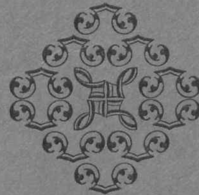
Mr. Attebery

EXTRACT FROM

CONFERENCE OF GOVERNORS OF THE FEDERAL RESERVE BANKS

DISCUSSION with MR. NEWTON D. BAKER



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TREASURY BUILDING ÷ WASHINGTON, D. C.

MARCH 23, 1926

WALTER S. COX, SHORTHAND REPORTER
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(Governor Crissinger, Vice-Governor Platt, Messrs. Hamlin, Miller, James, Cunningham, of the Federal Reserve Board, and Mr. Newton D. Baker, of Cleveland, Ohio, entered the Conference room, and the following proceedings were had:)

Governor Crissinger. Mr. Baker is here at the request of the Governors, to give an account of the Grimm-alfalfa case, as to the effect it might have upon the rediscount operations of the Federal Reserve Banks. Mr. Baker will explain the situation to you.

Mr. Baker. Governor Crissinger, and gentlemen, the Grimm-alfalfa case is largely a lawyer's brief to me. So far as that particular case is concerned I confess I thought the Supreme Court would hear it on a writ of certiorari, because I believed then and believe now that while it does not change the law, that it is a misapplication of the law to the facts in that particular case. My hope was that the Supreme Court of the United States would regard the legal principles in that case as so vital to the business of the country that they would not be willing to let that case stand with the possibility of the confusion that it might cause throughout the Federal

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Reserve System. I suspect that the Supreme Court excluded it for two reasons. In the first place the docket of the Court is very heavy and they are excluding all cases that they can. It was easy for them to exclude this case because it is a question which arises more on a determination of the facts in the lower court than determination of principles of law. If one takes the opinion of the Circuit Court of Appeals and takes the statement of law made by it no particular exception can be taken to what they state the law to be, with the single exception that in the opinion written by Judge Rodman they do say that the Federal Reserve Bank wittingly or unwittingly became party to a fraud which was committed by the S tanrod Bank, which was the member bank in the case. But if you read the rest of the Judge's opinion, and of course the Supreme Court did, it seems fairly clear that they held that there were facts enough to go to the jury on the question of fraud.

Now with regard to the Grimm-Alfalfa case, taking it altogether, I think it is fair to say this: That the trial Judge, with great respect to him, floundered a good deal in the trial of the cause. The case involved

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some drafts which had been deposited with the Stanrod Bank by the Grimm-Alfalfa Association and a deposit liability created for the proceeds of those drafts in favor of the Grimm-Alfalfa Association. Those drafts had been discounted at the Federal Reserve Bank, and when suit was brought after the Stanrod Bank closed, there were six causes of action, based upon the three drafts in question. The odd-numbered ones, 1, 3 and 5, applicable to separate drafts, rather irregularly charged the insolvency of the Stanrod Bank at the time that they were deposited there and inferentially charged, though they did not directly do it, the pleadings were not clear, two things: That the drafts were only deposited for collection purposes and also that there had been a fraud upon the Grimm-Alfalfa Association in the creation of a deposit liability and the acceptance of that deposit after the insolvency of the Stanrod Bank was known to its officers, and that the Federal Reserve Bank knew that also.

The even numbered drafts were dismissed. They set up causes of action on another theory, they were dismissed ultimately and did not figure in the law suit. The Judge allowed the cause, however, to be brought on the six

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causes of action, and allowed all the evidence to go before the jury, saying that he did not know whether he should try the case in equity or at law, that instead of trying to decide that question, which would have cleared the decks, he decided he would try it both ways; that if it was a law question the verdict of the jury would stand as a law verdict, and if it was an equitable question he would regard the jury as having been empaneled as an aid to the Chancellor in determining the question of facts; that he would adopt the decision of the jury on the question of fact as the Chancellor's decision, Judge Rodman in the Circuit Court of Appeals said that he was inclined to think that the case was at law, but that it wasn't necessary to decide that, since the double course which the Chancellor had taken was enough to justify the judgmemt if it would stand on other grounds.

Out of that somewhat confused situation in the lower courts, caused by the determination of the Trial Judge not to decide exactly what kind of case he had, it was very difficult to conduct the case and it is very difficult to apply facts to the law. Now the net result of all of that is this, that the Circuit Court of Appeals held that

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a jury having passed on the question the only thing they would determine was whether there was enough evidence to go to the jury on the question of either a tort or a fraud, or a tort in the nature of a fraud, and they decided that there was enough evidence. Now that evidence which the Circuit Court of Appeals reviews, is based on two or three things. First, the application that was made for discount of this paper at the Federal Reserve Bank of San Francisco, on which was the letter "D", which indicated to everybody in the Federal Reserve System, so far as I know the origin of the paper, that it had come from a depositor. That fact got twisted around ultimately and the Court of Appeals thought that it belonged to the depositor instead of belonging to the Federal Reserve Bank. It would seem very important, therefore, in your future course of action, to clarify that misunderstanding and either explain it on the application or take out of the application that designation of source which is confusable into a designation of ownership, thereby overcoming that difficulty.

The next thing that the Court of Appeals commented on was the fact that the Stanrod Bank had endeavored to

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borrow money from the Federal Reserve Bank of San Francisco and had been told by the Federal Reserve Bank that they would not lend them any more money, that their directors must put in some money to get the bank out of its difficulty; that they must have a statement signed by every member of the board of directors that they would reform their conduct, and growing out of that transaction there was the correspondence between the Utah branch of the Federal Reserve Bank of San Francisco and the Stanrod Bank which indicated to the Court of Appeals knowledge on the part of the Utah branch of the condition of the Stanrod Bank.

Then there were one or two other transactions, one the failure of the Stanrod Bank to pay a draft which had been presented to it for payment upon which it had failed to remit, and which fact was within the knowledge of the Federal Reserve Bank. All of those things put together, the Court of Appeals held, constituted some evidence, and enough evidence to go to the jury, and the jury having determined the facts, they would not disturb it as a question of fact.

So much for the Grimm-Alfalfa case as a case. I think it leaves the law exactly where it has always been,

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which you gentlemen know as well as I, and that is this: When a bank is in fact insolvent and is known by its officers and directors to be insolvent, the creation of deposit liability by that bank, with knowledge of its condition on the part of the officers and directors, is a fraud on the depositor. Any body that takes evidence by which that fraud was possible to be committed, like the paper that was deposited and sold to the Stanrod Bank, and takes it with knowledge of the condition of the bank, and also of the fact that the officers and directors of that bank itself had knowledge of its insolvent condition, becomes a party to the fraud. That has always been the law and is still the law, as stated in the Grimm-Alfalfa case. My judgment therefore is, as I said at the outset, that the Grimm-Alfalfa case has not changed the law and we must meet the question you have raised, it seems to me, from another set of considerations. The Grimm-Alfalfa case may be quoted hereafter in some cases like it, but it is not strong enough in itself to the change the very authoritative opinion of the Supreme Court of the United States in favor of the law as I have stated it to you; that is, that mere sus-

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picion is not enough, a condition of insolvency in a bank or a condition of suspicion in a bank which is bad enough to challenge the suspicion and alertness of the Federal Reserve Bank, will not be enough. There must be actual insolvency and it must be brought home to the Federal Reserve Bank in order to create liability. The Grimm-Alfalfa case, while it may be cited to show that a less degree of knowledge than has heretofore been supposed to be enough to charge a Federal Reserve Bank with knowledge, is not enough to overcome an oft-repeated decision of the Supreme Court of the United States on that subject.

