A meeting of the Board of Governors of the Federal Reserve System with members of the executive committee of the Federal Advisory Council was held in Washington on Wednesday, October 7, 1942, at 2:20 p.m.

PRESENT: Mr. Eccles, Chairman
Mr. Ransom, Vice Chairman
Mr. Szymczak
Mr. McKee
Mr. Draper
Mr. Evans

Mr. Morrill, Secretary
Mr. Carpenter, Assistant Secretary
Mr. Clayton, Assistant to the Chairman
Mr. Thurston, Special Assistant to the Chairman
Mr. Dreibelbis, General Attorney
Mr. Vest, Assistant General Attorney
Mr. Wyatt, General Counsel

Messrs. Brown, Harrison, Kurtz, Fleming, and Ragland, members of the Executive Committee of the Federal Advisory Council

Mr. Lichtenstein, Secretary of the Federal Advisory Council

Mr. Brown stated that banks were beginning to feel a great deal of concern as to the possibility of heavy losses to banks resulting from the exercise by the Government of its right to renegotiate contracts, which would establish claims against contractors prior to claims of banks for funds advanced to such contractors, and that the members of the executive committee of the Federal Advisory Council would like to renew the suggestion made by the Council at its meeting with the Board on September 14, 1942. He said that the existing situation created a number of difficulties for the banks and was a real obstacle to the extension of credit for financing the war effort.

Chairman Eccles stated that the Board had given informal consideration to the matter and felt that it would be a mistake to suggest to Congress the adoption of legislation which would subordinate claims of the Government to bank claims. He expressed the opinion that recognition might well be given to the suggestion that had been made that only one renegotiation of a contract be permitted, with the understanding that any unduly large profits thereafter would be reached through the medium of excess profits taxes. He said that the Board had not been asked for its opinion with respect to such an amendment to the law, and that it was felt the matter was not of sufficient urgency that the Board should undertake to inject itself into the situation at a time when the suggested amendment providing for only one renegotiation of a contract appeared to be making satisfactory progress.

Mr. McKee suggested that any representation that the Board of Governors might make with respect to this matter would not be as effective as representations made by financing institutions which had made advances to finance war contracts.

Turning from that subject, Mr. Brown stated that it was becoming the rule of the local draft boards that banking was not to be regarded as an essential industry and that employees of banks were not to be deferred on occupational grounds, with the result that it was becoming increasingly difficult for banks to retain sufficient personnel with which to carry on their operations. He said that when younger people were being drafted the matter was not so important, but with men being called who in some cases were 45 years of age it was becoming more difficult to retain key people. In these circumstances, he said, the members of the executive committee felt that this was a matter in which the Board of Governors should use its influence to obtain some relief for the banks.

Mr. Fleming stated that this condition had been very thoroughly discussed by the American Bankers Association, that a committee would be appointed, and that there had been some informal negotiation with the Director of the Selective Service System regarding it on the basis that the banks would ask for deferment only of married men in key positions and men over 44 years of age regardless of their position as being essential in carrying on the work of the banks.

Mr. McKee suggested that because of the services being rendered by the banks for the Treasury they should undertake to obtain the support of the Secretary of the Treasury for their position. In this connection, Mr. Fleming observed that if the proposal were carried out to have the banks handle rationing coupons an additional reason would be furnished for regarding banking as an essential industry.

Reference was made to the letter recently received by the Board of Governors from the Civil Service Commission requesting a list of positions on the Board's staff which were directly concerned with the war effort or with essential supporting activities, and Chairman Eccles stated that the reply made by the Board to this letter did not ask for deferment of any of the Board's employees but did lay the groundwork for requests for deferment of individuals in certain classes of positions in the event the Board should find it necessary to make such requests. It was also stated that the Federal Reserve Banks had not been given the benefit of the deferment of any of their employees on the basis of the Banks being engaged in essential work, and that in the letter to the Civil Service Commission the Board took occasion to point out the essential character of many of the Banks' activities.

