FEDERAL RESERVE BANK
OF NEW YORK

Fiscal Agent of the United States

[Circular No. 1918
February 17, 1939]

Public Notice of Offering of $100,000,000, or thereabouts, of Treasury Bills
Dated February 23, 1939 Maturing May 24, 1939

To all Incorporated Banks and Trust Companies in the Second Federal Reserve District and Others Concerned:

Following is the text of a notice today made public by the Treasury Department with respect to a new offering of Treasury bills payable at maturity without interest to be sold on a discount basis to the highest bidders.

The Secretary of the Treasury gives notice that tenders are invited for Treasury bills to the amount of $100,000,000, or thereabouts. They will be 90-day bills; and will be sold on a discount basis to the highest bidders. Tenders will be received at the Federal Reserve Banks, or the branches thereof, up to two o'clock p.m., Eastern Standard time, on Monday, February 20, 1939. Tenders will not be received at the Treasury Department, Washington.

The Treasury bills will be dated February 23, 1939, and will mature on May 24, 1939, and on the maturity date the face amount will be payable without interest. They will be issued in bearer form only, and in amounts or denominations of $1,000, $10,000, $100,000, $500,000, and $1,000,000 (maturity value).

It is urged that tenders be made on the printed forms and forwarded in the special envelopes which will be supplied by the Federal Reserve Banks or branches upon application therefor.

No tender for an amount less than $1,000 will be considered. Each tender must be in multiples of $1,000. The price offered must be expressed on the basis of 100, with not more than three decimal places, e. g., 99.125. Fractions must not be used.

Tenders will be accepted without cash deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by a deposit of 10 per cent of the face amount of Treasury bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Immediately after the closing hour for receipt of tenders on February 20, 1939, all tenders received at the Federal Reserve Banks or branches thereof up to the closing hour will be opened and public announcement of the acceptable prices will follow as soon as possible thereafter, probably on the following morning. The Secretary of the Treasury expressly reserves the right to reject any or all tenders or parts of tenders, and to allot less than the amount applied for, and his action in any such respect shall be final. Those submitting tenders will be advised of the acceptance or rejection thereof. Payment at the price offered for Treasury bills allotted must be made at the Federal Reserve Banks in cash or other immediately available funds on February 23, 1939.

The Treasury bills will be exempt, as to principal and interest, and any gain from the sale or other disposition thereof will also be exempt, from all taxation, except estate and inheritance taxes. (Attention is invited to Treasury Decision 4550, ruling that Treasury bills are not exempt from the gift tax.) No loss from the sale or other disposition of the Treasury bills shall be allowed as a deduction, or otherwise recognized, for the purposes of any tax now or hereafter imposed by the United States or any of its possessions.

Treasury Department Circular No. 418, as amended, and this notice prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or branch thereof.

In accordance with the above announcement tenders will be received at the Securities Department of this bank (2nd floor, 33 Liberty Street, New York City) or at the Buffalo Branch of this bank (272 Main Street, Buffalo, New York) until two o'clock p.m., Eastern Standard time, on Monday, February 20, 1939.

It is requested that tenders be submitted on special form and in special envelope enclosed herewith.

Attention is invited to the fact that payment for the Treasury bills cannot be made by credit through the War Loan Deposit Account. Payment must be made in cash or other immediately available funds.

George L. Harrison,
President.

T

No...

TENDER FOR 90-DAY TREASURY BILLS

Dated February 23, 1939. Maturing May 24, 1939.

Dated at...

....1939

TO THE FEDERAL RESERVE BANK OF NEW YORK,
Fiscal Agent of the United States,
New York City, N. Y.

Pursuant to the provisions of Treasury Department Circular No. 418, as amended, and to the provisions of the public announcement on February 17, 1939, as issued by the Secretary of the Treasury, the undersigned offers to pay..* (Rate per 100) for a total amount of $.. (maturity value) of the Treasury bills therein described, or for any less amount that may be allotted, payment therefor to be made at your bank in cash or other immediately available funds on the date stated in the public announcement.

The Treasury bills for which tender is hereby made are to be dated February 23, 1939, and are to mature on May 24, 1939.

This tender will be inserted in special envelope entitled "Tender for Treasury bills."

IMPORTANT INSTRUCTIONS:

1. No tender for less than $1,000 will be considered, and each tender must be for an amount in multiples of $1,000 (maturity value). Also, if more than one price is offered, a separate form must be executed at each price.

2. If the person making the tender is a corporation, the form should be signed by an officer of the corporation authorized to make the tender, and the signing of the form by an officer of the corporation will be construed as a representation by him that he has been so authorized. If the tender is made by a partnership, it should be signed by a member of the firm, who should sign in the form "..., a copartnership, by..., a member of the firm."

3. Tenders will be accepted without cash deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by a deposit of 10 per cent of the face amount of Treasury bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

4. If the language of this form is changed in any respect, which, in the opinion of the Secretary of the Treasury, is material, the tender may be disregarded.

Payment by credit through War Loan Deposit Account will not be permitted.

Before signing fill in all required spaces.

Name of Subscriber...
(Please print)

By..., ...
(Official signature) (Title)

Street Address ....

City, Town or Village, and State...

SPACES BELOW ARE FOR THE USE OF THE FEDERAL RESERVE BANK

Examined	Carded	Classified	Ledger	Acknowledged		Disposition

Allotment	Figured	Checked	Advised	Method of Payment	Amount	Date Released	By

Received	Checked	Recorded	Window	Custody	Mail	Other Departments

TENTB-451-*a*

* *Price should be expressed on the basis of 100, with not more than three decimal places, e.g., 99.125. Fractions must not be used.*

FEDERAL RESERVE BANK
OF NEW YORK

February 20, 1939.

ANNUAL REPORT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

We are sending to you, herewith, a pamphlet containing excerpts from the Twenty-fifth Annual Report of the Board of Governors of the Federal Reserve System. While it may be that you have received a copy of the complete Annual Report, or of this pamphlet, direct from the Board of Governors, the character of the information which it contains makes it seem desirable to us to run the risk of duplication in bringing it to your attention.

That part of the Annual Report of the Board of Governors, contained in the accompanying pamphlet, discusses what the Board deems to be major problems in the field of banking and credit administration. It contains no specific recommendations for new legislation or for administrative changes, but it points to the desirability of thorough and intensive study of these and related problems, by those who are interested in our banking and credit system.

We believe that a widespread knowledge of these problems is essential to success in their solution.

George L. Harrison,
President.

PROBLEMS

OF

BANKING AND BANK SUPERVISION

EXCERPTS FROM 1938 ANNUAL REPORT OF THE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

UNITED STATES OF AMERICA
WASHINGTON: 1939

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EXCERPTS FROM 1938 ANNUAL REPORT OF THE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

UNITED STATES OF AMERICA
WASHINGTON: 1939

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

December 31, 1938

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PHILIP E. BRADLEY, *Assistant Chief, Division of Security Loans*
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JOSEPHINE E. LALLY, *Deputy Fiscal Agent*

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PROBLEMS OF BANKING AND BANK SUPERVISION

FOREWORD

The present, when our banking system is under no stress, is an appropriate time to present to Congress a picture of the banking problems of today. The Board is convinced that it would be derelict in the discharge of its responsibilities if it failed to call to the attention of Congress such defects in our banking machinery, from the monetary, credit, and supervisory point of view, as still exist, notwithstanding the important improvements that have been made by Congress in recent years. This is a necessary first step in preparing the ground for such further improvements, within the general framework of our State and national banking systems, as Congress may deem advisable in order to enable the banking mechanism better to withstand stresses and strains to which it may be subjected in the future as it has been in the past. This report is confined to a discussion of major problems in the banking field and no attempt has been made to cover all the matters in this field that require consideration at this time. The Board stands ready to offer all the assistance in considering this subject that Congress may desire and that the Board is able to contribute.

Banking is a business vested with a public interest. The current financial needs of commerce, industry, and agriculture are met largely through the individual actions of the 15,000 separate banks in operation in this country. The volume of their loans and investments has a direct relationship to the volume of business activity, and the deposits created by these loans and investments, as they pass from hand to hand, are the medium through which the bulk of the nation's payments are made.