I think the next time a case arises in any of the Federal Reserve Banks which involves this question in any of its forms, that it ought to be regarded as -- no matter in what form it arises or where it arises -- it ought to be regarded as an opportunity to bring about a conference of lawyers representing the banks, and should become, if I may make a suggestion, what I think you would call a system matter, so that from its inception clear through to the end it can have the attention of the entire system with a view of getting, if you can get, a decision from some other Circuit Court of Appeals which

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will clarify the atmosphere. The decision in the Grimm-Alfalfa case has not in any degree affected the integrity and validity of those well established principles of law which I think the Grimm-Alfalfa case does not undertake to alter, but may be regarded as having altered the situation of the applicationof those principles to these facts, so I would suggest that the very next time a case arises anywhere in the System that involves this question, that it be made a System matter, and that from the very outset the record be molded with a view of presenting it to the last court that will hear it, the Circuit Court of Appeals, or the Supreme Court, as the case may be. That this precise question be extracted and made as much an issue as possible in the case in order that we will get an authoritative determination of it. The difficulty is not with the Grimm-Alfalfa case. It is the difficulty inherent in the system. Taking the law as I have stated it to you, where a Federal Reserve Bank has actual knowledge of the insolvency of a member bank, it takes by discount paper from that bank, it incurs liability.

Now what is to be said on the question of a statute giving the Federal Reserve Bank the right to examine the

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member bank and to become acquainted with the condition of the member bank, and where the Federal Reserve banks have access to examinations made by the Comptroller and by State bank examiners, even working in concert with those examining bodies in making a joint examination? Does that attribute knowledge of the condition of a bank to the Federal Reserve System of a kind that can be pleaded in a suit of this sort? I think that raises a very difficult and, perhaps, a very parlous question. That question was not raised in the Grimm-Alfalfa case. There was no suggestion in that record, or in any of the briefs, that the Federal Reserve Bank of San Francisco had any knowledge of the condition of the Stanrod Bank by reason of any examination it had ever made, as a mere examination. They attributed to it knowledge growing out of transactions which it had with the Stanrod Bank but it never attributed to it any knowledge growing out of its function as an examiner, or the fact that it had examined the bank. That question is going to be raised some time. A suit is going to be filed in which the Federal Reserve Bank will be held accountable by reason of the fact that it has knowledge which it has gained through an examination

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of a bank, or that it ought to have had it. That is, that it ought to have had knowledge if it had examined the bank as it had power to do. That is going to make it more difficult. I do not mean to say that that would be conclusive. I think it would not be conclusive. I think it is going to make it more difficult to get by a court on a motion to arrest the case from the jury on evidence which would justify submission of the question to the jury. Courts are going to raise the question as to whether there is not always some evidence of knowledge on the part of a Federal Reserve Bank where a Federal Reserve Bank has been examining and has had the fruits of the examination made by the Comptroller or the State bank examiners, as the case may be. Whether there is anything you could do to moderate the responsibility I do not know. It is a curious kind of responsibility. You have the power to examine and obviously you have the duty to examine, but you have no visitorial power in the sense that you can close the bank. You can expel it from the Federal Reserve System if it fails to live up to its condition ofmembership but you are not given power to

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close banks by reason of any condition disclosed by such an examination on your part. Your power as examiners falls short of being a visitorial power, and yet it is a power that is very essential to you in order to enable you to help banks for one thing and to deal safely with banks for another thing.

You have that power under the statute. I should think it would be undesirable to surrender that power, although it increases your difficulty in defense when you are charged with having knowledge in any situation where possession of knowledge imposes liability. Now, I am not a practical banker. I can merely state to you what the principles of law are. As I have tried to think it over it seems to me that the only answer that there could be would be to put a red ticket in your own banks upon every bank an examination of which, either by the Comptroller or by the Federal Reserve Bank or State Examiner, or because of the condition of its reserve account, showed that the bank was extended and in trouble, and that in dealing with any such institution an abundance of caution should be used with regard to paper offered by them for discount or as collateral to the Federal Reserve

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Bank. That is a statement of principle which is very easy to make and very difficult to apply. The problem you have of course is whether you should play high executioner to a bank that is in trouble -- and is not insolvent, but is in trouble -- but may get out of trouble, and make a catastrophe because of your knowledge of the bank by closing its doors and refusing to help it. I do not think there is any set rule you could apply. You have got to exercise just human judgment in each one of those cases and continue constantly to exercise that judgment. Doubtless it may mean some losses to the Federal Reserve Bank, but those loses will be moderated and minimised if care is used. In my judgment it would be very much better for you to take some risks and lose some money than it would be to put the Federal Reserve Bank in a situation of rigidity with regard to banks that are in trouble. I should be very happy to answer any questions.

Governor Crissinger. In a case where a bank proves to be insolvent, and there has been indication all the time that something is going wrong, and the Federal Reserve Bank neglected to supervise the examination, would you tell us what position you would get into?

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Mr. Baker. I think failure to examine is just as bad as that kind of examination. That is to say, where you have the power and do not use it I think you would be charged with responsibility just as though you did have knowledge.

Vice Governor Platt. Would that apply to your National Banks as well as your State banks?

Governor Crissinger. Right in the beginning of the Statute the Statute says it is for the purpose of creating a better supervision of banking and a better system of banking, or something of that kind.

Vice Governor Platt. Yes, it does say that.

Mr. Baker. I would not say that it was the duty of the Federal Reserve Banks to conduct independent examinations, or that they would be held to responsibility for not doing that where examinations are being made by others if they are perfectly free to take those examinations. I think the statute gives you that power.

Vice Governor Platt. Yes, it does.

Mr. Baker. So that where a Federal Reserve Bank relies upon examination and report of the Comptroller's office, then I think you would have a perfectly good

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alibi.

Governor Crissinger. Assuming that the report of the Comptroller on one of these examinations does show a lax banking system in the bank, and does show that there are things going on that are being criticised, would it be the duty of the Federal Reserve Bank to take notice of that fact?

Mr. Baker. Obviously I think where you find in the Comptroller's report or the Examiner's report such conditions as would put an ordinarily prudent man on guard, that you are then charged with any knowledge that you might discover by an independent examination.

Governor Calkins. I would like to ask a question with no regard to the kind of examination you were just speaking of. Inasmuch as the Federal Reserve Banks or the Federal Reserve Board have the power to accept the examinations of State and National departments, are they not charged with responsibility of determining whether those examinations are sufficient or not, and whether they are acceptable examinations? We believe that we are. I think in reviewing the reports of examinations that come to us, mainly from State departments, and possibly in some cases from the National department, that we are

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charged with responsibility of determining whether the examination is a sufficient examination, whether it is a dependable examination, and whether we can accept it or not. Is that your idea?

Mr. Baker. I think in view of the fact that the statute gives you the option to decide whether you will rely upon the examination of others, that it also imposes an obligation on you to determine whether that examinatiln is reliable, or one that you can rely on.

Governor Calkins. The other question that I have in mind, and I would appreciate it very much if you would elucidate it for my benefit, is the question of how, previous to the decision in the Grimm-Alfalfa case, insolvency might be determined or should be determined; in other words, what are the determining elements or factors, by which insolvency was determined in the absence of the actual closing of an institution?

