The following address, "Legislation Facing Banking Today," by W. Braddock Hickman, president of the Federal Reserve Bank of Cleveland, is to be delivered at 9:30 a.m. Monday, November 16, 1964, before the 70th annual convention of The Kentucky Bankers Association at the Brown Hotel in Louisville, Kentucky. For release Monday P.M.'s and after, November 16, 1964.
I would like to use this occasion to discuss with you my thoughts about some major issues in banking legislation. Although 1964 was a year in which very few banking laws were put on the books, some people, including my friend, Joe Barr, the Chairman of the FDIC, believe that we are on the threshold of a period of sweeping legislative changes. I am less willing to go on record about this than Mr. Barr, partly because I don't know the answer, and partly because of the well-known reluctance of central bankers to forecast the future in public. Nevertheless, it is timely to take a look at some important bills affecting banking that are under consideration and that will certainly be discussed fully during the next session of the Congress, whether they are enacted or not.

But before looking ahead, let's look back at the meager accomplishments in the field of banking legislation in 1964. It has been well said that to understand the future we must know the past. To the best of my knowledge, of the many banking bills introduced in the 88th Congress, only four of significance were passed. One pertained to the liberalization of bank loans on forest tracts, a second to the disclosure of financial information to stockholders, a third to moderately more liberal lending limits on real estate loans under the Housing Act, and a fourth, to notification regarding significant changes in bank ownership. These actions were hardly earth shaking; as one not-too-original commentator observed, they call to mind "A mountain laboring to bring forth a mouse."
Why was so little accomplished in the field of banking legislation in 1964? Basically, I think the reason was the general conviction of the majority of the people that our economic system and the financial institutions supporting it were working pretty well. There were, of course, disagreements within Congress on a number of major items, as well as between interested financial agencies and among various pressure groups. But so far as the public was concerned, the area of agreement was large, and the areas of disagreement correspondingly small. No one single point of view carried sufficient weight in the popular mind to bring about important legislative changes.

It would be a mistake, however, to judge the importance of the issues facing banking today by the meager legislative accomplishments of the recent past. Some very fundamental issues remain very much alive in the minds of some very important people. Bankers, above all others, should be familiar with good ideas that are in the public interest, as well as bad ideas against which all of us should be prepared to take a stand.

It seems to me that there are four areas in which legislation will be considered in 1965. The first and most important one has to do with the structure of the Federal Reserve System, and I shall return to this later. The second has to do with sections of the Federal Reserve Act having to do with the discounting of eligible paper, a subject that could become critical in the event of a liquidity squeeze on banks. A third important area has to do with the organization of bank supervision at the federal level. A fourth area has to do with legislation that, while not specifically banking legislation, should be of major interest to bankers. I refer specifically to the Interest Equalization Tax, which was passed by the Congress last September, and which will come up for consideration again in 1965.

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Let us look first at the Interest Equalization Tax, which was intended to help improve the U.S. balance of payments by reducing the outflow of U.S. capital to foreign countries. In effect, the legislation levies a tax on the sale of foreign securities to Americans, making it more costly for other nations to borrow capital funds in this country. As originally drafted, the legislation did not affect banks or bank loans, but an amendment--known as the Gore Amendment--was added less than a month before final passage. This amendment gives the President standby powers to extend the coverage of the tax to include bank term loans to foreigners, specifically, loans maturing in more than one year, if it appears that such loans are becoming excessive.

Under the Interest Equalization Tax legislation banks are required to report detailed information about current loan commitments to foreigners. Such reports currently are being filed with the various Federal Reserve banks, and are transmitted by us to the Treasury for evaluation.
According to recent official pronouncements, it seems likely that the Interest Equalization Tax will be renewed after its presently scheduled termination in December 1965, and it is at least conceivable that the tax could be extended to term loans made by banks on a compulsory rather than a standby basis. Let me say that I am personally disturbed over both of these possibilities--the possible renewing of the Interest Equalization Tax and the possible inclusion of bank term lending. The tax serves as an artificial constraint upon the flow of capital throughout the world, and is almost bound to bring forth a spate of retaliatory measures by other nations, such as import quotas and tariffs, export subsidies and the like. If the rationale of the tax is to bring interest rates here and abroad into closer alignment, so as to better balance capital flows, there is a better way to accomplish the same result. Specifically, we could adjust the movement of capital funds by the use of open market operations--by influencing the availability of credit and interest rates. This, as you know, is the task of the Federal Reserve System and of monetary policy, and could be accomplished in a free market without artificial restraints or hindrances. I believe bankers should express themselves forcefully on this subject when the Interest Equalization Tax is brought up in the Congress next year.

