments would be consistent with the basic purposes of present law and that such liberalization is desirable. Accordingly, the Board recommends their enactment. Since the provisions of section 2 of S. 714 do not relate to the Board's area of responsibility, we have no comments with respect to that section.

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Eligible Paper Presented by Member Banks as Collateral for Borrowing at Federal Reserve Banks, 1959-1966

	1959	1960	1961	1962	1963	1964	1965	1966
			(Face amounts in millions of dollars)					
All Member Banks:								
Number of Pieces	527	1006	123	397	277	833	18,343	24,345
Face Amount	153.0	673.0	5.4	71.3	133.7	248.6	7,186.4	20,085.2
Number of Banks	13	21	5	7	8	20	40	82
Reserve City Banks:								
Number of Pieces	355	448	5	131	223	271	11,934	16,606
Face Amount	82.3	241.3	4.2	56.9	133.4	239.3	7,064.9	19,630.4
Number of Banks	8	9	1	3	5	8	21	43
Country Banks:								
Number of Pieces	172	558	118	266	54	570	6,408	7,739
Face Amount	70.7	431.7	1.2	14.4	.3	9.2	121.5	454.8
Number of Banks	5	12	4	4	3	12	19	39

Source: Federal Reserve Banks.

Note: Eligible paper is counted for this table only when it is initially analyzed. If paper is left at the Reserve Bank and offered as collateral again without requiring further analysis, it does not enter into these totals a second time.

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Number of Member Banks Borrowing One or More Times During Year from Federal Reserve 1959-1966

	1959	1960	1961	1962	1963	1964	1965	1966
All Member Banks	1911	1903	1260	1102	1222	1232	1157	1614
Reserve City Banks	238	207	161	150	168	158	161	166
Country Banks	1673	1696	1107	956	1054	1074	996	1448

Member Banks Borrowing One or More Times During Year as Per Cent of Total Number of Member Banks, Year-End 1959-1966

	1959	1960	1961	1962	1963	1964	1965	1966
All Member Banks	30.7	30.8	20.6	18.2	20.0	19.8	18.6	26.3
Reserve City Banks	81.2	86.2	71.6	68.2	78.1	76.0	83.0	86.5
Country Banks	28.2	28.6	18.8	16.4	17.9	17.9	16.5	24.3

Source: Federal Reserve Banks

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