Mr. Baker. Of course the law is perfectly easy to state, but the application is again difficult. In the Grimm-Alfalfa case there never was, and has not to this date been, any determination that the Stanrod Bank was insolvent. There never has been to this hour any determina-

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tion that the Stanrod Bank was insolvent. What took place there was the bank closed its doors; I think its elderly president got scared and its principal directors got together on Thanksgiving Day, they decided that the situation was pretty dangerous, they did not want to do anything wrong and they closed the doors. Two or three months after that had taken place, when their assets had obviously lost a great deal of value, a schedule of their assets, with the appraised values then fixed, was exhibited in the case and it showed, on the basis of the valuation made two months after the bank closed its doors, that the bank could be inferentially regarded as having been insolvent at the time it did close its doors. But they never did determine the insolvency of the bank as of the date when those drafts were deposited in the bank.

Governor Calkins. I think you missed the point I had in mind, Mr. Baker. In practice we may say that a bank is insolvent under two conditions. First when it has committed the unmistakable act of insolvency by being unable to meet the demands of its depositors. A bank that cannot meet the current and local demands of its depositors is an insolvent institution in practice. Secondly, it may be determined by constituted authority,

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such as the Comptroller of the Currency or the State superi_ntendent of banking, to be insolvent. But as applied to banks from a practical point of view I do not know of any other kind of bank insolvency except those two kinds.

Mr. Baker. I think there is a third kind, which would perhaps be a rare occurrence;mbut you can imagine a bank in such an extended condition that every member of the board of directors would feel hopeless about being able to rescue it and yet be unwilling to face the music; where you would say there was nothing to do but close the doors, and they would say we know we have to do it but we are not going to do it, we just cannot face the wrath of this community. We will not do it today. Maybe something will happen tomorrow. When a bank is in an obviously hopelessly insolvent condition and yet they adopt a Micawber attitude toward it, and put off the evil day hoping that something will happen, then I think you know that bank is insolvent.

Governor Crissinger. What would you say as to the effect of evidence against a bank which demanded and was receiving a large amount of excess collateral for loans? Would not that be a fact that would be taken as charging

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the bank with knowledge there was something wrong?

Mr. Baker. Well, it does not seem so to me, Mr. Crissinger. It may be perhaps that I do not apply that as I ought to.

Governor Crissinger. I mean a bank that knows of criticism, through a National Bank Examiner, of that institution, knows it is very much extended, and because of that fact demands a large amount of excess collateral, in order to make the bank a preferred creditor? Aren't those some facts that would go to a jury to determine the question of whether the bank is on notice?

Mr. Baker. I should think so if that were an exceptional case; if you made an exception of that bank as against other banks.

Governor Crissinger. They are not exceptional cases. There are a great many cases of that kind, where the Federal Reserve Banks do know that those banks are largely extended and, for the purpose of trying to pull them through the condition in which they find them, they demand large excess collateral, sometimes all of the resources of the bank, to secure the lending bank? Isn't that one of the things -- at least it is so down in Ohio, if I re-

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member it correctly — which would reflect upon the question of knowledge of that bank's insolvency or solvency?

Mr. Baker. I think it would be, although as I understand it the Federal Reserve Banks, when they do get marginal or excess collateral, get it not only to secure the existing obligations but future obligations as well. I think if we were arguing to a jury we might well say that the reason for the excess collateral was not to take care of this particular claim, but that the Federal Reserve Bank was more or less a continuing creditor of the bank in question, and the excess collateral was deposited for that purpose as well. I understand, from something Mr. Mason said to me, that banks very often, of their own motion, deposit excess collateral as convenience for themselves, so that I should think that was a more or less equivocal circumstance in any particular case where excess collateral was demanded, unless it was done regularly in regard to a bank of which you otherwise had knowledge of its extended condition.

Governor Seay. It has really become a banking practice.

Governor McDougal. Requiring additional collateral is common banking practice. It has always been required

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by commercial banks, which have required a large margin of collateral, in connection with advances to other banks.

Governor Crissinger. I understand that, but I am inquiring about this because there are cases, about which you gentlemen of the Northwest know, where nearly all the paper of the bank has been taken by the Federal Reserve Bank, at least paper that is worth anything, and yet that bank is permitted to run and receive deposits.

Mr. Baker. Of course, Governor Crissinger, that is a different case from the one I was discussing. Here are a hundred member banks. The Federal Reserve Bank comes to the conclusion that Bank A, or No. 1, in that hundred, is in a different situation from all the other 99 banks. It says to Bank A, "You must put up more collateral than anybody else in this whole list of a hundred banks, in proportion to the service that you get from this bank." I think that places you in a prejudicial position and I think it would be prejudicial to argue it to any jury.

Now the condition of the reserve account of member banks is a circumstance that you are going to have to face before juries. The statute makes it obligatory to

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maintain those reserves, and a bank which over any substantial period of time is low in its reserves and sometimes has an overdraft in its reserves, creates a situation that challenges the attention of the Reserve Bank to the condition of that bank, and in some suit that we are going to have to face some day we are going to have the lawyer on the other side get up and produce in court the state of the reserve of the bank in question and the circumstance which we ought to have taken notice of which ought to have put us on our guard.

The Chairman. Of course the reserve banks are loaning a hundred million dollars and it is natural I think for every banking officer in the Reserve System to feel safe in observing the rules which have always applied to the loaning of money in commercial banks. We have now learned that those rules do not apply to the Reserve Banks because we are charged with certain special knowledge which the commercial bank never receives from its banking customers, and therefore we have got to consider to what extent, unwittingly, we may be building up evidence in our own transactions and in our method of conducting them which, even under the most excessive

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care, will cause losses to us which would not arise with a commercial bank at all. What I hope would result from the meeting here today is something like this: Here is the question of the application of the bank. We must be very careful to have that changed in such a way that we will not building up evidence against ourselves. Then comes the question of examination, the examiner's report. We ought to have as a result of our discussion and the advice that we get, I hope, some general principles to guide us in dealing with the reports that we get where conditions are disclosed that would put us to some extent on notice of the difficulties of the bank. Then there is the question of taking additional collateral, where we made collateral loans, additional collateral above the face amount of the paper discounted, where it would appear that we are making evidence against ourselves by giving exceptional treatment to individual banks. Under the general form of our liability contract, which many of the banks have, the additional collateral on one loan must serve as collateral on other loans which they may make, and which makes securities held in custody for a member bank

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pledges in effect of those securities for loans. There is a difficult question as to information disclosed in connection with collections we are making for banks, in cases where it is difficult to get checks paid, and which sometimes are held up. I have a feeling that we have got to have a very careful review of the practices of reserve banks so as to safeguard ourselves against making unnecessary records against ourselves. It seems in cases of failed banks or where we have earnestly endeavored to help a member bank at times, that our very efforts in that direction make us liable. It is a case of where our liability increases with the degree of care with which we conduct our business increases, so to speak. If we do business blindly, without any knowledge of the condition of the bank, and loan money to it, we are safer than we are if we know all about it.

Mr. Baker. Is it possible to see difficulties arising out of another situation than the creation of deposit liability? I mean, for instance this: Where you have demanded excess collateral, is it possible for the title to that collateral to be attached by the general creditors of the failed bank on the theory that your

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knowledge of the extended condition of the bank to which you were giving accommodations was indicated by your demand for excess collateral, and were assisting in continuing that failed bank beyond a point where it should have continued, to the prejudice of the general creditors, who could thus assert their right to the collateral held in preference to you. I do not know whether that is a practical proposition, but perhaps if it is you bankers have met it.