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Let us turn now to the matter of bank supervision and the choice between centralized or decentralized authority. As you know, at present the responsibility for examination and supervision of commercial banks is shared by three federal agencies, and the state banking departments. The Comptroller of the Currency supervises national banks; with the cooperation of state authorities, the Federal Reserve System supervises state member banks, and the FDIC, insured state non-member banks. This tripartite arrangement has many advantages and has worked well in the past. Recently, however, conflicts and controversies have emerged among the federal agencies, reflecting a general lack of cooperation, principally between the Comptroller of the Currency and the Federal Reserve System.

I will not enumerate the various points of controversy, since this would take up all of my time and then some. The important point is that these controversies all focus attention on a single fundamental issue. That issue is whether centralized control over all banks would be better for banking and for the general public than our present decentralized system.

The bill introduced by Congressman Multer (and fathered by Governor J. L. Robertson of the Federal Reserve Board) would place in a single agency all phases of bank supervision that are now distributed among the three federal agencies. Proponents of the bill argue that such consolidation would do away with disagreements in applying rules and regulations to banks and thereby eliminate inconsistencies at the federal level, which is true so far as it goes. Proponents of the bill also contend that a unified agency would relieve the Board of Governors of an onerous burden and allow the System to devote its full time to monetary policy, which is also true so far as it goes.
Despite these advantages, I am not convinced that the unified agency approach is in the public interest. It would in effect eliminate the dual banking system as we know it and place monolithic power in the hands of a small board or a single individual. The unified approach might work well under one individual or board, and might be disastrous under another. In any event, I am always uneasy about great concentrations of power.

Besides opening the way for possible misuses of power, the unified agency approach may sacrifice certain advantages in the present setup. For one thing, the burden of bank supervision borne by the Federal Reserve is not an unmixed blessing. Because we supervise banks, as well as formulate monetary policy, we are in a good position to observe the impact of monetary policy on the banking system, and this we need to do to be effective. In addition, the unified agency may not have all the advantages claimed for it. Centralized bank supervision would not necessarily improve the quality of supervision, even though it might eliminate some inconsistencies. It seems doubtful that such an approach would automatically provide better solutions to such complex problems as bank chartering, mergers, branching, and deposit insurance. I suspect that under the unified system, the same technicians would be processing these matters in much the same way as they are today, but without the present checks and balances.
The fundamental issue under our present decentralized system is whether men of good will can reach reasonably consistent positions on matters having to do with bank regulation. If the regulatory authorities fall out among themselves and issue conflicting regulations, the banking system will be divided into splinter groups and will lose out in the competitive struggle with more rationally supervised financial institutions. I believe that the present system can be made to work, as in the past, by the restoration of a spirit of cooperation among the regulatory agencies.

Turning now to the matter of eligible paper, you may recall that bills were introduced last year by Congressman Clarence Kilburn and Senator Willis Robertson to liberalize the regulations in the Federal Reserve Act dealing with member bank assets that can be pledged as collateral when borrowing at the discount window. Thus far there has been no action on either bill. The Federal Reserve System has taken a strong position on the need for this legislation and has recommended favorable action by the Congress. Interestingly enough, the Comptroller's office has taken a position similar to that of the Board of Governors, although the two agencies would probably prefer somewhat different versions of the final legislation.
The bill that has been introduced would help the Federal Reserve make discounts and advances on the basis of sound collateral without imposing a penalty merely because the collateral did not meet the archaic requirements of "eligible paper" as defined in the Federal Reserve Act. A change of this type would acknowledge the changes that have taken place in both banking and the economy at large since the "eligibility" requirements were first written into the original Act in 1913. We need a more flexible credit mechanism than is provided by current provisions that allow banks to borrow at the discount rate only if they use "eligible paper" or Government securities. When member banks use other collateral, they are subject to a penalty rate set 1/2 percent above the discount rate. I might note that the "eligible paper" requirement represents a historical hangover from the old "real bills" doctrine, with which I am sure many of you are familiar. The doctrine holds that banks should discount only short-term, self-liquidating paper, used to finance the production and distribution of physical goods. The present provisions exclude as collateral most of the assets now held by banks, except at a penalty rate.

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It is not surprising that most member banks, and the Federal Reserve banks as well, prefer U. S. Government securities as collateral for purposes of borrowing at the discount window, since that procedure involves less administrative detail and is simpler and less expensive. Thus, as long as banks have enough U. S. Governments on hand, there is no problem under the present Act. But as you know, the proportion of such securities held in bank portfolios has declined steadily since World War II. At the end of 1945, for example, commercial banks had about $125 billion in loans and investments, of which U. S. Governments amounted to $91 billion, or 73 percent. By the end of 1963, Governments held by banks had shrunk to $62 billion, and accounted for only 25 percent of total earning assets.

