STATEMENT OF CHAIRMAN MARTIN

ON BEHALF OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BEFORE THE HOUSE BANKING AND CURRENCY COMMITTEE

REGARDING THE PROPOSED "FINANCIAL INSTITUTIONS ACT OF 1957"

July 15, 1957

Mr. Chairman:

The bills that are the subject of this hearing have for their objective a complete streamlining of Federal statutes relating to financial institutions, including national banks, member banks of the Federal Reserve System, insured banks, Federal savings and loan associations, and Federal credit unions. The legislation would rearrange provisions of law on this subject in a more logical order, eliminate obsolete provisions, correct technical defects, and make a number of substantive changes designed to clarify and improve the operation of these statutes.

The Board of Governors is thoroughly in accord with the objectives of this legislation and believes that enactment of such a codification of the banking laws would be in the public interest. The Board's adverse comments on a few provisions should not be construed as indicating lack of general approval.

Most of the changes which would be made by the bill in the Federal Reserve Act are purely technical and would merely serve to

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bring that Act up to date by eliminating deadwood and clarifying ambiguous provisions. Such changes are clearly desirable and require no special comment. As to the changes of substance which would be made in Federal Reserve law, it may save time to review briefly those which the Board endorses or to which it has no objection and then direct attention to the few provisions of the bill which the Board would oppose or with respect to which it would have serious question.

PROVISIONS ENDORSED BY THE BOARD

In the order in which they occur in Title II of the bill and not necessarily in the order of their importance, the following provisions would make substantial changes in existing law which meet with the approval of the Board or to which the Board would have no objection. Most of these changes are in accordance with recommendations which were made by the Board last year to the Senate Banking and Currency Committee.

Expenditures for Federal Reserve Bank branch buildings (§ 4(c)). - The present statutory dollar limitation on the aggregate costs of construction for Federal Reserve Bank branch buildings would be eliminated.

Franchise tax (§ 7(b)). - A new provision would require each Federal Reserve Bank to pay 90 per cent of its annual net earnings to

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the United States as a franchise tax. This would have the effect of restoring the franchise tax provision which was repealed in 1933 when the Reserve Banks were required to subscribe half of their surplus to the capital stock of the Federal Deposit Insurance Corporation. The proposed specific statutory direction for the transfer of annual net earnings to the Treasury would replace the somewhat complicated and awkward procedure under which the Federal Reserve System, since 1947, has paid to the Treasury approximately 90 per cent of its annual net earnings.

Rotation of membership on Federal Advisory Council (§ 8(a)). - The bill would make any member of the Federal Advisory Council who has served six consecutive terms of one year each ineligible to serve again as a member of the Council until after an intervening period of not less than three years. Such a provision for rotation in the membership of the Council would have the advantage of obtaining broader representation and wider experience over a period of time.

Majority vote of Board members (§§ 10(b), 39(1), and 42). - Certain provisions of present law require designated actions of the Board to be approved by a stated number of Board members. For example, permission for the carrying of reduced reserves by member banks in outlying sections of reserve and central reserve cities requires the affirmative vote of not less than five members of the Board. These and similar

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provisions would be modified by the bill to require such actions to be taken on the affirmative vote of a majority of the members of the Board in office at the time the action is taken.

Repeal of authority for business loans. - The proposed revision of the Federal Reserve Act would omit and thereby repeal section 13b of the present Federal Reserve Act authorizing the Federal Reserve Banks to make working capital loans to industrial or commercial businesses. This authority has not been utilized extensively in recent years and in any event it is believed to be inconsistent with central banking functions. Repeal of these provisions has heretofore been recommended by the Board. Their repeal would mean that the Reserve Banks would repay to the Treasury approximately $27-1/2 million which has been paid by the Treasury to the Reserve Banks under these provisions.

Rotation of directors of Federal Reserve Banks (§ 17(a)). - Under the bill no director of a Federal Reserve Bank who has served two consecutive terms of three years each would be eligible to serve again as a director until after an intervening period of not less than three years, with a modification of the rule as to the chairman of the board of directors. Like the similar provision with respect to members of the Federal Advisory Council, this provision would insure broader representation and wider experience on the boards of directors of the Federal Reserve Banks.