The Chairman. I should think that it would arise.

Mr. Wyatt. We have a suit of that kind now pending.

Governor Harding. I would like to ask a question with regard to this excess collateral. The banks in Aroostook County, Maine, which is purely an agricultural section, producing one crop, potatoes, up to last fall were in a very badly extended condition and had been for about five years. The Federal Reserve Bank of Boston, ever since 1919, which was the last good year that they had, carried those banks along, at times carrying them for as much as a million dollars, for those three little banks. We took excess collateral, They

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managed to get those loand down, in 1923, to $750,000. But in 1924 they were up again, caused by a crop of potatoes the prices for which were as low as 60 cents a barrel. The condition of those banks a year ago was such that if they had had another low priced crop or a very short crop those banks would have been insolvent. In other words, there was no actual insolvency at the time, but there was prospective insolvency if those adverse conditions continued. Fortunately they sold their crop at $6 a barrel, they have all paid out, their deposits have increased 50 per cent and the automobile agents and radio agents are traveling up through there and selling them stuff. Those banks will certainly be back some time this summer for more money. They don't any of them owe anything now, but I have made up my mind when they come back that we will take excess collateral right from the start and while they are in perfectly good condition, but while we are in a position to point out that while we do not need it now that they are liable to have a repetition of that same thing and may have some bad years, and those people may go crazy again and spend the money that they have made. I want to establish

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a precedent by demanding excess collateral right at the start. If there is any objection to the demand for excess collateral against rediscounts we will just take their bills payable, and they can make ~~a~~ 15-day paper and put up collateral on the basis of one and a half for one, or something of that sort.

Mr. Baker. In order to get my own mind clear, the excess collateral you are now speaking of is an excess of paper?

Governor Harding. Yes.

Mr. Baker. On the theory that if hard times come up there again you will have established the precedent?

Governor Harding. If the 1924 conditions had continued those banks would have all been insolvent by this time. Their liabilities were such that they could not possibly have pulled through.

Mr. Baker. You would make this distinction: If they offered Government bonds as collateral you would not want any excess.

Mr. Harding. No, not on Government bonds, but they do not have Government bonds. All they have got are the

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notes of those farmers. The farmers have all got their land mortgaged.

Mr. Baker. Then your question comes down to this: Is there any imputation of knowledge against your bank growing out of the fact that you demand excess collateral of the kind which experience has shown you has a tendency to get frozen from seasonal causes? In answer to that question I would say no, there is no imputation of that kind. I think the proper administration of your bank would require you to exact more of that kind of collateral, when it depends upon anything as seasonal as the success of the potato crop in Aroostook County, Maine.

Governor Harding. In the South, when banks lend money not against the crop, actually made but against a crop that they hope is going to be made, they always demand three for one.

Mr. Baker. They demand that excess collateral because of the nature of the collateral rather than the condition of the bank, I believe.

Governor Harding. Here is another situation, and a practical case. The First National Bank of Putnam ,

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Connecticut, got in trouble in August of 1924. On Wednesday afternoon the Examiner was in. The previous examinations had shown that the bank was somewhat extended but the reserved were always carried intact and the paper with the Federal Reserve Bank was satisfactory. It turned out to be good paper because we collected practically all of it. When the cashier walked out they found that his peculations, as at first thought, were about $40,000 and the National Bank Examiner stated that as far as he knew the bank was solvent; that the losses that they had discovered were about $40,000, which was more than covered by the surplus profit. The checks were beginning to come in through the Boston Bank to be sent by us to this bank. We sent a man down there so that we could send these checks to him. The first day they paid us by giving us a check on a bank in Boston where they had an account. The second day they didn't have any money in any bank account to pay the checks with. The checks came in in increasing volume. You can see if we had demanded payment in cash for those checks and protested non-payment, we would have closed the bank Monday morning. The Bank Examiner stated that they had dis-

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covered losses amounting to a hundred and twenty thousand dollars, but they still thought the bank was solvent. He said they were going to get the directors together to do something. That day we had $48,000 worth of checks on the bank which we sent down there. We had our agent down there, one of our own officers to send the checks to. In order to take care of the checks that we had on
we had them
them/send in some paper, not by way of excess collateral, but merely paper that we could put to their credit in case we needed the funds to pay these current checks that were coming in. The point I want to bring out is this: The paper we took was not paper that the bank had taken a day or two before they finally closed; it was not sight draft or demand draft, but it was paper of the manufacturing concern which they had there for over two months, and was renewal of paper that they had been carrying for a year or so. We took care of those checks and finally on Tuesday the bank directors closed the bank. We had no trouble with the checks that we got on Monday because our man down there protested them all and they were sent back. The point was that we had a little dispute with the people whose note we had dis-

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counted on this Monday. They claimed that our discount had deprived them of their right of offset; that they had a deposit of $4500 in the Putnam Bank and that we had taken $15,000 worth of their paper; they said if we had not taken the paper they would have had an offset against that bank of $4500 that that bank owed them. They said our taking the paper deprived them of this right of offset. We temporized with them by telling them that if we managed to collect our debt in other ways that we would be glad to release the paper. The thing was finally adjusted and we came out without any loss, but it was a very ticklish situation. As I understand it, in the Grimm-Alfalfa case the discounts were demand drafts.

Mr. Baker. Yes.

Governor Hardin. The discount here was not a sight or demand draft but part of a customer's regular line of paper. The bank had this particular paper in its possession for over two months and it was a renewal of a loan that the bank had been carrying for several months, or perhaps years.

Mr. Baker. I confess that I do not see any spe-

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cial difference between the two cases, that is to say, if you believed that this particular bank was insolvent at the time you were taking its paper.

Governor Harding. We did not know whether it was insolvent or not. We were in a bad fix, because the Examiner did not know. This man did not keep any books of these transactions, but as cashier he received deposits and put them in his pocket and they were not shown on the books. The bank had a liability which was not shown on its books.

Mr. Baker. It is a difficult question. The elements necessary for liability are three. First, the bank must in fact be insolvent; second, its own officers and directors must know it is insolvent, or believe it to be; third, you must know both that the bank is insolvent and that its officers know it. In the case you put the officers and directors of the bank itself did not know that it was insolvent, did not believe it was insolvent, but believed otherwise.

Governor Harding. The only man who knew it was insolvent had shot himself in the head and was then in a

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comatose condition.

Mr. Baker. The case that you put plainly was not the kind of knowledge, as a matter of abstract law, that the statute covers. But if that case had ever gotten before a jury, and they had had all the knowledge produced before them which you had, whether or not they would have taken the position that you should have known, is a question that deals with the human element and which no one can answer.

Governor Harding. On the question of excess collateral, if a bank in an agricultural region takes excess collateral on a farm crop which is not produced, why is not the Federal Reserve Bank clearly entitled to take excess collateral from the bank whose entire loans are with those farmers on their crops?

Mr. Baker. I think it is. I think wherever the demand for excess collateral is due to the character of the collateral that you are perfectly within your rights and there is no indication of knowledge in that demand for excess collateral.