Successful operation of our banking institutions is, therefore, necessary to the orderly functioning of the nation's business. It is not merely the concern of those who have invested their money in the banking business, nor merely of those who have entrusted their deposits to the banks. It is also a matter of public concern, both because of the importance of safeguarding deposits and because of the part that the banks play in maintaining the flow of goods and services through the channels of production and distribution, from the farm, the forest, and the mine to the ultimate consumer. Interference with the orderly functioning of banks, whether through bank failures or otherwise, results in the elimination of an habitual source of financial assistance on which the banks' customers have relied, and in the loss or tying up of deposits belonging to the depositors who have made their business and personal plans in the assurance that they have this money at their disposal. The degree of eagerness of banks to extend credit and their ability to do so have an important influence on the course of business, because these factors result in an expansion or a contraction of loans and investments, and in changes in the volume of deposits, which are the country's principal medium of exchange.

SUMMARY

Composition of the Banking System and Trends in Banking.—At the present time our banking system, as considered in this report, consists of about 15,000 banks. National banks, which are chartered by the Federal Government, constitute about one-third of the number, and nearly all the rest are chartered by the forty-eight State authorities. All of the national banks and about 10 percent of the State banks are members of the Federal Reserve System, and these members hold 70 percent of total bank deposits and 85 percent of deposits at commercial banks. All but about 1,500 banks are insured by the Federal Deposit Insurance Corporation, which covers deposits up to $5,000 for each depositor. Of the total of approximately $60,000,000,000 of bank deposits at the present time, 45 percent is at national banks, 25 percent at State member banks, and the remainder at nonmember banks. Although about 85 percent of all bank depositors are protected in whole or in part by Federal deposit insurance, only about 38 percent of the aggregate amount of deposits is covered.

Since 1921 the number of banks has been approximately cut in two, principally by bank failures, which have resulted in losses to depositors of over $2,000,000,000. While the amount of bank deposits at present is larger than it has been at any previous time, and while in general the country has ample and in some localities excessive banking facilities, there may be some localities that do not have adequate banking service.

The nature of bank operations and the composition of bank assets have been greatly changed in recent years. Commercial borrowing at banks has declined. In the last decade, with the growth of the public debt, securities of the United States Government have become an increasingly important part of bank portfolios and now constitute over one-third of their total earning assets.

Public Supervision of Banks.—*Its Growth and Pattern.*—Recognition of the public interest in banking is indicated by the fact that banks have been subject to public supervision for nearly a hundred years. Banking legislation, State and national, has reflected the cumulative results of attempts by various governmental authorities to meet competitive conditions and specific situations and emergencies. As a consequence, the development of the mechanism of supervision has been piecemeal in character and not in accordance with comprehensive plans made with reference to the country's banking needs taken as a whole. From this process the banking picture emerges as a crazy quilt of conflicting powers and jurisdictions, of overlapping authorities and gaps in authority, of restrictions making it difficult for banks to serve their communities and make a living, and of conditions making it next to impossible for public authorities to apply adequate restraints at a time and in conditions when this may be in the public interest. A chart showing the confusion of jurisdictions under which the banks function appears on page 9.

Discriminations.—Different classes of banks are subject to different laws and jurisdictions, and these differences in many cases constitute competitive disadvantages, particularly for national banks and other members of the Federal Reserve System. The Board of Governors and the officers of the Federal Reserve banks strive to encourage eligible non-member banks to become members of the Federal Reserve System, yet there are provisions of law that tend to discourage membership since they apply to member and not to nonmember banks. Among such provisions, for example, are those that restrict banks in charging exchange, prescribe the minimum capital for the establishment of banks and branches, establish requirements for reserves against deposits, and limit the character of bank investments.[1]

Supervisory Responsibility Diffused.—Forty-eight State authorities and the Federal Government share the responsibility for bank supervision. Within the Federal Government authority over the banks is scattered among several agencies. The Comptroller of the Currency has the responsibility for the chartering and closing of national banks and the primary responsibility for their examination and supervision. The Federal Reserve System has some degree of supervision over all member banks, but in matters relating to national banks the primary responsibility is with the Comptroller, and in those pertaining to State member banks it is with State supervisory authorities. The Federal Deposit Insurance Corporation has definite responsibilities in regard to all insured banks, and exercises its supervisory powers particularly in the case of insured banks which are not members of the Federal Reserve System. The Treasury Department, under the emergency laws of 1933, still has the responsibility for licensing member banks and for approval of the purchase of bank stock by the Reconstruction Finance Corporation. This Corporation, because of its authority to make loans to banks and to purchase preferred stock and debentures from them, has proprietary and contractual powers of supervision over such banks as receive loans or capital from the Corporation.

As a consequence of this diffusion of authority, the banks themselves

[1] Provisions of law that also result in discrimination include restrictions on interlocking directorates, on loans to officers, and on other matters discussed on pages 10 and 11.

are frequently confused about the agency with which they must deal and by the variety of regulations. While cooperative arrangements have been worked out among the various governmental agencies by which banks are generally not subjected to separate examinations by more than one authority, the power to examine banks is possessed by several agencies and this power can be used. There are many regulations relating to various banking operations, the responsibility for which is divided between several authorities. For example, the power to determine maximum rates of interest to be paid on time deposits is divided between the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation. The same division exists in connection with enforcement of the law prohibiting the paying of interest on demand deposits. The power of granting and supervising the exercise of trust powers by national banks is divided between the Board of Governors and the Comptroller of the Currency. There are many other similar instances.

As a consequence of the diffusion of responsibility and diversity of authority over the banks there is often uncertainty of decision and delay in action where promptness is important in the public interest.

Problem of Uniformity in Examination Policy.—Diffusion of authority has also been responsible for difficulties in establishing uniform policies in connection with bank examinations. While a voluntary agreement has been worked out between the three principal Federal supervisory agencies—the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Board of Governors—the permanence of this arrangement depends on continuous agreement between the agencies on the policies involved, and its effectiveness depends on a uniform interpretation of the policies adopted. The interpretation, however, may vary from time to time in accordance with the points of view of those responsible for the policies of the three agencies.

Relation Between Supervisory and Credit Policies.—The Board wishes to raise a broad question as to the relationship that should exist between general credit policies and policies pursued in the examination and supervision of banks. There have been times in the past when these policies have worked in opposite directions, with a consequent aggravation of deflationary and inflationary trends.

This report presents for consideration the problem whether and, if so, by what method examination policies could be so harmonized with credit policies as to become jointly a stabilizing force in the national economy.

Nature and Function of Bank Reserves.—The Federal Reserve System's power to influence credit conditions as an aid to greater economic stability arises largely out of its ability to regulate the volume of member bank reserves. This subject was discussed at length in the Annual Report for 1936.

To state it briefly, under our system member banks are obliged to keep reserves in amounts equal to a definite proportion of their deposit liabilities. Consequently, in order to extend more credit, a bank must have reserves in excess of its existing requirements or be able to obtain such reserves. By increasing or decreasing the amount of reserves available to the banks, the Federal Reserve authorities may encourage or discourage the expansion of bank credit, particularly at times when the banks have a limited amount of unused reserves. Changes in the amount of unused reserves of member banks can be effected by the System through purchases or sales of United States Government securities in the open market, through discounts for member banks at the discount rate, and through changes in reserve requirements.

Growth of Reserves in Recent Years.—Bank reserves, however, are influenced also by developments over which the System has no control, such as gold imports and issues of silver certificates by the Treasury. Since the amount of money that remains in circulation is determined by the people's habits and needs for cash and not by the amount of currency issued, currency of any kind issued not in direct response to current needs of the public is deposited in the banks and is added to bank reserves.

In considering the problems of credit regulation in the future, the banking authorities are faced with the effects of the rapid growth of bank reserves in recent years. In the five years from 1933 to 1938 this growth has amounted to $6,000,000,000, due to additions to the gold stock and the issuance of silver certificates by the Treasury. When gold comes into the country and the Treasury purchases it, the funds thus released by the Treasury come into possession of the banks and become bank reserves, and when silver certificates are issued by the Treasury this also adds an equivalent amount to the reserves of member banks. The amount of reserves needed by banks has been augmented by the increase in reserve requirements and by the growth in deposits, but their reserves now exceed requirements by $3,600,000,000. This amount of excess reserves can be more than doubled, even without further gold imports or silver purchases, through disbursement by the Treasury of amounts equivalent to the gold it holds in the Stabilization Fund and elsewhere, by a reduction of its unusually large balances with the Federal Reserve banks, and by the issuance of silver certificates against the free silver bullion now in the Treasury's possession. This leaves out of consideration the Treasury's authority to issue United States notes. The Treasury can also absorb member bank reserves by increasing its cash holdings and its Federal Reserve balances. Under existing conditions the Treasury's powers to influence member bank reserves outweigh those possessed by the Federal Reserve System.