Residence of Federal Reserve directors (§ 17(a)). - Every Federal Reserve Bank director would be required to be a resident of

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the Federal Reserve district served by his Federal Reserve Bank or to reside within fifty miles of the Reserve Bank.

Federal Reserve Agents (§ 19). - The bill would eliminate the present unnecessary requirement that Federal Reserve Agents and Assistant Federal Reserve Agents be persons of "tested banking experience". Other provisions would make it clear that a Federal Reserve Agent could delegate ministerial functions to his Assistants and that an Assistant Federal Reserve Agent could act in the place of the Agent during a vacancy in that office as well as during the absence or disability of the Agent.

Reports of State member banks (§ 23(b)). A new provision would authorize the obtaining of special reports from State member banks and thereby enable the Board to call for relatively simple reports from smaller banks and more detailed reports from the larger member banks engaged in a variety of banking operations.

Stock acquisitions in connection with absorptions (§ 23(d)). - A new provision would permit a State member bank, with the Board's approval, to purchase and hold for not more than 90 days the stock of another bank as a step in connection with the absorption of such other bank. Such temporary stock acquisitions would sometimes be convenient as a step in the absorption process and the requirement for the Board's approval would serve to prevent any abuses of this exception from the general rule against the acquisition of corporate stock by member banks.

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Shareholders' lists and disclosure of stock ownership (§ 23). - New provisions would require each State member bank to maintain a list of its stockholders and to notify the Board of any single transaction involving the transfer of 10 per cent or more of the outstanding shares of the bank. In addition, the record owner of any such stock would be required to notify the Board of the names of any persons having a beneficial or equitable interest in such stock in excess of 5 per cent of the outstanding shares of the bank. Although this requirement for disclosure of equitable ownership might be burdensome in some instances, the Board believes that the proposed provisions have merit.

Investments in bank premises (§ 23(h)). - Under the bill, investments in bank premises by a State member bank would require the Board's approval only if they exceed 100 per cent of the bank's capital stock or 50 per cent of the bank's capital and surplus, whichever may be greater. Existing law requires Board approval in all cases in which the investment would exceed 100 per cent of the capital stock.

Audits of State member banks (§ 24(c)). - A new provision would authorize the Board, whenever it deems it necessary, to require an independent audit to be made of a State member bank.

Confidentiality of examination reports (§ 24(f)). - Reports of examinations of State member banks and related correspondence would be made privileged against disclosure without the Board's consent, except to committees of Congress upon request.

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Loans to executive officers (§ 28(e)). - Present law prohibiting loans by member banks to their executive officers includes an exemption with respect to loans not exceeding $2,500. This exception would be liberalized by increasing the dollar limitation to $5,000. In addition, a requirement that executive officers make reports of their borrowings from other banks would be modified to make such reports unnecessary where the indebtedness does not exceed $15,000, in the case of home mortgage loans, or $5,000 in the case of all other extensions of credit.

Reserves of holding company affiliates (§ 33(b)). - Under present law a holding company affiliate is required to maintain certain reserves of readily marketable assets, and this requirement has been interpreted as meaning that each of several holding company affiliates of the same member banks must maintain the statutory reserve. The bill would make it possible, where such a multiple holding company situation exists, for only one of the holding company affiliates to carry the required reserve, provided it is designated for that purpose by the Board, and provided that the designated company directly or indirectly owns or controls the stock of the affiliated banks.

Audits of Board's accounts (§ 38(h)). - The bill would require the Board to have its accounts audited annually by a firm of certified public accountants, and reports of such audits would be required to be submitted to the Banking and Currency Committees of Congress.

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Conflict of interests (§ 38(i)). - It would be made a criminal offense for any employee of the Board or any Federal Reserve Bank to accept employment in a member bank within two years after terminating his employment with the Board or the Reserve Bank, except with the Board's approval. While the Board doubts that such a "conflict of interests" provision is necessary, it would not object to the provision of the bill on this subject.