At the conclusion of the discussion, Mr. Brown stated that the Board of Governors was fully aware of the situation and was faced with the same problem in connection with its own employees and employees of the Federal Reserve Banks as that faced by the commercial banks, and that it was hoped that it would not overlook the needs of the member banks in considering the matter. He said that the banks did not want any special privileges, but that they did feel the draft boards should regard banking as an essential industry and permit deferments of key people to the extent proposed by Mr. Fleming which, in the case of his (Mr. Brown's) bank, would not exceed 5 per cent of the male employees.

At this point, Chairman Eccles withdrew from the meeting to keep another appointment.

Mr. Brown then stated that the members of the executive committee of the Federal Advisory Council felt that reserve requirements of central reserve city banks should not be reduced below the requirements for banks in reserve cities, and that any further reduction in requirements should apply to the country as a whole. He said that it was felt that the time had come when banks should be encouraged to borrow for the purpose of replenishing reserves, that for that purpose it would be desirable for the Federal Reserve Banks to establish a preferential rate of, say, 1/2 per cent on advances secured by obligations of the United States maturing within one year, that possibly the Federal Reserve Banks of New York, Chicago, and San Francisco would wish to establish such rates whereas banks in predominantly agricultural sections such as Minneapolis and Dallas would not, and that if such rates should be established the Board should approve them but should not force any Reserve Bank to reduce its discount rate against its will.

In response to an inquiry as to whether uniformity of rates was desirable, Mr. Brown stated that uniformity did not exist now and that he did not think uniformity was necessary, but that it would be unfortunate if the Federal Reserve Bank of New York were permitted to have a 1/2 per cent preferential rate and other Reserve Banks were denied that privilege. He expressed the opinion that the directors of each Federal Reserve Bank were better able to judge whether the district needed a reduced rate or whether a lower rate would encourage borrowing and "scalping" by banks, and that, if a preferential rate were established on advances secured by Government obligations maturing within one year, practically the only banks that would avail themselves of that rate would be the large banks that had short-term Government paper.

Inquiry was made by members of the Board as to the reasons of the executive committee for favoring a preferential rate, and Mr. Brown stated that member banks would have to hold Government securities maturing within one year in order to take advantage of the rate, and that for that reason banks would be encouraged to buy short-term rather than long-term Government obligations. A reduced general discount rate, he said, would encourage a considerable percentage of banks, particularly the smaller banks, to buy long-term securities which they could offer as collateral for borrowings at the Federal Reserve Banks.

Mr. Fleming suggested that there was less danger in banks borrowing from the Federal Reserve System than there was in continued reductions in reserve requirements of banks in central reserve cities.

Mr. Brown stated that it was recognized that banks should not be continuously in debt but that the country was faced with a war situation, and that, inasmuch as there were only three ways in which banks could obtain reserve funds, it would be much easier when the time came for liquidation to put pressure on individual banks if they were borrowing than would be the case if general action had to be taken by the Board of Governors. He also said that in order to get banks to borrow on short-term Government paper it would be necessary to reduce the discount rate to a point not higher than the market rate on such paper, and that he felt 1/2 per cent would be the correct rate.

Mr. McKee inquired whether there was a sufficient amount of short-term Government obligations outstanding to make a preferential rate really effective, or whether, if such a rate were established, it would result in an increased demand for short-term paper. Messrs. Brown and Harrison expressed the opinion that such a rate would not have any material effect on existing market rates, and Mr. Harrison stated that there was a total of approximately $13,500,000,000 of Government securities outstanding which would mature within one year, and that most of the banks that would borrow had a sufficient amount of that paper to take care of any borrowing they might wish to do. He added that, while it was realized in the last war that preferential rates were a "snare and a delusion" and that the manner in which a member bank borrowed did not control in any way the use of the funds received by the bank, the question of principle involved should be sacrificed and the preferential rate used as a means of encouraging banks to invest in short-term securities.