System's Powers to Control Excess Reserves.—Under the present law the Federal Reserve System can absorb excess reserves only to the extent of approximately $800,000,000, the amount by which it can increase member bank reserve requirements, and the additional amounts that could be taken up by such sales out of its portfolio of $2,560,000,000 of Government securities as may be in the public interest. After the System had done all in its power to absorb excess reserves, a considerable amount would remain at the disposal of the banks. In view of the many changes in bank assets and in money market conditions that have occurred in recent years, only experience can determine at what level of excess reserves banks will be responsive to Federal Reserve policy. It is clear, however, that the present and prospective volume of excess reserves may at some time become the basis of an injurious credit expansion. If this should develop, the Federal Reserve System with its present powers might not be in a position to carry out the mandate of Congress to prevent such an expansion.

The Board is convinced that there is no immediate prospect of excessive expansion of bank credit and no reason to change the present policy of monetary ease adopted for the purpose of facilitating recovery. It believes, however, that the present is an appropriate time to review our banking, credit, and monetary system in order that Congress may consider such changes and improvements as appear desirable.

THE BANKING SYSTEM TODAY

Composition of the Banking System.—A brief statement about the number and size of the different types of banks that exist today, and the changes that have occurred in recent years in the character of the banking business, will supply a background for the banking picture with reference to which banking laws and banking administration will be considered in this report.

Our banking system is the result of an evolutionary development. At the time of the passage of the National Bank Act in 1863, all incorporated banks were under State authority. After establishment of the national banking system, supervision of a large part of the country's commercial banking resources passed to the Federal Government. Upon this composite structure of national and State banks was superimposed in 1913 the Federal Reserve System, which extended Federal supervision to such State banks as joined the System. In 1933 the organization of the Federal Deposit Insurance Corporation extended Federal supervision to all banks having Federal insurance of deposits.

The number and deposits of the principal groups of banks as of June 30, 1938, are shown in the following table. The total includes all commercial banks and trust companies in the United States and some private banks, as well as mutual and stock savings banks and a few so-called industrial banks. The figures do not include institutions which may engage in some banking operations but which are not generally considered as being primarily banks. For example, security brokers, land

BANKING STRUCTURE OF THE UNITED STATES

June 30, 1938

	Number of banks	Gross deposits[1] (in millions of dollars)	Percent of total	
			Number of banks	Deposits
All banks	15,287	59,044	100	100
Insured banks:				
National	5,242	26,763	34	45
State member	1,096	14,546	7	25
Insured nonmember	7,437	7,123	49	12
Noninsured banks	1,512	10,612	10	18

[1] Include interbank deposits.

banks, building and savings and loan associations, mortgage companies, finance companies, and credit agencies owned in whole or in part by the Federal Government are not included.

In this table, so arranged as to show the four principal groups of banks from the supervisory point of view, the first two groups together comprise all member banks of the Federal Reserve System, and the first three together all represent banks insured by the Federal Deposit Insurance Corporation. The table shows that 41 percent of all banks are members of the Federal Reserve System, that they hold 70 percent of deposits, that 90 percent of all banks are insured, and that these insured banks hold 82 percent of all deposits. Of the total amount of bank deposits about 38 percent is covered by Federal deposit insurance.

Ten percent of the banks with 18 percent of deposits are noninsured banks. Most of the deposits of noninsured banks are in about 600 mutual savings and private banks. Leaving these out, all but 900 commercial banks with $900,000,000 of deposits are covered by Federal deposit insurance.

The number of banks in operation at present is only about one-half as large as in 1921. Through failures and consolidations the number of banks has been reduced from 30,000 to 15,000. The banks which suspended held deposits of about $8,500,000,000, of which about one-fourth has been lost to depositors. The aggregate volume of deposits of the banking system, however, has generally grown, except in the three years from 1930 to 1933, and at the end of 1938 was larger than at any previous time.

Changes in Character of Banking.—The character of the banking business has undergone considerable change in the past twenty years. Increasing use of the corporate form of business enterprise, together with the growth in the importance of large concerns and in the custom of meeting corporate financial needs through security issues or out of retained earnings, has resulted in a decline in the extent to which business relies upon banks for commercial loans. There has also been in recent years an increase in the amount of savings deposited in banks, which has placed on the banks the responsibility for the investment of these funds.

During recent years, with the decrease in demand for commercial loans and the increase in funds held by banks, there has been a pronounced change in the nature of bank assets. Holdings of Government and other securities and loans on real estate have increased, while commercial loans have diminished in importance. Banks have been forced to find outlets for the funds through channels other than those which were customary in former days and this has been reflected in revisions of banking laws relating to mortgages, of regulations applicable to bank investments, and a liberalization of the basis of borrowing from the Federal Reserve banks.

Laws and Jurisdictions to Which Banks Are Subject.—As has been pointed out above, the banks of the country, viewed in relation to the laws and supervisory authorities to which they are subject, can be divided into four groups: (1) National banks; (2) State bank members of the Federal Reserve System; (3) Nonmember State banks covered by Federal deposit insurance; and (4) Noninsured State banks. Of these four groups of banks the first three are covered by Federal deposit insurance. The network of laws and regulations to which these banks are subject is illustrated by the chart on page 9.

Summarizing the matter briefly, and in reverse order, noninsured State banks are subject to only a few Federal banking laws and are almost entirely controlled by State laws and authorities.

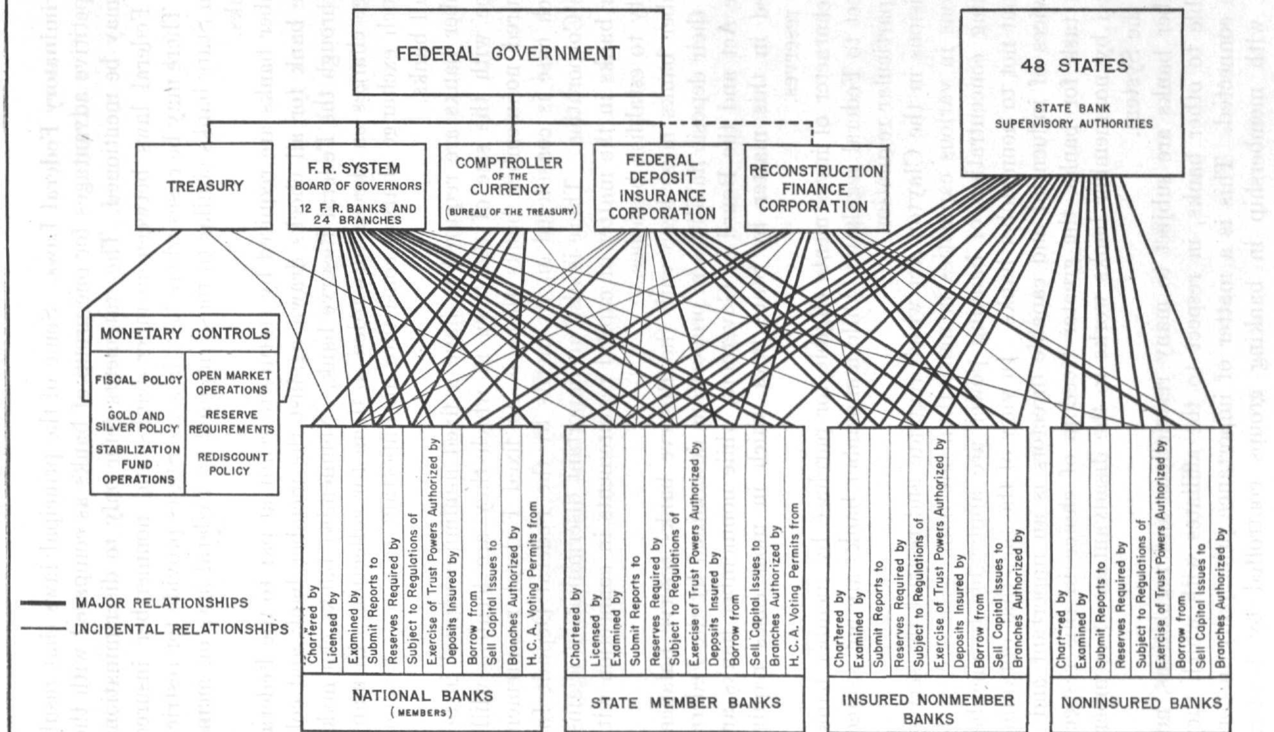
Insured nonmember banks are subject to State laws and to such Federal banking laws as apply to all banks whose deposits are covered in whole or in part by Federal deposit insurance.