Trust powers of national banks.- Present provisions of the Federal Reserve Act relating to trust powers of national banks would be transferred to the National Bank Act as revised in Title I of the bill and authority for granting such powers and regulation thereof would be vested in the Comptroller of the Currency instead of the Board. Since national banks are under the supervision of the Comptroller, the Board would have no objection to this proposal.

Audits of Federal Reserve Banks (§ 39(m)). - The Board would be required by the bill to take measures to insure that examinations of the Federal Reserve Banks meet the highest standards of commercial audits and the Board would be authorized to arrange for review by certified public accountants of the adequacy of the procedures and techniques followed in the examination of the Reserve Banks. Copies of the reports of examinations of the Reserve Banks, including each examination of the System open market account, would be required to be transmitted promptly to the Banking and Currency Committees of Congress.

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Federal Reserve notes (§ 43). - Present provisions of law relating to the issuance of Federal Reserve notes, which have become antiquated over the years and in many respects are ambiguous, would be completely rewritten for purposes of simplification and clarification. The revision would make no substantial change with respect to Federal Reserve notes, although existing provisions regarding the redemption of such notes would be eliminated as obsolete. Redemption in the traditional sense in gold or gold certificates is no longer permissible and in any event Federal Reserve notes, like other types of currency, have been legal tender for all purposes since 1933.

Powers of foreign branches of national banks (§ 44(f)). - The Board would be empowered by regulation to authorize foreign branches of national banks to exercise such further powers as might be usual in connection with the transaction of the banking business in the foreign countries in which they operate. This authority is intended to enable foreign branches of national banks to operate more effectively in the foreign countries in which they do business.

Mergers and consolidations. - Title III of the bill, relating to insured banks, contains in section 23 new provisions which would make it necessary for all bank mergers or consolidations to be approved in advance by the appropriate bank supervisory agency. Thus, the Board's approval would be necessary in connection with any merger or consolidation if the acquiring or resulting institution would be a State member bank. The Board would be required in such a case to consider, not only the usual banking factors stated in the Federal Deposit Insurance Act,

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but also whether the effect of the proposed transaction might be to lessen competition unduly or to tend unduly to create a monopoly. On the question of competition, the Board would be required to consult the Comptroller of the Currency and the Federal Deposit Insurance Corporation and would be authorized to request the Attorney General's opinion with respect to that question. The Board believes that these provisions would fill a gap in the present law. They would insure consideration by the Federal bank supervisory agencies, on a substantially uniform basis, of the impact of bank mergers upon competition in the banking field. A separate bill along the lines of these provisions of section 23 of Title III of the pending bill was passed by the Senate last year and was endorsed by the Board, as well as by the other Federal bank supervisory agencies.

PROVISIONS OF TITLE II QUESTIONED BY THE BOARD

There are two provisions in Title II of the bill which, while not of the greatest importance, would make changes in present law which in the Board's opinion would not be desirable.

Removal of officers and directors (§ 29). - Provisions for the removal of directors and officers of member banks, which are now contained in section 30 of the Banking Act of 1933, would be repeated in substance in section 29 of Title II of the bill as far as State member banks are concerned. Certain changes would be made in these provisions as to which the Board would have no objection. The Board

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would, however, object to one of the proposed changes. Under the Administrative Procedure Act, agency action may be set aside on judicial review if the reviewing court finds that such action was "unsupported by substantial evidence." Despite this provision, the bill would include a statement that any hearing held in connection with the removal of a director or officer of a State member bank shall be held in accordance with the provisions of the Administrative Procedure Act and be subject to review as therein provided, except that the review by the court shall be upon the "weight of the evidence." The Board sees no sound reason for this departure from the general rule laid down in the Administrative Procedure Act and the Board questions whether it is desirable to single out the type of action here involved as an exception from the "substantial evidence" rule uniformly applied in the case of all other agency actions. Application of the "weight of the evidence" rule would, of course, mean that the decision of an expert administrative agency in proceedings for the removal of a bank director or officer could be upset by a reviewing court even though that decision was clearly supported by substantial evidence.