The comment was then made by Mr. Brown that the members of the executive committee felt that not enough Government securities were being absorbed out of current income, that, if $30,000,000,000 of bonds were sold to banks during the current year as had been indicated would be necessary, this amount would be entirely too high in relation to the total Government financing, that a more reasonable figure would be $10,000,000,000, and that if the present trend persisted for three or four years it would destroy the banking system.

Mr. Ransom stated that the Federal Reserve System had gone on record as being in favor of the sale of the greatest possible amount of Government securities to nonbank investors and that, while the Treasury had gone a considerable distance to meet that problem, it had not gone far enough. Mr. Brown pointed out that the necessary steps to effect the financing of the war by taxation and out of current savings would take considerable time, that in the meantime the banks would be called upon to buy a large amount of securities which they should not be asked to take, and that one of the ways to get the banks to do the best possible job would be to establish a preferential rate which would encourage bank investment in securities with maturities within one year. He suggested that there was the greatest need for better coordination of the activities of the Victory Fund Committees and the war savings staff, and that it would be helpful if these activities of the Treasury were placed under the direction of a single individual.

Mr. McKee inquired whether an adequate job of selling securities to the public could be done on a voluntary basis so as to reduce to $10,000,000,000, which was the amount suggested by Mr. Brown as a reasonable figure, the amount to be taken in one year by the banks. Mr. Brown's response was that it could be done on a voluntary basis only in the event the situation became much more desperate from a military standpoint or if the United States achieved a number of victories and it became evident that by strong immediate support through the purchase of Government securities the period of the war could be shortened. Aside from that, however, Mr. Brown felt that with a better organization the amount of money raised from current income could be increased 100 per cent.

Mr. Ransom suggested that an even more important step would be for action to be taken so that the public would know that the Government intended to do everything possible to stablilize the situation and to prevent inflation.

Mr. Harrison stated that another reason for the preferential rate was that it would be much easier, when the time for reversal of policy came, to eliminate the 1/2 per cent preferential rate than it would be to increase the general discount rate.

Mr. Szymczak raised the question whether a preferential rate should be extended to advances to nonmember banks as well as member banks, and the members of the executive committee indicated the feeling that it should be extended to member banks only, Mr. Brown suggesting that nonmember banks would benefit from the policy because of the fact that the short-term securities involved would command a higher price in the market.

During the discussion of the above matter, Mr. Huntington, a member of the executive committee of the Federal Advisory Council, joined the meeting.

Mr. Brown then stated that another matter on the agenda for consideration was the question of the ratio of bank capital to deposits, which he said was bothering a number of banks, examiners, and supervisory authorities. He said that the tendency to adhere to the theory of a 10 to 1 ratio deterred banks from buying Government securities, even in the face of an increase in deposits, and also caused them to resist an increase in deposits. The members of the executive committee, he said, felt that the theory was outmoded and that the ratio of capital to risk exposure was the thing to be considered. He added that various members of the executive committee had proposed formulas that they felt could be applied, and that at the meeting of the Federal Advisory Council with the Board in November the Council would like to see if some agreement could be reached with respect to a formula that would be regarded as furnishing adequate protection to depositors and at the same time in keeping with existing conditions.

Mr. McKee reviewed for the information of the members of the executive committee the consideration that had been given to this matter by the Board in recent months and to the discussions which had been had with representatives of other supervisory agencies.

On the question of the handling of ration coupons by the banks for the Office of Price Administration, Mr. Brown stated that it was the hope of the executive committee that the Board of Governors would work closely with the Office of Price Administration with a view to developing a procedure which would be as simple as possible. He said that this was a task which the banks believed they were in a position, and wanted, to undertake, but that with the shortage of manpower it would be desirable for representatives of the Board and the banks to participate in working out plans so as to make them as simple as possible and at the same time accomplish the desired purpose. This matter was discussed in the light of the arrangements made for the experimental operation being conducted in the Albany, New York, area.

At the conclusion of the discussion, the meeting adjourned.

Chester Morrill
Secretary.

Approved:

M S Eccles
Chairman.