The Chairman. If it were possible -- I do not know whether it would be, because practices of reserve banks

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differ quite materially and the situations in which they deal differ in the different districts -- but if it were possible to prepare a statement which would make fairly clear what the practices of each Federal Reserve Bank were on these various points, if that could be assembled in such shape that it would be illuminating as to any danger, any special danger to be guarded against, do you think it would be possible for you to review all of them and give us some sort of suggestion of how to shape our course?

Mr. Baker. Do you mean in the way of a questionnaire? Mr. Wyatt has practical knowledge of these things, and if they were sent to him he and I could spend some time with them. I think he would be glad to do that.

The Chairman. That is exactly what I had in mind: That we arrange at this meeting some scheme by which each Federal Reserve Bank could submit to Mr. Wyatt an accurate statement of their attitude on these matters, how they handle them in the banks, and in fact get the information up in intelligible form so that you would not have to go over a mass of papers. I was wondering

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whether Mr. Wyatt and yourself might not advise all of the Reserve Banks in this matter.

Mr. Baker. I am wondering, and I am willing to think out loud about it, and some of the questions I ask may be very foolish to you practical benkers, but I am wondering whether it would be possible to put in the application a certificate to be signed by the applying bank that it was the owner of the paper.

The Chairman. Quite possible.

Mr. Baker. That avoids the question as to whether the paper is there for collection or whether it is paper that is owned by the bank. In this case, for instance, if the Grimm-Alfalfa paper had been sent to the Stanrod Bank and the Stanrod Bank had sent it to the Federal Reserve Bank with a statement on the application that it was the owner of that paper, it would have eliminated half a dozen confusing questions from the case when it came to be tried.

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Mr. Miller. I am wondering whether this provision of Section 4 of the Federal Reserve Act has any bearing on these matters. It is in the nature of a direction to the directors of the Reserve Bank to extend to the member bank such advances as may safely and reasonably be made. I can conceive that a loan might be made by a Reserve

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Bank to a member bank which is close to the point of insolvency and yet it be an individual loan in the sense that it is well secured and the Reserve Bank would have no loss. Does this mean that such loan shall be made to a bank which is not safe, although the individual loan may be safe? Does it mean that the Federal Reserve Bank must make a loan, or according to the language in the Act, shall extend to each member bank such discounts, and so forth, as may be safely made? The question that it raises in my mind is, under the various circumstances that lead the member banks to come to a Federal Reserve Bank for accommodation, what constitutes a safe loan?

Governor Strong. Certainly a loan that is charged with fraud would not be a safe loan. Where the circumstances of this Grimm Alfalfa case applied they were charged with knowledge that it was distinctly unsafe, the statute would not impose any mandatory obligation to make a loan under those circumstances.

Mr. Miller. I wonder whether there is anything mandatory there.

Mr. Baker. I think not. That statute has to be

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read as though it was turned about, that the Federal Reserve Bank shall not refuse to extend to a member bank any discount or advancement or accommodation on any other ground than that it is not safe or reasonable. The mandate is that you are to assist the bank where it can safely and reasonably be done, but you are not under mandatory obligation to assist banks in all cases.

Mr. Miller. What do you say as to the distinction between a loan that is safe and a bank that is not safe?

Mr. Baker. I do not think that distinction is there. I think the reasonableness of the extension of the discount or the advancement of the accommodation has to do with the condition of the bank.

Mr. Miller. With the condition of the bank?

Mr. Baker. Yes. Obviously it would never be that they should accept a piece of paper that was not in itself safe.

Mr. Miller. Of course that is done, the paper is not safe in the sense that it unquestionably will liquidate itself at maturity, and the Reserve Bank therefore demands what is called excess collateral, because it has doubt as to that paper. In addition to that, Mr. Baker,

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in connection with this interpretation, all of the paper that the Reserve Bank takes from a member bank comes in of course with the member bank's endorsement, and the minute it exacts excess collateral does not that suggest a question in the mind of the Federal Reserve Bank as to the safety of that bank?

Mr. Baker. I think not.

Mr. Miller. You think not?

Mr. Baker. I think it might in certain cases, but not necessarily. I think Governor Calkin's proposition illustrates the situation. His Utah bank had been in the center of the district where everything was extended and everything frozen, and the duty of that bank, under this Act as a part of the general fiscal agency of the Government, seems to me to have been that of tiding over that situation in the national interests. I think that is the first duty of that bank. It is a duty that carries with it the responsibility and likelihood of loss, and such loss as the Federal Reserve Bank of San Francisco has suffered by reason of its desire to tide over a bad, widespread situation affecting that section, it seems to me a loss that is expected by the statute that

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the Reserve Bank should sustain. The most that the statute can require of a bank dealing with that situation is that it act with caution and reasonableness. Fortunately the statute uses the word "reasonable" as well as the word "safe." So that if there is reasonable hope, based on any facts that Governor Calkins could show that the situation that happened in the Middle West that happened in such and such a year, that the situation had changed favorably and he could on past history anticipate a sufficiently favorable change in the situation to justify the extension of credit, then I think that history of what had happened in the past would impose that liability upon him.

Governor Calkins. Mr. Baker, I would like to say that you talk as if you had been running the Federal Reserve Bank of San Francisco during the period to which you have referred. You have stated the policy followed by the Federal Reserve Bank in that situation almost exactly. However, I would like to return to the crucial question with which we are dealing, and that is what is the ground upon which you must determine the solvency or insolvency of a member bank. This Grimm Alfalfa

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case, and the other cases we have been talking about, hinged entirely upon the question of whether the bank in question was solvent or insolvent at a certain moment. Now, I stated my two causes for, or my two kinds of insolvency, and you added one more. I realize the force of that. I am wondering if you will undertake to say that the Federal Reserve Bank was chargeable with knowledge of insolvency under certain conditions as you described, and for the purpose of illustration, I would like to say this: We have another bank, and this is a good illustration of the point I am trying to make, in the same town in which the Stanrod Bank is located, the officers of which were desparately incompetent. The bank was in a terribly over extended condition, in fact it found itself in almost the same difficult situation in which the Stanrod Bank found itself. But it happened that the President of this bank, a man 86 years old, is a man with an ample fortune, and that man said, "This bank is not going to close; I have sufficient fortune to protect it and to protect all of its depositors and stockholders. I will pledge, without any reservation, everything that I have to protect the creditors and depositors of this bank."

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And he did that. That bank today is in first class condition and doesn't owe a cent to anybody. Now by the usual test of the condition of a bank, the knowledge of its officers and the knowledge that we had, that bank was as truly insolvent as the Stanrod Bank ever was, and yet it never was insolvent. This is a crucial question in our dealings with the member banks in extended condition. What puts us on notice that a bank is in a dangerous condition first, because then we must exercise additional caution, and second, what puts us on notice that a bank is insolvent, because then we must stop making any further advances to it. The whole thing boils itself down, in my opinion, in these cases and comparable cases to this: What facts may we apply to determine the solvency, or more particularly the insolvency, of a member bank? I go back and say that there are two kinds of bank insolvency known to those who practice banking. One is the insolvency as evidenced by an act of insolvency and the second is insolvency because of the declaration of the constituted authority, such as the Comptroller of the Currency or the superintendent of banking, that a bank is insolvent. I am still somewhat at a loss to find

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some debatable ground upon which we may determine that a bank is insolvent.