Use of reserves of holding company affiliates (Title II, § 33). - Mention has already been made of one change which would be made by the bill with respect to the reserve of readily marketable assets required by present law to be maintained by holding company affiliates. Another proposed change in this respect would be to permit a holding company affiliate to use such reserve for additions to capital of affiliated banks as well as for the replacement of capital in such banks. This reserve was originally

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intended to enable a holding company affiliate to come to the aid of its subsidiary banks in times of stress or emergency. The Board questions whether the proposed broadening of this provision to permit the reserve to be used for capital additions would be consistent with the purposes of the law, since, if it were used in normal times for such purposes, it might well become depleted and not be available when it would be needed in unusual circumstances in order to maintain the sound condition of the holding company affiliate's subsidiary banks.

PROVISIONS OF TITLE I QUESTIONED BY THE BOARD

Most of the provisions of this bill outside of Title II have no direct effect upon the Federal Reserve System. Title I of the bill, however, relating to national banks, includes two provisions which are of concern to the Board because of their possible effect upon the soundness of the banking system.

Cumulative voting. - Under present law cumulative voting in elections of directors of national banks is mandatory, and this has been the case since 1933. Cumulative voting is based on the principle of permitting due representation of minority shareholders on a corporation's board of directors. Section 26(c) of Title I of the bill would permit cumulative voting only if provided for in the national bank's articles of association. The Board feels that the principle of cumulative voting is sound and questions whether the proposed change should

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be made unless Congress is satisfied that cumulative voting has produced undesirable results so great as to outweigh the obvious justice of giving proper representation to minority interests. Since the contents of the articles of incorporation of a national bank are determined by a majority of the bank's shareholders, it is obvious that the practical effect of the proposed change would be to eliminate all cumulative voting in elections of national bank directors. Although proponents of this change have contended that cumulative voting has given rise to situations in which minority shareholders have been able to place an undesirable individual on the board of directors of a national bank, the Board doubts whether abuses of this kind have been so great as to justify abandonment of the basically sound principle of cumulative voting. It should be borne in mind in this connection that minority-elected directors often can stimulate other directors to greater activity in behalf of a bank and, furthermore, that if a minority-elected director should engage in unsound activities, he would be subject to removal under the law.

Debt limit of national banks. - Section 37 of Title I would increase the maximum limit of a national bank's total indebtedness from 100 per cent of its capital stock to 100 per cent of its capital stock and surplus. This considerable expansion in the borrowing ability of national banks would, in the Board's opinion, be unnecessary and undesirable. Although bank borrowings may occasionally be necessary in limited amounts and for limited periods in order to avoid liquidation

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of assets that might otherwise be necessary, it is a practice that should not be encouraged because it tends to dilute the cushion of protection which is afforded depositors by a bank's capital and surplus. Enlargement of the borrowing limits as here proposed might well encourage national banks to hold smaller amounts of liquid assets and to rely unduly upon borrowings for necessary adjustments. In the case of an emergency requiring unusual borrowing, the discount facilities of the Reserve Banks are readily available. To encourage the ability of national banks to borrow outside the Reserve Banks would tend to diminish the restraining influence that the Reserve Banks are directed by law to assert upon borrowing member banks which may be making undue use of credit for speculative purposes.

ADDITIONAL PROVISIONS RECOMMENDED BY THE BOARD

Before concluding this statement, the Board would like to bring to the attention of the Committee certain proposed changes in Federal Reserve law which are not included in the pending bills but which, in the Board's opinion, should appropriately be incorporated in this legislation.

Repurchase agreements. - For many years the Federal Reserve Banks in connection with their open market operations have utilized repurchase agreements as a convenient and flexible means of helping to smooth out temporary irregularities in the money market. These agreements are in the form of a purchase and sale and they are used only to

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implement open market operations pursuant to regulations of the Federal Open Market Committee. However, such transactions admittedly have some of the attributes of a loan and present law contains no specific reference to these transactions. Accordingly, the Board believes that a clarifying amendment which would specifically authorize such repurchase agreements by the Federal Reserve Banks would be desirable.