State bank members of the Federal Reserve System are subject to three sets of laws: State laws; Federal laws connected with Federal deposit insurance; and other Federal laws applicable to members of the Federal Reserve System.

National banks are governed by Federal banking laws, some applicable to them as banks chartered by the Federal Government, some as members of the Federal Reserve System, and some because they are insured by the Federal Deposit Insurance Corporation.

Out of this complicated network of independent laws and overlapping jurisdictions and authorities arise many discriminations against one or another group of banks. When national laws are compared with State laws the comparison has to be made with 48 different sets of laws. It is obvious that such a comparison cannot be made in detail within the scope of this report. Some of the outstanding differences between the various laws in effect have to do with capital requirements for the organization of banks, with the character of loans and investments permitted, with amounts permissible to be loaned to an individual, with

PRINCIPAL BANK SUPERVISORY RELATIONSHIPS



the establishment of branches, and with the charging of exchange on checks.

Discriminatory Federal Laws.—Some of the principal laws that result in competitive advantages for one group of banks as compared with the others may be mentioned. The statements refer only to discriminations in the Federal laws between member banks and nonmember insured banks. There may be cases where laws in some States provide for restrictions on State banks similar to those imposed by Federal laws on member banks.

Member banks are required by statute to remit at par to the Federal Reserve bank for all checks drawn against the member bank and collected through the Federal Reserve bank. Nonmember banks can make exchange charges on checks forwarded to them for collection. In many cases such exchange charges constitute an important source of revenue for small banks.

Member banks are required to have a fixed minimum capital in accordance with the size of the town in which they are located, while for insured nonmember banks there is no fixed Federal requirement and each case is considered on its merits by the Federal Deposit Insurance Corporation. There is also an important discrimination against member banks in the matter of capital requirements in connection with authority to establish branches.

Member banks must keep with the Reserve banks reserve balances against their deposit liabilities in proportions determined by the Federal Reserve Act and the Board of Governors, while nonmember banks are governed in this matter by State laws which in most cases require smaller reserves.

The character of investments eligible for purchase by member banks is subject to Federal regulation while nonmember banks are not subject to this particular regulation.

Provisions in the Clayton Act which regulate and restrict the service of persons in various capacities in more than one bank with a view to preventing concentration of banking power are applicable to member banks but not to nonmember banks. In view of the fact that obtaining the services of influential and capable directors is an important and a difficult task for banks, the greater freedom of choice in this respect possessed by nonmember banks works to the disadvantage of membership in the System.

Member banks are subject to many restrictions and regulations, not applicable to other banks, in respect to the affiliates with which they may be connected. This is a matter of importance principally in connection with membership in banking groups controlled by holding companies.

Member banks, but not other banks, are also subject to Federal laws by authority of which officers and directors may be removed by the

Board of Governors in cases of continued violation of law or continued unsafe or unsound practices. This provision of law was designed to strengthen the hand of supervisory authorities in promoting sound banking conditions, short of taking steps that would result in the suspension of the bank.

Member banks, but not other banks, are subject to Federal restrictions and limitations regarding loans to officers.

A list of all Federal statutory provisions that do not apply uniformly to all banks subject to Federal supervision is too lengthy for the report. A partial list appears in the Appendix.

The application of some of these laws singly or in combination tends to discourage membership in the Federal Reserve System. Specific instances have come to the attention of the Board of Governors during the past year.

A number of national banks have recently surrendered their national charters and taken State charters because they can operate branches with less capital under State law; a number of State banks which desire to join the Federal Reserve System have been prevented from doing so because they have branches and do not have the capital required by Federal law for the operation of branches by State member banks; and a number of banks have threatened to withdraw from the System rather than give up valued directors because of the provisions of the Clayton Act. Many State banks in the Mississippi Valley and the South Atlantic States refrain from joining the Federal Reserve System because members of the System are required to be members of the par clearance system while nonmember banks may deduct exchange charges. There have been withdrawals from the Federal Reserve System for which the same reason was given.

These are but a few illustrations of the many ways in which the Federal banking laws discourage membership in the Federal Reserve System and encourage banks to continue to operate as nonmember banks.

BANK SUPERVISION

Allocations of Authority.—Not only do laws regulating bank operations differ for different groups of banks, but banks are also subject to a number of different supervisory authorities and to diverse regulations issued and enforced by such authorities.

Supervision and regulation of banks differ materially from State to State as well as between banks that are chartered by States and those that are chartered by the Federal Government. Even within the Federal Government there is extensive diversity, overlapping, and confusion of jurisdiction in the regulation and supervision of different groups of banks. There are five Federal agencies engaged in bank supervision. Prior to 1933, Federal supervision of the commercial banking system, in so far as it was subject to such supervision, was in the hands of the Comptroller of the Currency and the Federal Reserve Board. Since 1933 there has been added the Federal Deposit Insurance Corporation, which exercises broad supervisory powers. Certain powers of the Reconstruction Finance Corporation also give it a measure of responsibility for the operation of banks, and the Secretary of the Treasury, through the exercise of authority under the President's emergency powers, licenses the operation of member banks and has authority to exercise other regulatory powers.

Broadly speaking, the function of the Comptroller of the Currency is to charter and supervise national banks and, when necessary, to appoint conservators or to close and supervise the liquidation of national banks. When the Comptroller closes a bank, however, on account of its inability to meet the demands of its depositors, he is required to appoint the Federal Deposit Insurance Corporation as receiver.

The Federal Reserve System has authority to supervise and examine all banks that are members of the System and to lay down requirements for admission of State banks to membership. But in relation to national banks its authority is parallel to a considerable extent with that of the Comptroller of the Currency, and in regard to State banks with those of State supervisory authorities. When banks receive national charters from the Comptroller, they become members of the Federal Reserve System, without any action by the Board of Governors, and State banks, while they can join the System only with its approval, bring with them charter rights obtained from State authorities.

The supervisory functions of the Federal Deposit Insurance Corporation revolve around the insurance of deposits of banks that are insured and the termination of this insurance. Supervisory functions of the Federal Deposit Insurance Corporation relating to State insured banks parallel to some extent the functions exercised by State authorities and as to national banks and State member banks duplicate to some extent the functions of the Comptroller of the Currency and the Federal Reserve System. National banks chartered by the Comptroller of the Currency and State banks admitted to membership in the Federal Reserve System are all insured by the Federal Deposit Insurance Corporation.

The supervisory activities of the Reconstruction Finance Corporation occur in connection with the purchase and ownership of preferred stock and capital notes and debentures of banks. These activities are not based directly on legal requirements but indirectly on the proprietary and contractual relationships between the Corporation and the banks.

Confusion and Conflict of Authority.—In many matters there are divisions of authority, both in the law vesting the authority and in its exercise.

For instance, the Comptroller of the Currency issues regulations defining and governing the purchase of investment securities by national banks. The regulations, however, are applicable also to State member banks but not to insured nonmember banks. The Comptroller of the Currency enforces the regulations with respect to national banks and the Reserve System enforces them with respect to State member banks.

A similar situation exists in relation to the exercise of trust powers by national banks. Authority to grant trust powers and to issue regulations rests with the Board of Governors. Supervision over the exercise of these powers and over compliance with these regulations, however, is in the hands of the Comptroller of the Currency.

Confusion and conflict of authority exist also in the matter of regulation of interest to be paid by banks on deposits. Payment of interest on demand deposits is prohibited for all insured banks, including national banks, State member banks, and insured nonmember banks. This would appear to be a simple matter. But application of the definition of interest to particular cases is not simple and has many implications. It has, for example, an important bearing on the practice of city banks in absorbing expenses and exchange charges on items collected for country correspondents in return for the maintenance of balances. There is, however, no single authority having power to administer this law. In regard to member banks it is administered by the Board of Governors and in regard to nonmember insured banks by the Federal Deposit Insurance Corporation. The Federal Deposit Insurance Corporation enforces its own regulation, but the Board's regulation, in so far as it applies to national banks, is administered by the Comptroller of the Currency. Determination of the maximum rate of interest to be paid on time deposits is made for member banks by the Board of Governors and for nonmember insured banks by the Federal Deposit Insurance Corporation.