Further reductions in holdings of Governments, which could easily come about for both supply and demand reasons, would encourage banks to offer other collateral to obtain Federal Reserve credit. Ultimately, this could create serious administrative problems. It is thus prudent to act now, when the situation is not pressing. The Federal Reserve banks should be given the authority to allow member banks to borrow on any satisfactory collateral, subject to such requirements as the Board of Governors might wish to spell out in Regulation A. By so doing, the Federal Reserve would be better able to meet the needs of a dynamic banking system and a growing economy. We should provide appropriate credit to member banks, when warranted, and thus help banks to meet the legitimate credit demands of businesses, consumers, and the general economy.

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Now a word or two about recent proposals that would alter the structure and independence of the Federal Reserve System. As background, I think it is important to point out that the Federal Reserve is always interested in legislation that would improve its effectiveness, whether the legislation would alter its structure or would provide it with new or improved tools for efficient operation. This is evident from our support of legislation designed to broaden the eligible paper provisions of the Federal Reserve Act.

What is of the utmost importance for all of us to realize is that there are people in this country who do not want an independent, regional, nonpartisan Federal Reserve System. These individuals—including some Congressmen, many academic economists, and vocal spokesmen for powerful pressure groups—would like to reorganize our central banking system and place it directly under the Executive Branch of the Government.

The nature of the changes considered comes out clearly from a report entitled "Proposals for Improvement of the Federal Reserve System," that was released this summer by the majority members of the Subcommittee on Domestic Finance of the House Banking and Currency Committee. The Subcommittee indicated that it intended to consider a number of proposals in public hearings when the next Congress convenes in January. The principal proposals of the Subcommittee include the following:

1. Retire the stock of the Federal Reserve banks.
2. Eliminate the Federal Open Market Committee, and invest all power to conduct open market operations in the Federal Reserve Board.
3. Reduce the number of Governors on the Board to five and shorten their terms to five years.
4. Make the term of the Chairman coterminous with that of the President.

5. Provide for public audit of all expenditures of the System.

6. Provide that all income of the System be channeled into the Treasury and all expenditures be authorized by Congressional appropriation.

7. Require that the President in his annual economic reports set forth "guidelines" concerning monetary policy, and express the sense of the Congress that the Federal Reserve operate in the open market so as to achieve these guidelines.

8. Transfer the present bank supervisory functions of the Federal Reserve System to the Comptroller of the Currency, the FDIC, or a newly formed Federal banking authority.

This is a watered-down version of proposals originally made by the Chairman of the House Banking and Currency Committee, and we might take heart from this fact. On the other hand, the entire list of proposals received the enthusiastic support of one of Washington's most influential newspapers. In addition, one of New York's leading newspapers, which favors the retention of the Federal Open Market Committee and the regional structure of the System, endorsed the public audit proposal and the elimination of the capital stock.

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Things have been relatively quiet in recent weeks insofar as the dialogue about the Fed is concerned. Much of this can probably be explained by the excitement of the election campaign, and the need of many legislators to turn their temporary attention to other matters—including the important matter of being reelected. But this is only a lull in the storm. The reconvening of the Congress in January will bring forth a resurgence of interest in the structure and organization of the Federal Reserve System. The Chairman of the House Banking and Currency Committee has promised us more investigations, more hearings, and more discussion—some of which could be informative and fruitful.

In closing I should like to say that, despite much discussion to the contrary, I do not believe the Federal Reserve System will be changed in any fundamental way over the foreseeable future. If the public really wanted change, this would have been reflected in the platforms of our two major political parties. Instead, both platforms were silent on the structure of our monetary system. Yet, silence on this matter does not necessarily imply approval. While the Fed is not "on the spot" at the moment, the public should be apprised of the fact that persistent maneuvering is going on to bring about fundamental changes in the System.

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Where does all of this come out? Changes will come about, in my opinion, only if the System makes a serious blunder, or if the System fails to act in a responsive, judicious and prudent manner. Stripped down to the fundamentals, the Federal Reserve must be responsive to the goals of the American people. This means that the Federal Reserve must provide all the credit needed for balanced and sustainable economic growth, but it must not provide so much credit as would lead to price inflation, deterioration in credit quality, and a worsening of our balance of payments position.

Recognition of the appropriate role of the Federal Reserve was clearly revealed in a statement by President Johnson, just before the election. Mr. Johnson pointed out that, if there is restraint by labor and industry in wage and price demands and if government holds the line on spending, there is no reason why we should not have the "monetary expansion essential to economic growth." The President went on to say, however, that "if inflation occurs, or if excessive outflows of funds occur, the Federal Reserve System is in a position to do what is necessary."

Doing what is necessary has never been an easy task—indeed, it taxes the resources of the Federal Reserve System to the utmost. But so long as we perform to the best of our ability in the public interest, I believe we will continue to have the support of the majority of the people.