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Statement of

William McChesney Martin, Jr.,

Chairman, Board of Governors of the Federal Reserve System,

before the

Subcommittee on Financial Institutions

of the

Senate Committee on Banking and Currency

on

S. 1308, S. 1309, S. 1556, S. 1557,

S. 1558, and S. 1559

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Of the six bills that are the subject of this hearing, four were recommended by the Board in its Annual Report for 1964, those relating to delegation of the Board's functions, the purchase by the Federal Reserve Banks of foreign government obligations, loans by member banks to their executive officers, and advances by the Reserve Banks. The bill regarding destruction of unfit Federal Reserve notes has been strongly endorsed by the Board, and the Board has favorably reported on the bill authorizing the drawing of Government checks payable to a banking organization for the accounts of specified persons.

My comments regarding these bills will be presented in accordance with their numerical designations.

Procedure for Destruction of Unfit Federal Reserve Notes (S. 1308)

Under existing law, Federal Reserve notes unfit for further circulation must be returned by the Federal Reserve Banks to the Comptroller of the Currency in Washington for cancellation and destruction. In addition, before such notes are destroyed, they must be sorted in order to allocate credit therefor among the Reserve Banks.

S. 1308 would permit the cancellation and destruction of unfit Federal Reserve notes at locations designated by the Secretary of the Treasury and authorize the Board of Governors of the Federal Reserve System to determine the basis for allocating credit for the

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destroyed notes among the 12 Federal Reserve Banks. This would mean that procedures could be adopted for the destruction of unfit Federal Reserve notes on the premises of the Reserve Banks instead of in Washington, and without sorting them by Bank of issue.

Since 1953, silver certificates have been destroyed at the various Reserve Banks and their branches in accordance with procedures prescribed by the Treasury Department; and it is contemplated that under this legislation substantially the same procedures would be followed with respect to the destruction of unfit Federal Reserve notes.

The need for this legislation has become particularly pressing since enactment of legislation in 1963 authorizing the issuance of $1 Federal Reserve notes to replace $1 silver certificates. By avoiding the need for shipping unfit Federal Reserve notes to Washington for destruction and for the physical sorting of such notes according to Bank of issue, the legislation would produce substantial economies that are not possible under present law and procedures. It is estimated that the savings would amount to approximately $800,000 annually.

Meanwhile, in the hope of avoiding seemingly unnecessary expenses, the Reserve Banks and their branches have been holding unfit $1 Federal Reserve notes instead of shipping them to Washington for destruction. At present, these holdings total over 160 million pieces. Unfit notes are accumulating more and more rapidly as time

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goes by, and they have already caused a storage problem in the vaults of some of the Reserve Banks.

The Board strongly recommends the prompt enactment of this bill.

Drawing of Government Checks in Favor of Banks for the Credit of Specified Persons (S. 1309)

S. 1309 would make it possible for the disbursing officer of a Government agency to draw a single check on the Treasury Department in favor of a banking organization for credit to the accounts of persons entitled to regular payments from the agency, such as payments for salaries and retirement and pension benefits.

It is understood that, for a number of years, the Department of the Air Force followed a practice of this kind, but that the Comptroller General held that the practice did not fully comply with the requirements of the Assignment of Claims Act or with provisions of law that require a Government disbursing officer to draw from public moneys only in favor of the persons entitled to receive payment.

Authorization of such procedures, as contemplated by S. 1309, would tend to promote economies and efficiencies of operation, particularly in the case of the larger Government departments and agencies. Moreover, to the extent that Government agencies might elect to utilize such procedures, the number of Government checks presented to the Federal Reserve Banks for collection would be

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reduced and to that extent the operating costs of the Reserve Banks would likewise be reduced.

Accordingly, the Board of Governors favors enactment of this bill.

Delegation of Certain Functions of the Board of Governors (S. 1556)

S. 1556 would authorize the Board of Governors to delegate to its members or employees or to the Federal Reserve Banks the performance of functions of the Board other than its functions relating to the issuance of regulations or pertaining principally to monetary and credit policies. The Chairman of the Board would assign responsibility for the performance of particular delegated functions. Effective administrative means for review and control of actions at a delegated level would be afforded by a provision of the bill that would enable any member of the Board to require review of such action by the Board itself.

In recent years, the responsibilities of the Board of Governors have increased tremendously, both in the field of monetary and credit policy and in the field of bank supervision and regulation. For example, the Bank Holding Company Act of 1956, the Bank Merger Act of 1960, and the Securities Acts Amendments of 1964 have substantially added to the regulatory duties of the Board.