Mr. Baker. I do not think there can be any answer to that question. I think each case has to stand on its own facts. It is just a question of exercising sound judgment with regard to each case. Take the Stanrod Bank case. You recall the exact facts better than I do, but someone sent in a draft for ten or twelve thousand dollars to be collected and the proceeds remitted. They did not get the remittance.

Governor Calkins. The facts in that case were such as would appeal to a jury as constituting an act of insolvency but which, as a matter of fact, did not constitute an act of insolvency, because as you will recall, the reason that that draft was not paid was that a junior officer of the Stanrod Bank had misapplied the funds provided to meet the draft and the other officers held back payment of that draft in order to apply pressure to the father of the junior officer who had misapplied the funds, in order to make him get the money back. That was not in fact an act of insolvency, but it appeared to the jury as such an act.

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Mr. Baker. While the explanation in regard to the pressure being applied to the father is not in the record in just that form, it was a circumstance that was known, but not put in the record in that form. The naked facts that stood in the record were these, and the Circuit Court of Appeals puts them in alongside of one another: A draft for ten thousand dollars was sent to the Stanrod Bank and no remittance followed. The transmitter of the draft sent a personal agent down to find out why they didn't get their money. They were told by the cashier of the Stanrod Bank that they could not pay it immediately but would in a few days. In a few days they did. But concurrently with that, about the same time, the Stanrod Bank was endeavoring to borrow $10,000 from the Federal Reserve Bank and the Circuit Court of Appeals put those two circumstances together and held that they were in effect committing an act of bankruptcy by failing to remit the proceeds of that draft and at the same time trying to borrow ten thousand dollars from the Federal Reserve Bank. When things come as close together as that it is not strange that a jury regards them as related to one another. If you are unfortunate enough

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to have those two things happen at the same time the freedom of your judgment is not always credited.

Governor Young. Naturally Minneapolis is very much interested in this question. We attempt to work it out as well as we can ourselves as to when a bank is insolvent, but I think I can say with safety that so far as reports on National banks and State banks are concerned that I have never seen one which showed an insolvent condition, even with 206 closed banks. Now that is not any reflection on the Comptroller's office or the National Bank Examiner. It is an extremely difficult thing to set up losses in a bank unless the directors of that institution want to admit the losses. An examiner has an extremely difficult job. He cannot set up any losses unless the directors of the bank admit those losses. So far as the Examiners' reports are concerned I think our bank could safely say that we have never had any knowledge of insolvency of any of the 206 banks that have

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Let us assume that a man discounted a note in a member bank, payable to the bank, that they sent it to us and we rediscounted it. He could not set up the defense very well that he had put his own note in the bank and could collect it upon himself. I do not think, so far as 99 per cent of the notes that we get are concerned in the Ninth District, that we are assuming any liability. Those people have got to pay those notes. But in the transit department I think there may be liability.

Mr. Baker. I do not feel as confident as you seem to feel about your safety when it is a customer's own note that is discounted.

Governor Young. But suppose he has no dealings with the bank at all. He is simply a customer of the bank and we take that as a negotiable instrument. He does not lose anything.

Mr. Baker. That is a different question.

Governor Young. On 99 per cent of the notes they have the offset balance, we get them to pay down to the amount that we have advanced collateral — we get in a position where we can return the paper to the Receiver so that it works out from a practical standpoint. But

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there is another feature of the situation that has concerned us a good deal. We are dealing with a great number of banks that are slow in paying. In the Northwest the grain trade is financed by the country elevators. They draw a draft on a car of wheat with a bill of lading attached and send that in to us for collection, the same as in the Grimm Alfalfa case. They do not ask for any time credit, they do not ask us to rediscount but simply want us to present it, collect the proceeds and place to their credit. Now it seems to me that there is a great liability on our part in handling these non-cash items and passing credit to a member bank that we are on notice is insolvent. Am I correct in that?

Mr. Baker. Do you think there is any danger if you do not pass credit to the member bank until after the collection is made?

Governor Young. I should think so. That is what I would like to know. I do not know whether it belongs to the bank or belongs to the customer. Here is an insolvent bank and we have got to find out to whom it belonged. We are handling millions of dollars worth of that every day.

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Mr. Baker. That does not seem to me to impose liability. You have done what you were asked to do. You are selected as the agent to collect the money. You have turned the money over to the person you were authorized to turn it over to. It certainly cannot be your duty to go to the man who started that collection and tell him that the agent that he picked out and selected was not worthy, that you could not operate through him and that therefore you would have to seek him out and turn it over to him personally.

Governor Young. And there would be no liability in that?

Mr. Baker. I should not think so.

Governor Young. Then I am satisfied.

Mr. Baker. I think it would be important for you to get some concurrence, in my judgment. I am just trying to follow it through as you stated it. I had not thought of it before.

Governor Seay. Not to multiply suppositious cases, but along the lines of Governor Calkins' inquiry as to what definite thing constitutes notice of insolvency, when the Comptroller's examiner reports that he has as-

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certained that the doubtful paper in the bank is more than sufficient to wipe out the capital of the bank, and yet the Comptroller has taken no steps to close that bank, would that constitute, in your opinion, notice of insolvency, or merely evidence of insolvency?

Mr. Baker. I should think that the wiping out of the complete capital and surplus of a bank would be so striking a suggestion that it would impose the duty upon you of assuring yourself of conditions by proper inquiry. I do not think the impairment of capital would be enough to put you on inquiry. I am surprised that no Comptroller's report ever showed that. When you speak of never having seen a report which showed an insolvent condition, it seems to me of course that that is so because if the Examiner's report showed insolvency the Comptroller would close that bank before he made the report to you.

Governor Young. Governor Seay was inquiring about doubtful paper. I do not know whether you would be justified in calling it doubtful paper, but much of the paper in the Northwest is paper that that is very difficult to tell whether it is good or bad.

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Mr. Baker. It depends on whose doubt it is.

Governor Young. You have to wait to see whether it is bad or not bad. That is the only way you can determine whether it is good or not.

Mr. Baker. As I say, it depends on whose doubt it is. Certainly a Federal Reserve Bank is not clothed with such knowledge of the widespread clientile of a member bank such as to enable it to assay all the commercial paper that is presented. That is a human element and you haven't that information. I do not believe the burden goes that far. Your examination of the bank shows apparently good paper and nothing about the paper or nothing about the banks to suggest the possibility of the paper being bad. I do not think it is up to you to trace out each piece of paper and find out for yourself that it is good paper. Until your attention is challenged by something in the bank which shows it to be indulging in a dangerous practice or is in an extended condition — and if that is called to your attention, then you are put on notice.

Governor Young. You always have that in the transit department. You cannot avoid notice. It is right there.

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Governor McDougal. The practice established many years ago by the Comptroller's Department, and I think likewise by many of the State departments, to determine solvency or insolvency, was first to determine a fair appraisal of the assets and then to find out whether those assets, based on that appraisal, were of sufficient value to protect the depositors; or, in other words, if the known losses were equal in amount or greater than the capital and surplus then the bank was declared to be insolvent. Now it seems to me that as the result of this decision the Federal Reserve Banks have a greater responsibility than ever before in the matter of extending credit to their member banks. It seems to me also that we probably have greater responsibility than we have been aware of in the matter of determining solvency and insolvency. I think we ought to have some understanding about that and I would like to get your views upon what constitutes insolvency. There have been times when a bank in difficult circumstances has not been able to pay at the moment the checks that were presented, but hours later, or possibly the next day, they have been able to pay them. I have known cases of that sort that might constitute in-

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solvency according to the decision quoted in this opinion, but I would like to know if that constitutes insolvency in your own mind, Mr. Baker.