The Federal Reserve System is charged with the administration of the law regarding holding company affiliates of member banks; but the same holding company sometimes controls national banks supervised primarily by the Comptroller of the Currency, State member banks supervised principally by the States and the Federal Reserve System, nonmember insured banks supervised principally by the States and the Federal Deposit Insurance Corporation, and non-banking corporations which are required to submit to examinations and to furnish reports of condition to the Federal Reserve System or the Comptroller of the Currency but usually are not subjected to any further supervision by bank supervisory agencies. Such situations involve additional overlapping, conflicts, and gaps in authority.

The conflicts of authority in bank supervision cause much confusion and delay and not infrequently prevent prompt action in cases where quick decision is necessary to prevent losses to the public and to remedy critical situations.

In one case, for example, an excessively long period of time elapsed between initiation of negotiations and the final consummation of a plan for the relief of a dangerous banking situation in an overbanked community in which were located two State member banks and a national bank, all in an unsatisfactory condition. The lapse of time was largely due to the fact that the plan for working out the situation had to be satisfactory not only to the local interests and to the State banking authorities, but to the following Federal agencies: the Reconstruction Finance Corporation, which purchased preferred stock in the new bank organized to succeed the three; the Secretary of the Treasury, who had first to request the Reconstruction Finance Corporation to subscribe to the preferred stock and then had to license the new bank; the Federal Deposit Insurance Corporation, which made a loan to the national bank; the Comptroller of the Currency, whose cooperation was necessary in order that the national bank might be included in the program; and the Federal Reserve bank of the district and the Board of Governors, in connection with the admission of the new bank to membership in the System. Officials and examiners of all these agencies were participants in numerous conferences, both at Washington and in the field.

In the case of another national bank, while the Federal Deposit Insurance Corporation was preparing to institute proceedings to terminate the bank's insurance, which might be expected to end in the appointment of the Federal Deposit Insurance Corporation as receiver, the Comptroller of the Currency filed a certificate with the Board of Governors instituting proceedings against the president of the bank to remove him from office under authority granted by the Banking Act of 1933. The Board then initiated a hearing but, while this proceeding was under way, the Comptroller of the Currency found it necessary to appoint a conservator. After the conservator was appointed, the Board proceedings were concluded and the president of the bank was removed from office. Subsequently the conservator was supplanted by the Federal Deposit Insurance Corporation as receiver.

There are cases of banks threatening to give up national charters in order to escape regulation and supervision by the Comptroller of the Currency; of other banks threatening to retire from the Federal Reserve System in order to escape regulation and supervision by the Reserve System; and of still other banks threatening to join the Federal Reserve System in order to escape some requirements or conditions imposed by the Federal Deposit Insurance Corporation.

In practice there is less confusion in many of the supervisory activities of the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation than in the authority under which these agencies act. Bank examinations are an example. Generally speaking, national banks are examined only by the Comptroller of the Currency; the Federal Reserve System has power to examine all member banks but does not examine national banks and examines State member banks in cooperation with State authorities, and State member banks are not examined by either the Comptroller of the Currency or the Federal Deposit Insurance Corporation; the Federal Deposit Insurance Corporation in cooperation with State authorities examines the insured State banks which are not members of the Reserve System. The Federal Deposit Insurance Corporation has power to examine national banks, with the permission of the Comptroller of the Currency, and State member banks, with the permission of the Board of Governors. Such examinations, however, are seldom made. State banks belonging to the Reserve System and insured nonmember banks are examined by Federal, as well as by State, authorities but the extent of duplication in this respect is reduced through arrangements for joint or alternating examinations. In practice, therefore, the effect of these conflicting authorities to examine banks has been minimized by agreement by which the Federal agencies accept each other's examinations, but the authority, nevertheless, exists and can be used.

Somewhat the same situation exists as regards condition, dividend, and other reports, and their publication. The Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Reserve System all have powers and responsibilities in this field. They all maintain, in addition to examination departments, statistical organizations, and here again only agreements moderate the bad effects of duplicate and conflicting requirements.

While duplication in reports and examinations by different Federal agencies is largely avoided by cooperative arrangements, nevertheless delays and difficulties arise from the overlapping of responsibility. Even after an agreement is reached, there may be, and in fact, there are, differences of interpretation of the procedure, formula, or policy agreed upon.

For example, after lengthy negotiations a voluntary agreement between the agencies in connection with examination policy was reached last summer.[1] The effectiveness of this agreement, however, depends, in the first place, on the continuance of cooperation between the agencies and, in the second place, on the nature of interpretations placed by the different agencies on the agreed principles of examination. A similarity of interpretation is difficult to attain because the agencies have different responsibilities and, therefore, different approaches to the problem. The Comptroller of the Currency is primarily a supervisory and examining agency and is interested principally in matters affecting the status of individual banks. The Federal Deposit Insurance Corporation is primarily an insurance agency and is, therefore, primarily concerned about the protection of the insurance fund. The Board of Governors, in addition to its supervisory responsibilities, is concerned with national credit and monetary policies, and is, therefore, interested in supervisory policies

[1] See Appendix.

that are in conformity with credit policies. Such policies must look not only to the status of individual banks and the safeguarding of the interests of depositors, but also to the maintenance of sound credit conditions in the aggregate and a sound banking system, without which credit policies cannot be effectively put into operation.

While the ultimate objective of all the agencies concerned is a sound banking condition and an unimpeded flow of funds to finance commerce, industry, and agriculture, the different points of approach to the problem by the different agencies inevitably lead to differences in emphasis in the interpretation of principles of policy.

RELATION BETWEEN SUPERVISORY AND CREDIT POLICIES

The agreement upon examination procedure which has been mentioned marks a cooperative forward step by the agencies concerned. The fundamental question as to what should be the relationship between the administration of national credit policies and of bank examination and supervision, however, still remains and is of so vital importance as to deserve careful consideration by Congress.

Criticism has been directed in recent years at supervising authorities for the influence they have exercised towards the curtailment of credit at times when such curtailment has been contrary to prevailing national credit policies and has tended to retard economic recovery. There are wide differences of opinion on this subject and it deserves full and fair exploration and consideration.

Some of the questions that may be considered in this connection are here presented:

What effect does bank supervision have on changes in the outstanding volume of bank credit?

What influence do examinations have on the expansion or contraction of credit during the different phases of the business cycle?

Should examination policy be so directed as to contribute to the protection of the general economy from the effects of undue expansion or contraction of credit?

What distinction, if any, exists between the considerations upon which a sound national credit policy should be based and the measures that should be taken to insure the soundness of individual banks?

Is harmony between examination policies and credit policies necessary to the discharge of the responsibilities of the agencies vested with authority to determine these policies?

Consideration should be given to the question whether examiners' appraisals of loans and investments based on current conditions and market quotations may at times accelerate the downward spiral of a depression or delay recovery; also whether at other times examiners, in passing on loans which may be currently collectible, fail to take into consideration the existence of a tendency towards unsound credit conditions and to exert a restraining influence on boom conditions. This may result from the fact that in a period of decline current quotations may merely reflect the temporary absence of a fair market, and may understate intrinsic values, while in a boom period market quotations may reflect speculative expectations rather than true values.

May efforts of supervisory agencies to produce increased bank liquidity at times of low business activity and depressed markets have unanticipated and unintended adverse effects upon the local community, and may these local effects, when aggregated, exert a general deflationary influence on business and credit conditions in the country as a whole?

In considering relationships between examination policies and general credit policies, it would be desirable to determine whether bank supervisory authorities should exert their influence to encourage extension of sound credit by banks at times when they have funds available and when such extension of credit may be helpful to the national economy; and, on the other hand, whether at times of unduly rapid growth of bank credit the influence of these agencies should be exerted to discourage banks from freely making loans, even of the kinds that ordinarily could be made with apparent safety by a particular bank. This question involves consideration of the relationship between the extension of credit at certain times by particular banks and the broader and longer-range problem of nationwide credit expansion.

Consideration might also be given to the possible effect on the general economy of rigid definitions of the character of loans and investments that may be made by banks. May such definitions cause unnecessary liquidation at certain times and result in the holding of idle funds at other times? Has the problem of definition of assets that banks may acquire been affected by changes that have been made in recent years in the laws, regulations, and conditions governing assets on which banks can borrow from the Federal Reserve banks? Can agencies charged with the responsibility of determining general policies that affect the extension of credit by banks discharge this responsibility unless examinations, which affect the policies and practices of individual banks, are in harmony with these general credit policies?

The bank examiner in the field deals with local situations. He attempts to appraise assets in the light of such information as is available to him and values must be determined in many cases by local conditions. These conditions may relate to the position of the particular bank being examined or of the particular community. It is a problem of great complexity to find means by which this local procedure, when multiplied by the thousands of banks throughout the country, can be brought into conformity with national policies.