The efficient and expeditious performance of the Board's important functions would be facilitated by clear authority, such

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as that provided by S. 1556, to delegate certain types of bank supervisory functions that now must be performed in all cases by the Board itself.

For example, present law expressly requires Board approval for an extension of time for filing of reports by affiliates of State member banks, for extensions of time for registration by a bank holding company, for extensions of time for registration of securities of State member banks, for waiver of the six months' notice that a State member bank must give before withdrawing from membership, for any investment by a State member bank in bank premises in excess of its capital stock, for the declaration of dividends by a State member bank in certain circumstances, and for the purchase of certain stocks by foreign banking corporations.

The Board might not decide to delegate the performance of all of the particular functions just mentioned if S. 1556 were enacted. They are cited here merely to illustrate the kinds of functions that could be delegated under the bill if, in the light of experience, the Board determined that their delegation would be desirable.

Other Federal regulatory agencies have been authorized by statute or Reorganization Plans to make more or less unlimited delegations of their functions. Such authority is possessed, for example, by the Interstate Commerce Commission, the Federal Trade Commission, the Federal Home Loan Bank Board, the Civil Aeronautics

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Board, the Federal Maritime Commission, and the Securities and Exchange Commission.

The situation with which the Board of Governors is presently faced because of its lack of specific authority to delegate any of its functions is perfectly described in the following excerpt from a message sent to Congress by President Kennedy on April 13, 1961:

> "The reduction of existing delays in our regulatory agencies requires the elimination of needless work at their top levels. Because so many of them were established in a day of a less complex economy, many matters that could and should in large measure be resolved at a lower level required decision by the agency members themselves. Even where, by the force of circumstances, many of these matters are now actually determined at a lower level they still must bear the imprimatur of the agency members. Consequently, unnecessary and unimportant details occupy far too much of the time and energy of agency members, and prevent full and expeditious consideration of the most important issues."

Accordingly, the Board strongly recommends prompt approval of S. 1556 by your Committee and by the Congress.

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Investments by Federal Reserve Banks in Securities of Foreign Governments (S. 1557)

Under regulations of the Federal Open Market Committee, the Federal Reserve Bank of New York, on behalf of the System Open Market Account, engages in foreign currency operations in order to prevent disorderly conditions in foreign-exchange markets, to offset the effects of temporary and reversible international flows of volatile funds, and, more generally, to safeguard the value of the dollar in the international exchange markets. These operations are implemented by reciprocal balances on the basis of "swap" arrangements that have been established between the New York Reserve Bank and foreign central banks.

The full amount of the balance held by the Reserve Bank in an account with a foreign bank may not always be needed for foreign currency operations. Under present law, idle funds in the account may be invested in short-term commercial paper in the foreign country or placed in an interest-bearing time account with the same or some other foreign bank. In most countries, however, there is a scarcity of commercial paper for investment, and in some countries time deposit facilities are not conveniently available. Present law contains no authority for the investment of such idle funds in obligations of foreign governments, such as foreign treasury bills. On the other hand, a foreign central bank may - and generally does - invest unused funds in its balances with the New York Reserve Bank in interest-bearing securities of the United States Government.

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S. 1557 would expressly authorize a Federal Reserve Bank to buy and sell securities of a foreign government or monetary authority that have maturities of not more than 12 months and are payable in a convertible currency. This authority would provide a convenient means for investment of idle funds carried by the Federal Reserve System with a foreign central bank where, as previously indicated, other sources of investment are not conveniently available. For this reason, the Board recommends enactment of this bill.

Loans to Executive Officers (S. 1558)

Section 22(g) of the Federal Reserve Act prohibits a member bank of the Federal Reserve System from making loans to its executive officers except in amounts not exceeding $2,500 and then they may be made only with the prior approval of a majority of the bank's board of directors. The section further requires an executive officer to file a written report with his board of directors regarding any loan obtained by him from another bank.

The underlying purpose of these restrictions is unquestionably sound. However, they seem unrealistically severe in the light of changes in economic conditions that have taken place since they were first enacted in 1933. The President's Committee on Financial Institutions in 1963 recognized the desirability of increasing the $2,500 ceiling on the amount that an executive officer may borrow from his own bank. In addition, it would seem appropriate to provide a

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consideraly higher ceiling on mortgage loans covering the purchase of an executive officer's home. Under present law, such an officer is compelled to obtain home mortgage financing from another bank or financial institution.