Mr. Baker. Would you mind reserving that question until Governor Strong's suggestion is carried out, that is that an examination be made of the practices of all the banks, with a view of making suggestions that will protect the banks so far as they can be protected in these situations? I want to include in that the traditional and established definition of insolvency and ascertain if they apply to the Federal Reserve Banks in view of the facilities placed at their disposal.

Governor McDougal. That would be entirely satisfactory to me. I should like to go a little further and say that my experience over a number of years has been in accordance with that of Governor Young. I have never seen a report of the National Bank Examiner which reported a case of insolvency from the standpoint that I have pointed out, with respect to which we have been called upon to render any assistance, and, of course, under those circumstances, we could not and would not do it.

Governor Crissinger. Take a bank of that kind that

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was running along for two or three years to your knowledge, in a very extended condition; you know that things are a little slipshod in the bank, and you make no effort to ascertain from your own examining department the condition of the bank, and don't you think you create liability in that way?

Mr. Baker. You cannot establish insolvency in that way.

Governor Crissinger. No, you cannot, but you can make yourself negligent in not checking up on that bank, can you not?

Governor McDougal. There are no cases of that sort where we do not check them up.

Mr. Baker. In the Grimm Alfalfa case we were satisfied with the appraisal made by the bank authoritieis ---

Governor McDougal. But it does not constitute necessarily insolvency. As a matter of fact experience has demonstrated the fact, in connection with closed banks, that their insolvency frequently is not known before the closing but can only be determined by closing the bank and thereby forcing them to make an appraisal of the assets of the bank through an outside authority, the bank

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examiner or somebody else.

Vice Governor Platt. If that is true, when a bank is closed and they subsequently pay only 45 to 50 cents on the dollar, it would seem to indicate that the bank must have been insolvent for a year, anyway, before it was closed.

Governor McDougal. But in most cases the officers and directors themselves do not admit insolvency and the reports of the Examiners do not show insolvency.

Mr. Miller. Does it not mean a little more than that? Isn't insolvency something like human death? We don't have to wait until somebody certifies to the death of a man in order to satisfy ourselves that he is dead. It is a question of judgment of value of assets set along-side liability.

Mr. Baker. It is a question of judgment, until an act of insolvency is committed, as Governor Calkins has said.

Mr. Miller. I rather refer to your statement to the effect that as the Federal Reserve banks legally are equipped with the power to inform themselves at first hand, if they so desire, of the condition of their member banks,

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they are in a position where they can form a judgment as to whether or not the bank in question is solvent or insolvent, or approaching insolvency, and therefore they are not obliged to wait until that fact is declared by some authority. I do not understand that the declaration of that fact by a State superintendent or by the Comptroller of the Currency makes a bank insolvent. It is simply a public announcement of the fact, made upon his best belief and judgment after an examination of the bank and after certain facts have been brought to his attention, or after some actual act shows that the bank cannot pay its obligations and, as a matter of fact, is insolvent.

Mr. Baker. I think that is perfectly true. The determination by the Comptroller or the State bank examiner that a bank is insolvent, may in fact be erroneous.

Mr. Miller. Yes, it may.

Mr. Baker. But it is rarely erroneous.

Governor Seay. Would you think it desirable to attempt by statute to define technical insolvency of a bank?

Mr. Baker. I do not think so. I think the Supreme Court of the United States --- and I am speaking now just

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from general recollection — has stated what constitutes insolvency so authoritatively, that a statute could not clarify it very much.

Governor Norris. The Federal Reserve Act, in its general title, states that there shall be a more effective supervision of banking, and then it provides, as a condition of membership, that such bank shall likewise be subject to examination made at the direction of the Federal Reserve Board or the Federal Reserve bank. Then as to State banks it provides that when the directors of the Federal Reserve Bank shall approve examinations made by State authorities, they may be accepted in lieu of examinations made by the examiner of the Board. You do not think, do you, that anywhere in that act there is any duty imposed upon us, or even authority given to us, if we wanted to exercise, to constitute ourselves the power and authority to determine when a bank is insolvent and to take such action as would result in closing that bank?

Mr. Baker. No, I think not. I think that statute was plainly passed for the purpose of enabling youto exclude the banks from the privileges of membership in the system which did not live up to the conditions imposed upon

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members; and when you have determined that you won't have a bank in the System I think that is as far as you can go. The question of determining the insolvency of that bank is, in the case of the national bank placed upon the Comptroller and in the case of a state bank upon the State bank examiner, by authority of Congress, and not upon the Federal Reserve Bank.

Governor Norris. One more question, as to banks that are not on the special examination list of the Comptroller or of the State department. They certainly are entitled to a presumption of solvency until they show some evidence of insolvency. If in the course of operations of their transit department or otherwise any suspicious circumstances arise that give us a doubt as to the condition of a bank that is supposed to be in good condition, we immediately request either the local chief examiner or the State banking department to make a special examination of that bank; if the circumstances that lead us to make that request are substantial, or they think it worth while -- in fact, almost without exception they have always made those examinations, there never has been a case where such an examination disclosed the fact that the

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bank was insolvent, but it shows that there is a certain amount of paper in which certain loss is estimated, or there is a certain paper that is slow, but the Comptroller or the State department does not regard that bank as insolvent and does not make any objection to the bank continuing in business; they may impose some conditions with regard to a change of officers or a change of policy or something of that sort; but they do not report that bank as insolvent, and if that report appears on its face to us to be a fair and intelligent report, made by proper authority, are we not absolutely justified in relying on it?

Mr. Baker. Entirely so, in my judgment. You have met the entire burden by your action.

Governor Young. Is my interpretation of the ruling of the Supreme Court correct, that insolvency may be determined by the inability of the bank to meet its due obligations?

Mr. Baker. Yes.

Governor Young. That is correct?

Mr. Baker. Yes.

Governor Young. Let us assume that we take the spe-

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cific case that Governor Norris has cited. Let us assume that we find the assets of the bank satisfactory but we find that the bank has no reserve, that it has many cash items unpaid which have been unpaid for several days, haven't you got pretty good knowledge that that bank is insolvent from a financial standpoint? In other words, you have got to lend them some money to pay those obligations.

The Chairman. No bank can pay all of its depositors overnight if they have a run.

Mr. Baker. No, it is a question of judgment. You look at the bank's assets; you find that those assets are perfectly good according to the best judgment you can exercise but they are not sufficiently fluid and flowing to meet the demands as rapidly as applications are made, then you can tide that bank over with perfect safety. If you make a mistake where you have exercised reasonable discretion, I think you have relieved yourself of any liability. Does that answer the question?

Governor Young. Yes, I think it does.

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Mr. Baker: But the question I want to raise, and I want to do it for my own information, is a practical question. Suppose a situation would arise like that in the case of the Stanrod Bank, an extended bank where, due to the view of the Circuit of Appeals, the Federal Reserve Bank had knowledge of the perilous, if not the insolvent condition, of the Stanrod Bank, is it impracticable for the Federal Reserve Bank, which is appealed to for assistance, to say to the bank, with regard to the paper presented, "Where did you get this; how did you come to have it? Was there any deposit liability created at the time you got it, which still exists?" And to take only paper which did not come concurrently with the creation of a deposit liability after the dangerous condition of that bank was known? Is that impracticable?