Can the examination policies of the several Federal supervisory agencies be further coordinated to promote effective functioning of the entire banking system, making it a force toward increased national economic stability? Furthermore, can the responsibilities vested in the Federal agencies and the agencies of the 48 States charged with the examination and supervision of their respective State banks also be properly coordinated to the same end?

It seems hardly possible to consider any of these questions singly. If they are considered as a whole and studied in the light of the past history of bank examination, of existing banking and credit conditions, and of the objectives to be sought, answers should be found which will go far toward producing a sounder and more flexible banking system.

THE PROBLEM OF RESERVES

Reserves and Credit Regulation.—The Federal Reserve System's power to influence the volume and cost of bank credit arises largely out of its authority over member bank reserves.

Under our system member banks are obliged to keep an amount equal to a prescribed proportion of their deposit liabilities in the form of reserve balances with the Federal Reserve banks. Reserve requirements for nonmember banks are determined by State authorities and are generally lower in effect than those prescribed for member banks. In order to extend more credit without themselves borrowing, member banks must have reserves in excess of their legal requirements. By increasing or decreasing the amount of reserves available to the banks, therefore, the Federal Reserve System can encourage or discourage the expansion of bank credit and bank deposits, particularly at a time when banks have little or no unused reserves. For a complete exposition of the functions of reserves and of reserve requirements, reference is made to the Board's Annual Report for 1936.

The usual situation in years gone by, when the pressure for credit expansion was considerable and the volume of reserves limited, was for the banks generally to have no reserves in excess of legal requirements. In other words the banks were at all times practically loaned up. An aggregate increase in their loans and investments, therefore, involved borrowing from the Federal Reserve banks in order to acquire additional reserves. When the banks are borrowing, they are less willing to make loans and they become subject to the discount rate and to other measures of regulation of their operations under provisions of the Federal Reserve Act. When the System wished to encourage the expansion of bank credit, it could take the initiative in increasing bank reserves by buying Government securities in the open market, which would place at the disposal of banks funds with which to pay off debt at the Reserve banks or to expand their own credit. On the other hand, when the System wished to restrain expansion, it could sell Government securities, thereby taking money out of the market and reducing reserves to the point where banks would have to borrow in order to expand. By further sales the System could reduce member bank reserves even below the amount needed to maintain the existing aggregate volume of loans and investments, and put the banks in a position of having the alternative of borrowing from the Reserve banks or contracting their loans and investments.

This was the main line of action in encouragement and restraint as long as the banks did not have a volume of reserves far in excess of their current needs. In recent years banks have had continuously a large amount of excess reserves. This is true at present, notwithstanding the fact that, in accordance with authority under the Banking Act of 1935, reserve requirements have been increased by approximately 75 percent above the percentages stated in the statute.

The entire technique of influencing changes in the volume of bank credit needs to be reconsidered in the light of changed banking and money market conditions. It is probable that the increased importance of holdings of Government securities and the shrinkage of the Street-loan account, through which individual banks were in the habit of making adjustments in their position in response to changing commercial demands, as well as other changes in the situation, have made the banking system more responsive than formerly to measures of restraint. One influence in this direction would come from the fact that sales of Government securities by the Reserve System, in addition to their effects on bank reserves, would have a direct effect on the capital market of which these securities now constitute an important part. The large holdings by the banks of such securities make the banks more sensitive to changes in bond prices. For these reasons it may not prove necessary in the future, as it has been in the past, for banks to be without excess reserves and actually to be borrowing from the Reserve banks in order to make them responsive to restraining influences.

Only experience can determine to what extent these changes in conditions have altered the effectiveness of existing methods of regulation. There is no doubt, however, that such a volume of excess reserves as is held by the banks today and as is likely to be at their disposal in the near future presents an important problem to the country's credit and monetary authorities.

Sources of Reserves.—Since the end of 1933 reserve balances of member banks have increased three-fold and at the end of 1938 totaled $8,700,000,000, of which $3,200,000,000 were excess reserves. As shown in the table, this growth in reserves has been due principally to the extraordinary inflow of gold from abroad. The country's monetary gold stock in dollars has increased during the five years by $10,500,000,000, of which $2,800,000,000 represents the effect of revaluation and $7,700,-000,000 additions of new gold from abroad and from domestic mines. A portion of this additional gold is still held by the Treasury in the

Stabilization Fund and otherwise and some of it was used to retire national bank notes in a manner that did not add to member bank reserves.

FACTORS OF CHANGE IN MEMBER BANK RESERVES

December 30, 1933, to December 31, 1938
(Approximate figures, in millions of dollars)

Additions due to:	
Gold operations	7,422
Issue of silver certificates	1,221
Total additions	8,643
Deductions due to increase in money in circulation, growth in Treasury and nonmember deposits at Federal Reserve banks, etc.	2,648
Total increase in member bank reserves	5,995
Increase in required reserves due to:	
Increase in percentage requirements	2,342
Increase in member bank deposits	1,307
Increase in excess reserves	2,346
Changes in reserve position from December 30, 1933, to December 31, 1938:	
Total reserves	Increased from 2,729 to 8,724
Required reserves	Increased from 1,870 to 5,519
Excess reserves	Increased from 859 to 3,205

Of the inflow of gold from abroad, about two-thirds has resulted from the movement of foreign capital to the United States. Large and erratic movements of floating capital from country to country at a time of political uncertainty and financial disorganization have been one of the most disturbing factors in the financial fabric of post-war years. Such movements are not like capital movements for long-term investment or seasonal movements in connection with foreign trade, nor like movements in response to differences in interest rates, which have long been a part of the international financial mechanism. Large and sudden capital withdrawals tend to cause contraction of credit and to retard business activity in the country from which the capital is withdrawn. At the other end, accumulation of foreign funds in the money market which appears for the time to offer the best security or the greatest opportunity for profit is disturbing to the monetary and credit systems of the country where this market is located. These movements accentuate speculative changes in the security market and create either a condition of artificial monetary ease or the need of absorbing excess reserves at public or private expense. International capital movements account for the greater part of the reserve problem with which this country has to contend.

In addition to the gold inflow another source of reserves amounting to $1,200,000,000 has been the issuance by the Treasury of silver coin and certificates in connection with domestic and foreign silver purchases.

Additions to member bank reserves from the above sources have been absorbed to the extent of $2,600,000,000 by increases in the demand for currency and through growth of Treasury and nonmember bank deposits at the Federal Reserve banks.

As a net result of all these developments and transactions, $6,000,000,000 was added to member bank reserves in the five years 1934-1938. Of this amount $3,650,000,000 was absorbed by increases in required reserves, due both to the increase in the prescribed ratios of reserves to deposits and to the growth in the banks' deposit liabilities. Excess reserves of member banks increased by $2,350,000,000 and at the end of 1938 were $3,200,000,000. In the early weeks of 1939, with a return flow of currency from circulation and a decline in Treasury balances, excess reserves increased to $3,600,000,000. A continuation of gold inflow and of silver purchases would further add to excess reserves.

The volume of excess reserves now in existence, furthermore, can be greatly increased by actions of the United States Treasury. By disbursements of funds equivalent to the gold held in the Stabilization Fund and elsewhere, by reduction of its unusually large balances with the Federal Reserve banks, and by the use of its authority to issue silver certificates against silver bullion now in its possession, the Treasury could more than double existing excess reserves of member banks. In addition, the Treasury has authority to issue up to $3,000,000,000 of United States notes which would also be added to member bank reserves. The Treasury also has power to absorb member bank reserves; it can do so by increasing its cash holdings and Federal Reserve balances. With these powers and the general gold and silver policies in the hands of the Treasury, its power to influence the volume of member bank reserves under existing conditions outweighs that of the Federal Reserve System.

Long-view Problem Raised by Excess Reserves.—In considering the problem of reserves at this time the Board wishes to emphasize that the long-view problem created by the existing large volume of bank deposits and bank reserves is distinct from the immediate problem of making ample bank credit available for the expansion of business from current levels.

In recent years it has been the policy of the Government and of the Federal Reserve System to encourage the expansion of credit. This has constituted the so-called policy of monetary ease, which has been directed at keeping banks supplied with an abundant volume of reserves, so as to encourage them to expand their loans and investments. This policy has been one of the factors in the creation of the existing large volume of deposits in the hands of business enterprises and of individual and corporate investors, and has resulted in reducing interest rates to the lowest level in history. It has been reflected in a decline in the carrying charges on mortgage debt for farmers and urban householders, has enabled many corporations to refund their debt at lower rates, and has lightened the cost of current financing to commerce, industry, and agriculture.