S. 1558 would make three principal changes in section 22(g). It would raise the present general exemption from $2,500 to $5,000, and permit home mortgage loans up to $30,000. Secondly, instead of requiring approval of such exempted loans by the board of directors of the officer's bank, the bill would require only that the officer report the borrowings to his board of directors. Finally, reports of borrowings from other banks would be required only where they would exceed in the aggregate the amount that the officer could borrow from his own bank.

The Board believes that the liberalizing effect of the bill would be consistent with the basic purposes of present law and that such liberalization is desirable. Accordingly, the Board recommends enactment of S. 1558.

Advances by Federal Reserve Banks (S. 1559)

S. 1559 would permit member banks of the Federal Reserve System to borrow from the Federal Reserve Banks on the security of any satisfactory collateral without paying a "penalty" rate of interest. A new section 13A would replace present provisions of the Federal Reserve Act under which member banks may borrow from the Reserve Banks

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at the regular discount rate only on the security of Government obligations or on commercial paper that meets certain outmoded "eligibility" requirements, including narrow limitations as to maturity. Borrowings on any other security under present law must bear interest at a rate at least one-half of one per cent higher than the regular discount rate.

The proposed legislation was originally recommended by the Board nearly two years ago after an exhaustive study of the subject. While its principal effect would be to permit borrowings on any sound assets without a penalty interest rate, it would also simplify the law in this area and eliminate the concept that Federal Reserve credit should be extended only on the basis of short-term, self-liquidating commercial or agricultural paper.

Drastic changes in the types of loans made by commercial banks have occurred since 1913. The credit needs of American businessmen, farmers, and consumers have evolved in ways not anticipated at that time, and the rapid growth of Government as well as private economic activity has generated credit requirements far in excess of those that could be supported by the relatively small volume of short-term, commercial-type "eligible" paper. A departure from the "real bills" doctrine took place as early as 1916 when the law was amended to authorize advances by the Reserve Banks on direct obligations of the United States as well as on "eligible" paper; and a more significant departure occurred in 1932 when advances on any satisfactory

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security were first authorized, although at a penalty rate of interest. Today it is generally recognized that paper representing a medium or long-term loan on mechanized equipment, durable goods, or even real estate, may be as sound as a short-term commercial loan made in expectation of repeated renewals.

The concept that a limitation of Federal Reserve credit to advances on short-term, self-liquidating paper would act as an automatic regulator of the volume of Federal Reserve notes in circulation has also been refuted by experience and has been weakened by amendments to the law under which Government obligations have become the principal security for Federal Reserve notes. Today, the volume of currency fluctuates with the changing demands of the economy, without regard to the nature of the paper offered as collateral for Federal Reserve advances or pledged as security for Federal Reserve notes.

As long as member banks hold a large enough volume of U. S. Government securities, which may be pledged as security for Federal Reserve borrowings, no great problem exists. However, since World War II there has been a sharp net decline in the aggregate holdings of Government securities by member banks. There has recently been a certain amount of borrowing on collateral other than Government securities. If a continuing increase in economic activity should lead to a further reduction of their holdings of Government securities, member banks might be obliged to tender, on a larger scale, other

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kinds of collateral for Federal Reserve advances, and only a relatively small portion of their customers' paper would meet the strict requirements of "eligible" paper entitled to the basic discount rate. A considerable part of their assets - for example, real estate loans, medium-term consumer paper, and municipal securities - would not meet such requirements, and banks could borrow on such assets only under section 10(b) of the Federal Reserve Act at a penalty interest rate.

In large measure, of course, the objectives of S. 1559 could be achieved simply by an amendment that would eliminate the penalty interest rate prescribed by section 10(b). However, any such action would leave in the law many unnecessary provisions that would continue to reflect the outmoded "real bills" concept and might still give rise to questions of interpretation and in some cases perpetuate cumbersome administrative procedures that are not warranted by current banking conditions.

The Board of Governors and the Federal Reserve Banks believe that S. 1559 represents a long-overdue and essentially noncontroversial up-dating of the law in this field. Its enactment would provide assurance that the Reserve Banks will always be in a position to carry out promptly and efficiently one of their principal responsibilities - the extension of appropriate credit assistance to member banks to meet the legitimate credit needs of the economy.

The Board, therefore, strongly urges approval of this bill.

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