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X-4500

January 8, 1926.

Honorable Louis T. McFadden, Chairman,
Committee on Banking and Currency,
House of Representatives,
Washington, D. C.

My dear Congressman:

The Federal Reserve Board welcomes the opportunity afforded by the request conveyed in your letter of December 11, 1925, to express its opinion on your Bill, H.R. 2, amending the National Bank Act and the Federal Reserve Act.

The urgent importance of liberalizing the law so as to enable national banks to compete more effectively with State institutions has long been recognized by the Board, and appropriate legislation for this purpose has been under consideration during the last year by a special committee of officers of various Federal reserve banks assisted by the Board's Division of Research and Statistics. The opinions herewith submitted are based in large measure upon the work of this Committee after consultation with the Federal Advisory Council.

Many of the provisions of the bill as introduced are approved without change, but the Board ventures to suggest considerable changes in Section 5200 designed in part to clarify that very complicated section and in part to limit certain somewhat hazardous classes of loans. While strongly in favor of liberalizing the statute, the Board feels also that it is highly desirable to introduce additional safeguards, especially in view of the numerous bank failures in recent years. The Board, therefore, submits a limited number of suggestions with this object in view. They are designed mainly to secure more adequate data regarding the conditions of the banks through examination and it is not believed that they would hamper in any way the conduct of its business by any well managed bank.

SECTIONS APPROVED WITHOUT ANY SUGGESTED CHANGES.

The Board approves the following provisions of H.R. 2 in their present form:

Section 2(a), amending subsection 2 of Section 5136 of the Revised Statutes so as to give national banks indeterminate charters in lieu of charters for a term of 99 years.

Section 2(b), amending subsection 7 of Section 5136 of the Revised Statutes so as to regulate the safe deposit business and the business of buying and selling investment securities when transacted by national banks.

Section 3, amending Section 5137 of the Revised Statutes so as to permit the purchase by national banks of such real estate as shall be necessary for their accommodation in the transaction of their business rather than merely such as may be necessary for their immediate use.

Section 4, amending Section 5138 of the Revised Statutes so as to authorize the chartering of national banks in outlying sections of large cities with a capital of \$100,000.

Section 5, amending Section 5142 of the Revised Statutes so as expressly to authorize national banks to increase their capital by means of stock dividends.

Section 6, amending Section 5150 of the Revised Statutes so as to authorize the board of directors of a national bank to designate a director in lieu of the president to be chairman of the board of directors.

Section 13, amending Section 5208 of the Revised Statutes relating to the certification of checks by officers, directors, agents or employees of Federal reserve banks and member banks of the Federal Reserve System.

Section 14, amending Section 5211 of the Revised Statutes so as to permit reports of condition of national banks to the Comptroller of the Currency to be signed by the vice president or assistant cashier.

Section 15, amending the fourth paragraph of Section 15 of the Federal Reserve Act so as to permit Federal reserve banks to rediscount for member banks the eligible paper of any one borrower in an amount equal to that which may be borrowed lawfully from any national banking association under the terms of Section 5200 of the Revised Statutes as amended.

Section 16, amending Section 22 of the Federal Reserve Act, so as to make thefts by any bank examiner or assistant bank examiner from any member bank of the Federal Reserve System a Federal offense.

REAL ESTATE LOANS.

The Board approves of that portion of Section 17 of your Bill which would amend Section 24 of the Federal Reserve Act so as to broaden the power of national banks to make loans on real estate and increase the aggregate amount of such loans which may be made by any national bank from 33 1/3 per cent of its time deposits to 50 per cent of the national bank's savings deposits; but the Board is opposed to that portion of this section of the Bill (page 27, lines 4 to 9, inclusive) which would provide that the rate of interest which national banks may pay upon time deposits, savings deposits or other deposits shall not exceed the maximum rate authorized to be paid upon such deposits by State banks or trust companies.

CONSOLIDATION OF NATIONAL BANKS.

Upon consideration of Section 1 of your Bill, which would amend the Consolidation Act of November 7, 1918, by the addition thereto of a new section simplifying the procedure involved in the consolidation of State banks with national banks, the Board voted to approve all of such proposed new section except that portion thereof which relates to branch banking.

SECTION 5200 OF THE REVISED STATUTES.