Fiscal agency operations by the Federal Reserve Banks. - Under various provisions of present law, the Federal Reserve Banks are authorized or directed to act as fiscal agents of the United States and of a number of departments and agencies of the Federal Government. The activities of the Reserve Banks as such fiscal agents have increased tremendously in recent years. More than 3,100 of the approximately 18,600 employees of the Federal Reserve Banks are now engaged full time in fiscal agency operations on behalf of more than 25 Governmental agencies in some 50 different capacities. It has become increasingly evident that, in addition to the general authority of the Board to supervise the Reserve Banks, the law should contain some more specific authority for the over-all coordination of the fiscal agency operations of the Reserve Banks. In five instances such authority now exists; and it would be helpful if it existed in all cases so as to make certain that the many activities which the Reserve Banks are required to perform on behalf of Government departments and agencies do not become inconsistent with the over-all purposes of the Reserve Banks or unduly burdensome. The Board, therefore, recommends that this legislation include at an appropriate place a provision making all fiscal agency

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operations of the Reserve Banks specifically subject to supervision and regulation by the Board.

Payment of interest on deposits. - Since 1933, the law has prohibited member banks from paying interest on demand deposits, directly or indirectly, by any device whatsoever, and has required the Board of Governors to fix maximum rates of interest which may be paid by member banks on time and savings deposits. Similar provisions are contained in the Federal Deposit Insurance Act with respect to payment of interest on deposits by nonmember insured banks. For many years, the matter of determining whether particular practices involve a payment of interest on deposits has presented substantial and almost impossible administrative problems. Questions arise, for example, as to whether the furnishing of free parking facilities, special printing of checks, lower rates of interest on loans to depositors, and numerous other practices constitute indirect payments of interest under the broad language of the statute. In order to make the law more workable, the Board recommends that the words "directly or indirectly, by any device whatsoever" be deleted from the statute and that the words "payment of interest" be expressly defined as including only cash payments made, or credits given, by a bank for the account or benefit of a depositor. In the Board's opinion such a change would carry out the basic purposes of the statute and at the same time make possible a more practical administration of the law.

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In this connection, the Board also recommends that the law be clarified so as to make the same rules as to what constitutes a payment of interest on deposits apply to member banks and nonmember insured banks alike. Obviously this was the intent of Congress when the law was originally enacted. However, in the application of the statute, the Board has ruled that absorption of exchange charges by member banks is a payment of interest, whereas the Federal Deposit Insurance Corporation has taken the opposite position with respect to nonmember insured banks. As a result, member banks in some sections of the country have been placed at a serious competitive disadvantage with respect to nonmember banks, and the check collection process has been slowed up by the unnecessary circuitous routing of checks drawn on nonpar banks. If the law should be amended as previously suggested by the Board to define interest as including only cash payments or credits, it is believed that absorption of exchange would come within that definition. However, if the law should not be amended to include such a definition, the Board believes that the law should be amended either by including an explicit statement regarding absorption of exchange charges by both member and nonmember insured banks, or, in the alternative, by authorizing either the Board or the FDIC to define a "payment of interest" for both classes of banks.

It should be emphasized that this recommendation is made only for the purpose of removing existing inequities which have arisen in this field and not for the purpose of forcing "par clearance" upon

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banks that now charge exchange. The Board's proposal relates not to the making of exchange charges but to the absorption of such charges as a device for paying interest on deposits. The purpose is simply to make the same rules applicable to all insured banks and to preclude situations in which nonmember insured banks are permitted to absorb exchange while competing State and national member banks are not allowed to do so.

With respect to this matter, the report of the Senate Banking and Currency Committee recognized that the law should apply uniformly to both classes of banks, but stated that the Board and the FDIC should resolve the question by developing uniform regulations for both member and nonmember insured banks. However, all efforts for such uniform regulations, over a period of many years, have proved fruitless. In the Board's opinion, the problem is one which can be resolved only by specific legislation.

Conclusion

In view of the length of this statement, it may be appropriate in conclusion to say again that the Board endorses the general objectives of the pending legislation. With the few exceptions that have been indicated, the Board approves the provisions of the bill insofar as they affect the Federal Reserve System. Enactment of such a codification of Federal statutes relating to financial institutions is long overdue and the Board hopes that it will be approved.

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