Nor is there any immediate reason for considering a reversal of this policy. There is nothing in the present monetary or banking situation that would point to a proximate danger of injurious credit expansion. It is in such a period as this, however, when there is no call for quick action to meet emergency situations, that problems that may arise in the future should be analyzed and the efficiency of existing machinery appraised.

It is from this point of view that the System's existing powers to absorb excess reserves should be considered. Member banks at present have excess reserves of $3,600,000,000, and this total may be doubled in the future. To absorb these reserves the System has the power to raise reserve requirements by $800,000,000 and to make sales out of its portfolio of United States Government obligations, which amounts to $2,560,000,000. The use of these available means of absorbing reserves, to the extent that it may be in the public interest to do so, would still leave the banks with a volume of excess reserves upon which it would be possible for an injurious credit expansion to develop.

The ability of the banks greatly to expand the volume of their credit without resort to the Federal Reserve banks would make it possible for a speculative situation to get under way that would be beyond the power of the System to check or control. The Reserve System would, therefore, be unable to discharge the responsibility placed upon it by Congress or to perform the service that the country rightly expects from it.

In view of this situation the Board has deemed it its duty to point out to Congress the present and prospective reserve position of our banking system and the limitations on the powers of the System to regulate it.

APPENDIX

COMPARISON OF SOME OF THE FEDERAL STATUTORY PROVISIONS REGULATING THE BUSINESS OF DIFFERENT CLASSES OF BANKS[1]

I. Federal statutory provisions applicable to national banks ONLY.

Restrictions on real estate loans.
Regulations governing exercise of trust powers.
Restrictions on acting as insurance agent.
Restrictions on acting as real estate loan broker.
Requirement that one-tenth of earnings be transferred to surplus until surplus equals common capital.
Prohibition against holding "other real estate" for more than five years.
Limitations on total loans to one borrower.[2]
Restrictions on absorption of another bank.
Limitations on indebtedness which bank may incur.

II. Federal statutory provisions applicable to all member banks, but NOT to nonmember insured banks (standards not necessarily uniform between national banks and State member banks).

Regulations governing purchase of investment securities.
Prohibition against purchasing stocks and engaging in underwriting of investment securities and stocks.
Restrictions on loans to executive officers.
Restrictions on dealings with directors.
Prohibition against paying preferential rate of interest on deposits of directors, officers, etc.
Restrictions on interlocking directorates or other interlocking relations with other banks.
Restrictions on interlocking directorates or other interlocking relations with securities companies.
Prohibition against bank having less than 5 or more than 25 directors.
Provision authorizing supervisory authority to remove officers or directors for continued violations of law or continued unsafe or unsound practices.
Prohibition against affiliation with securities company.
Restrictions on holding company affiliates.
Restrictions of bank stock representing stock of other corporations.
Limitations on loans to affiliates.
Limitations on investment in bank premises.
Minimum capital requirements.
Minimum capital requirements for branches.

[1] There are a few Federal banking laws which apply to all banks including noninsured banks. Among them are provisions of law restricting the receipt of deposits by nonbanking institutions, including securities companies; those regulating loans for the purpose of purchasing or carrying securities registered on national securities exchanges; and those granting certain tax advantages in connection with the operation of a common trust fund if operated in conformity with the regulations of the Board of Governors.

[2] Loans in excess of the limit fixed by the National Banking Act may not be discounted with a Federal Reserve bank by a State member bank but that part of a loan which is not excessive may be discounted by a national bank.

Prohibition against loaning on or purchasing own stock.
Restrictions on withdrawal of capital and payment of unearned dividends.
Requirement that reserves specified in Federal Reserve Act be maintained.
Prohibition against making loans or paying dividends while reserves deficient.
Requirements in connection with par clearance collection system.
Prohibition against false certification of checks.
Limitations on acceptance powers.
Prohibition against acting as agent for nonbanking institutions in making loans to brokers or dealers in securities.
Limitations on loans to one borrower on stocks or bonds.
Limitations on aggregate loans to all borrowers on stocks or bonds.
Limitations on deposits with nonmember banks.

III. Federal statutory provisions applicable to member banks and to nonmember insured banks (standards not necessarily uniform between national banks, State member banks, and insured nonmember banks).

Restrictions on establishment of branches.
Restrictions on consolidating or merging with noninsured bank, assuming liability for such bank's deposits, or transferring assets to such bank for assumption of deposits.
Restrictions on payment of interest on deposits.
Restrictions on paying time deposits before maturity or waiving notice before payment of savings deposits.
Prohibition against payment of dividends while delinquent on deposit insurance assessment.
Prohibition against loans or gratuities to bank examiners.
Provision authorizing supervisory authority to publish examination report if bank does not follow recommendation based thereon.
Provision authorizing supervisory authority to require that bank provide protection and indemnity against burglary, defalcation and similar insurable losses.

REVISION IN BANK EXAMINATION PROCEDURE

An important development during the year in the field of bank examination and supervision was the revision of procedure in bank examinations agreed to by the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the Directors of the Federal Deposit Insurance Corporation, and the Comptroller of the Currency. The agreement was reached in the summer and the revised procedure was made effective in September after the examination report forms had been revised to give effect to the changed procedure. Representatives of the National Association of Supervisors of State Banks were consulted in regard to the program and the Executive Committee of the Association agreed in principle with the program as adopted. The revised procedure has been made effective in many States and is being made effective in whole or in part in others.

The principal changes in the examination procedure were the abandonment of the "slow" classification of assets and recognition of the principle that bank investments should be considered in the light of inherent soundness rather than on the basis of day-to-day market fluctuations.

The "slow" classification had long been a source of irritation, complaint, and misunderstanding. By its very name it emphasized liquidity but the term was a misnomer inasmuch as the "slow" classification did not include all loans of longer maturities. The exact meaning of the term was not clear, nor could a substitute term be found to express clearly what was intended by the classification. Accordingly the old classifications of "slow," "doubtful," and "loss" as used in reports of examinations were discontinued and numerical classifications were adopted with the reports of examination containing definitions of the types of assets to be included in each classification. Under the new designations the principle is clearly recognized that in making loans banks should be encouraged to place emphasis upon soundness and intrinsic value rather than upon liquidity or quick maturity, and the examiners are expected to follow this principle in their examinations.

With respect to the appraisal of investment securities, the revised examination procedure is based on the view that the soundness of the banking system depends in the last analysis upon the soundness of the country's business and industrial enterprises and should not be measured by current market quotations which often fail to reflect true appraisals of intrinsic worth. Under the revised procedure, as formerly, stocks and defaulted securities are grouped separately and net depreciation in such issues based on current market prices is classified as loss to be charged off. Other securities, however, are divided into two groups which might be considered, broadly, as (1) securities of investment character, and (2) securities having distinctly or predominantly speculative characteristics. Appreciation or depreciation in securities in the first group is disregarded, and banks are permitted to carry these securities at book value with proper provision for amortization of premiums. Banks are also not required to charge off on their books any depreciation in securities in the second group. Such securities, however, are appraised in the report of examination on the basis of the average market price for 18 months preceding examination and in the computation of adjusted capital account of the bank, as shown in the report of examination, 50 percent of the net depreciation figured on such average basis is deducted. By separating appraisal of bank investments from current market quotations it was hoped that banks would be encouraged to purchase securities for true worth. The revised procedure also recognized the need for conservation of profits from the sale of securities, emphasized the necessity for the maintenance of adequate reserves to provide for possible losses in securities and other assets, and reaffirmed the position against the practice of speculation in securities.

In considering the question of bank examination and supervision recognition was given to the great changes which have occurred during the past 20 years in the composition and character of bank assets, the substantial decrease in the holdings of short-term, self-liquidating commercial paper, and the great increase in the holdings of investment securities, both in aggregate amount and as compared with total assets.

As a result of these developments, banks find it necessary to look, to a considerable extent at least, for other forms of loans to replace the lost volume of short-term commercial loans and to treat the security account more as a permanent investment account than as a means for the temporary investment of idle funds. Changes made by the Banking Act of 1935 in the law regarding advances by Federal Reserve banks and the revised regulation on this matter issued in 1937 by the Board of Governors were designed to assist banks to meet these changed conditions. The new policies with respect to bank examination and supervision were framed with the same end in view. The revised examination procedure does not represent a relaxation of standards. It was worked out as a measure which, with its emphasis upon fundamental soundness of assets of every type, would further the maintenance of a sound banking system and enable banks better to serve their depositors and their communities.