Governor Seay. As to the existing deposit liability, I think that is impracticable; but it certainly is not impracticable to require a statement that the paper was discounted, because we have already done that and do it now. We do require the statement that this paper has been discounted for so and so, but we do not

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now, and never have, nor do I believe has any Federal Reserve Bank, required any statement as to the contingent deposit liability of the applying bank.

Mr. Baker. Such a statement required might be helpful but it would not be conclusive. The Stanrod Bank would undoubtedly have told the San Francisco Bank that it was the owner of that paper.

Governor Bailey. Didn't the evidence show that they never lost title to that paper until they actually got the money? Didn't they have that kind of an agreement?

Mr. Baker. There is a statement of that kind in the opinion of the Circuit Court of Appeals, or something that looks in that direction in the evidence; but it is also in evidence in that case that the Grimm Alfalfa Association knew that that paper was going to the bank for discount and had done nothing to put the Federal Reserve Bank on notice that they had any claim to the paper.

Governor Young. From a practical standpoint, as I said before, in our district the offsets are few and far between, because the borrowers as a rule are not heavy depositors. What we do is to just get it paid down to the offset, get the money and turn the balance of it back

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to the receiver, in cases where we are not going to get it paid out in full. Where we think we have the right to collect from the banker, which may involve a hundred dollars or two hundred dollars, and it is a question of paying an attorney a thousand dollars to collect the $200, we just forget it and keep on forgetting it.

Governor Crissinger. That is rather hard on the attorneys.

Mr. Baker. Yes, but it is good for the bank.

Governor Harding. With regard to the Grimm Alfalfa case, suppose instead of drafts that they had made their fifteen day note and put the drafts up as collateral for the note; then the note with drafts attached was sent to the Federal Reserve Bank. The bank could have collected the draft just the same, and it seems to me that they would have been barred from making the plea that the Federal Reserve Bank had discounted a note of an institution that they knew was insolvent. They could not have said that the bank was on notice that this was their property.

Mr. Baker. Why not? In the case as you put it they deposited the draft as collateral security.

Governor Harding. But if they made their fifteen-day

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note to the Stanrod Bank, which discounted the note and gave them credit for the proceeds, and put up as collateral the drafts, then they would send the note with drafts attached to the Salt Lake City branch of the Reserve Bank of San Francisco, the Salt Lake City bank would give the Stanrod Bank credit for the proceeds of the note, and then proceed to collect the collateral.

Mr. Baker. How would the Stanrod Bank get title to that collateral with the reserve bank?

Governor Harding. When they discounted the note to which the drafts were attached as collateral.

Mr. Baker. Then the Grimm Alfalfa Association note is itself discounted with the Federal Reserve Bank?

Governor Harding. Yes.

Mr. Baker. And carries the collateral with it.

Governor Seay. The note of the member bank is discounted for the member bank and carries the assignment of the Grimm-Alfalfa Association.

Governor Harding. Instead of putting the draft up they get the Stanrod Bank to take their note for fifteen days.

Governor Bailey. The Court went so far as to say that the Stanrod Bank was not rich enough to loan $30,000.

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Mr. Baker. I think implication of knowledge in that case is very remote. The Circuit Court of Appeals says that the Federal Reserve Bank had knowledge of the fact that the Stanrod Bank could not have paid the note because it didn't have money enough to pay it, and I think that is going pretty far.

Governor Bailey. Ordinarily if notes of that kind come to our bank we give them credit, if they have drafts attached of that kind, but we don't pass the money over.

Mr. Baker. The case which Governor Harding has put I have not gotten straight in my head. The Grimm Alfalfa Association makes its own note for $30,000?

Governor Harding. Yes.

Mr. Baker. And discounts that with the Stanrod Bank.

Governor Harding. Yes. It takes credit for it and secures that note with these drafts.

Mr. Baker. What relation does the Stanrod Bank have to the Federal Reserve Bank of San Francisco?

Governor Harding. The Stanrod Bank would send that collateral note ---

Mr. Baker. With the collateral, the note and the collateral?

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Governor Harding. Yes, to the Federal Reserve Bank, which would immediately put that collateral in process of collection, and when they collected the collateral they would pay off the note.

Mr. Baker. I don't quite see that the fact that it was the note of the Grimm Alfalfa Association which was discounted would make it any different from the draft of an outside party, because the note is a collectable note; the Grimm Alfalfa Association would have to pay that note unless it was paid out of the collateral. I do not see that it would make any substantial difference whether it is a note or whether it was a draft endorsed by it. There may be something practical that I have missed in it, but I do not see that it would be different.

Governor Harding. Suppose it had been a case of bonds; that they had the bonds in the bank for safekeeping, the bank had sent the bonds to the Reserve Bank and borrowed money and sold the bonds to the Reserve Bank? Then the man could say "Those are not the property of the bank; those are my bonds. I had them there for safekeeping and they had no authority to negotiate them." But if that man has gone ahead and made a note and put the bonds up as

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collateral back of the note, he certainly would be barred from showing that the bank had made any improper use of the bonds.

Mr. Baker. Yes, I think he would be barred from that. That is not quite the question, Governor Harding. The question that faces us is the relation between the first bank of discount and the customer. Now if those relations are fraudulent and the Federal Reserve Bank has knowledge of the fraud, then that transaction is a thing that becomes infirm. If I go to a bank and give my note for $30,000 and deposit Government bonds to secure that note; they discount it and place to my credit $30,000 and fail the next day, and knew at the time that I put my note in there and they put that $30,000 to my credit as a depositor that they were going to fail, and that they were insolvent, that is certainly fraud.

Governor Harding. I can see where you might raise the question that the bank had deprived you of your right of offset.

Governor Crissinger. It goes further than that. It goes to a question of fraud, to the condition that nothing ever passed.

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Mr. Baker. Nothing ever passed. What they are entitled to have back is their note and their bond and have the deposit cancelled as though it had never been made. If that note and those bonds had gotten into the hands of the Federal Reserve Bank with notice of fraud, then they are entitled to come back from the Federal Reserve Bank; and if the Federal Reserve Bank, with knowledge of the fraud, has disposed of those bonds and changed that situation, they are liable to make good out of their own funds what is due to the depositor by reason of their knowledge of and participation in the original fraud. That is the way the proposition works out.

Mr. Miller. What is going to happen in the Grimm Alfalfa case? Is it going to be appealed?

Mr. Baker. We tried to get the Supreme Court of the United States to take it in. Governor Calkins did not think they would. I think I told Governor Calkins I thought we had a fifty-fifty chance -- that we had better than a fifty-fifty chance to get it in and a fifty-fifty chance to reverse it after we got it in.

Mr. Miller. On what grounds did they refuse?

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Mr. Baker. They never assign grounds when they decline a writ of certiorari. My best judgment is that they took the statement, as contained in the opinion of the Circuit Court of Appeals, that the verdict of the jury was taken as a special finding of fact, and they took that statement of fact as being some evidence and let it go on the question of fact.

Governor Crissinger. Is there anything else that you want to bring up at this meeting? If not it is about time to adjourn for lunch.

(Whereupon, at 12:50 o'clock p.m., the Conference recessed until 2:30 o'clock p.m. of the same day,) the members of the Federal Reserve Board and Mr. Baker retiring from the conference room.)

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