Following is a description of the revision of procedure in bank examinations as agreed to by the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the directors of the Federal Deposit Insurance Corporation, and the Comptroller of the Currency:

The Classification of Loans in Bank Examinations.—The present captions of the classification units, namely, "Slow," "Doubtful," and "Loss" are to be abandoned.

The classification units hereafter will be designated numerically and the following definitions thereof will be printed in examination reports:

I. Loans or portions thereof the repayment of which appears assured. These loans are not classified in the examination report.

II. Loans or portions thereof which appear to involve a substantial and unreasonable degree of risk to the bank by reason of an unfavorable record or other unsatisfactory characteristics noted in the examiner's comments. There exists in such loans the possibility of future loss to the bank unless they receive the careful and continued attention of the bank's management. No loan is so classified if ultimate repayment seems reasonably assured in view of the sound net worth of the maker or endorser, his earning capacity and character, or the protection of collateral or other security of sound intrinsic value.

III. Loans or portions thereof the ultimate collection of which is doubtful and in which a substantial loss is probable but not yet definitely ascertainable in amount. Loans so classified should receive the vigorous attention of the management with a view to salvaging whatever value may remain.

IV. Loans or portions thereof regarded by the examiner for reasons set forth in his comments as uncollectible and as estimated losses. Amounts so classified should be promptly charged off.

Present practice will be continued under which the totals of II, III and IV above are included in the recapitulation or summary of examiners' classifications.

Fifty percent of the total of III above and all of IV above will be deducted in computing the net sound capital of the bank.

The Appraisal of Bonds in Bank Examinations.—Neither appreciation nor depreciation in Group I securities will be shown in the report. Neither will be taken into account in figuring net sound capital of the bank.

Group I securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group includes general market obligations in the four highest grades and unrated securities of equivalent value.

The securities in Group II will be valued at the average market price for eighteen months just preceding examination and 50 percent of the net depreciation will be deducted in computing the net sound capital.

Group II securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes general market obligations in grades below the four highest, and unrated securities of equivalent value.

Present practice will be continued under which net depreciation in the securities in Group III and Group IV is classified as loss.

Group III securities: Securities in default.
Group IV securities: Stocks.

Present practice will be continued under which premiums on securities purchased at a premium must be amortized.

Present practice of listing all securities and showing their book value will be continued.

The Treatment of Securities Profits in Bank Examinations.—Until losses have been written off and adequate reserves established, the use of profits from the sale of securities for any purpose other than those, will not be approved.

Present practice will be continued under which estimated losses must be charged off.

Present practice will be continued under which the establishment and maintenance of adequate reserves, including reserves against the securities account, are encouraged.

Present practice will be continued under which speculation in securities is criticised and penalized.

REVISED REGULATION ISSUED BY THE COMPTROLLER OF THE CURRENCY ON PURCHASES OF INVESTMENT SECURITIES

By virtue of the authority vested in the Comptroller of the Currency by paragraph Seventh of Section 5136 of the Revised Statutes, the following regulation is promulgated:

SECTION I

(1) An obligation of indebtedness which may be purchased for its own account by a national bank or State member bank of the Federal Reserve System, in order to come within the classification of "investment securities" within the meaning of paragraph Seventh of said Section 5136, must be a marketable obligation, i.e., it must be salable under ordinary circumstances with reasonable promptness at a fair value; and with respect to the particular security, there must be present one or more of the following characteristics:

(a) A public distribution of the securities must have been provided for or made in a manner to protect or insure the marketability of the issue; or,

(b) Other existing securities of the obligor must have such a public distribution as to protect or insure the marketability of the issue under consideration; or,

(c) In the case of investment securities for which a public distribution as set forth in (a) or (b) above cannot be so provided, or so made, and which are issued by established commercial or industrial businesses or enterprises, that can demonstrate the ability to service such securities, the debt evidenced thereby must mature not later than ten years after the date of issuance of the security and must be of such sound value or so secured as reasonably to assure its payment; and such securities must, by their terms, provide for the amortization of the debt evidenced thereby so that at least 75 percent of the principal will be extinguished by the maturity date by substantial periodic payments: Provided, That no amortization need be required for the period of the first year after the date of issuance of such securities.

(2) Where the security is issued under a trust agreement, the agreement must provide for a trustee independent of the obligor, and such trustee must be a bank or trust company.

(3) All purchases of investment securities by national and State member banks for their own account must be of securities "in the form of bonds, notes, and/or debentures, commonly known as investment securities"; and every transaction which is in fact such a purchase must, regardless of its form, comply with this regulation.

SECTION II

(1) Although the bank is permitted to purchase "investment securities" for its own account for purposes of investment under the provisions

of Revised Statute 5136 and this regulation, the bank is not permitted otherwise to participate as a principal in the marketing of securities.

(2) The statutory limitation on the amount of the "investment securities" of any one obligor or maker which may be held by the bank, is to be determined on the basis of the par or face value of the securities, and not on their market value.

(3) The purchase of "investment securities" in which the investment characteristics are distinctly or predominantly speculative, or the purchase of securities which are in default, either as to principal or interest, is prohibited.

(4) Purchase of an investment security at a price exceeding par is prohibited, unless the bank shall:

(a) Provide for the regular amortization of the premium paid so that the premium shall be entirely extinguished at or before the maturity of the security and the security (including premium) shall at no intervening date be carried at an amount in excess of that at which the obligor may legally redeem such security; or

(b) Set up a reserve account to amortize the premium, said account to be credited periodically with an amount not less than the amount required for amortization under (a) above.

(5) Purchase of securities convertible into stock at the option of the issuer is prohibited.

(6) Purchase of securities convertible into stock at the option of the holder or with stock purchase warrants attached is prohibited if the price paid for such security is in excess of the investment value of the security itself, considered independently of the stock purchase warrants or conversion feature. If it is apparent that the price paid for an otherwise eligible security fairly reflects the investment value of the security itself and does not include any speculative value based upon the presence of a stock purchase warrant or conversion option the purchase of such a security is not prohibited.

(7) As to purchase of securities under repurchase agreement, subject to the limitations and restrictions set forth in the law and this regulation:

(a) It is permissible for the bank to purchase "investment securities" from another under an agreement whereby the bank has an option or a right to require the seller of the securities to repurchase them from the bank at a price stated or at a price subject to determination under the terms of the agreement, but in no case less than the value at the time of repurchase.

(b) It is permissible for the bank to purchase "investment securities" from another under an agreement whereby the seller or a third party guarantees the bank against loss on resale of the securities.

(c) It is not permissible for the bank to purchase "investment securities" from another under an agreement whereby the seller reserves the right or the option to repurchase said securities itself or through its nominee at a price stated or at a price subject to determination under the terms of the agreement, notwithstanding the fact that the bank may also, under such agreement, have the right or option to compel the seller to repurchase the securities at a price stated or at a price subject to determination under the terms of the agreement.

(8) As to repurchase agreements accompanying sales of securities,

(a) It is permissible for the bank selling securities to another to agree that the bank shall have an option or right to repurchase the securities from the buyer at a price stated or at a price subject to determination under the terms of the agreement, but in no case in excess of the market value at the time of repurchase.

(b) It is not permissible for the bank selling securities to another to agree that the purchaser shall have the right or the option to require the bank to repurchase said securities at a price stated or at a price subject to determination under the terms of the agreement, notwithstanding the fact that the bank may also, under such agreement, have the right or option to repurchase the securities from the buyer at a price stated or at a price subject to determination under the terms of the agreement.

In view of the fact that some banks may have bought or sold securities under a form of agreement which is prohibited by this regulation, the bank should either terminate or modify same so as to conform to this regulation, where such action may lawfully be taken. Existing agreements of the prohibited type must not be renewed.

EXCEPTION

The restrictions and limitations of this regulation do not apply to securities acquired through foreclosure on collateral, or acquired in good faith by way of compromise of a doubtful claim or to avert an apprehended loss in connection with a debt previously contracted, or to real estate securities acquired pursuant to Section 24 of the Federal Reserve Act, as amended.

This regulation supersedes prior regulations governing the purchase of "investment securities" and is effective from and after July 1, 1938.

Signed and promulgated this 27th day of June, 1938.

Marshall R. Diggs
Acting Comptroller of the Currency