The Board recommends that the following be substituted for Section 11 of your Bill, which would amend and reenact Section 5200 of the Revised Statutes:

"Sec. 11. That Section 5200 of the Revised Statutes of the United States, as amended, be amended to read as follows:

'Section 5200. The total direct liabilities to any national banking association of any person, firm, company or corporation for money borrowed shall at no time exceed 10 per centum of the amount of the capital stock of such association actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund; and the aggregate liabilities to any national banking association of any person, firm, company or corporation, to wit, the direct liabilities for moneys borrowed and the indirect liabilities as surety, endorser or guarantor, where such surety, drawer, endorser, or guarantor obtains a loan from, or discounts paper with, or sells paper under guarantee to, any such association, shall at no time exceed 25 per centum of the amount of the capital stock of such association actually paid in and unimpaired, and 25 per centum of its unimpaired surplus fund.

'Within the meaning of this section: (a) The liabilities of any company or firm shall include the liabilities of the several members thereof; (b) where the majority of the stock of any corporation is owned by any borrower the liabilities of such corporation as surety, drawer, endorser or guarantor shall be considered part of the aggregate liabilities of such borrower; and (c) all liabilities of the actual borrower on accommodation paper, whether in the form of liabilities as maker, acceptor, surety, drawer, endorser, or guarantor shall be considered direct liabilities within the meaning of this section.

'The limitations prescribed above in the first paragraph of this section shall be subject to the following exceptions:

'(1) Liabilities arising out of the discount or purchase of the following classes of paper shall be subject to no limitation based upon the amount of such capital and surplus except where both the drawer and drawee, or both the maker and payee, are corporations and one of such corporations is affiliated with, or a subsidiary of, the other - i.e., where a majority of the stock of one of such corporations is owned by the other or by the stockholders thereof:

(a) Bills of exchange drawn in good faith against actually existing values.

- (b) Commercial or business paper actually owned by the person, company, corporation, or firm negotiating the same.
- (c) Drafts and bills of exchange secured by shipping documents conveying or securing title to goods shipped.

(2) Liabilities arising out of the discount or purchase of the following classes of paper shall be subject to no limitation based upon the amount of such capital and surplus:

- (a) Demand obligations which are or have been discounted or purchased for the account of the drawer or endorser and which are secured by documents covering commodities in actual process of shipment.
- (b) Bankers' acceptances of the kinds described in section 13 of the Federal Reserve Act.
- (c) Notes secured by not less than a like face amount of bonds, notes, or certificates of indebtedness of the United States.

(3) In addition to the 10 per centum permitted under the first paragraph of this section, liabilities to any national banking association may be incurred in an amount equal to 15 per centum of the paid in and unimpaired capital and 15 per centum of the unimpaired surplus fund of such national banking association, when such liabilities are evidenced by notes secured by shipping documents, warehouse receipts, or other such documents conveying or securing title covering readily marketable nonperishable staples, the actual market value of which is not at any time less than 115 per centum of the face value of such notes, and which are fully covered by insurance if it is customary to insure such staples; but this exception shall not apply to liabilities of any person, corporation, firm or company or the several members thereof arising from the same transactions and secured upon the identical staples for more than six months; Provided, however, That liabilities of this character may be incurred for a period of not more than three months in an additional amount equal to 15 per centum of the paid in and unimpaired capital and 15 per centum of the unimpaired surplus fund of such national banking association, in addition to the 10 per centum permitted under the first paragraph of this section and the 15 per centum hereinbefore permitted under this paragraph.

(4) In addition to the 10 per centum permitted under the first paragraph of this section, liabilities to any national banking association may be incurred in an amount equal to 15 per centum of the paid in and unimpaired capital and 15 per centum of the unimpaired surplus fund of such national banking association, when evidenced by notes secured by documents conveying or securing title to live stock which is being prepared for market during the period of the loan evidenced by such notes, and the market value of which is not at any time less than 115 per centum of the face amount of such notes; but this exception shall not apply to the liabilities of any person, corporation, firm, or company, or the several members thereof, for more than nine months; Provided, however, That exceptions (3) and (4) are not cumulative but only alternative exceptions - i.e., only one of the two shall be available to the same borrower and not both at the same time."

This proposed revision of Section 5200 is a result of a thorough study which the Board has caused to be made by a committee of officers of the Federal Reserve System aided by the Board's Division of Research and Statistics. The recommendations of this committee were also considered by the Federal Advisory Council. In the opinion of the Federal Reserve Board, this revision combines the best features of the various drafts of Section 5200 incorporated in the bills on this subject heretofore introduced in Congress, together with certain new provisions which the Board believes to be desirable. Those features of this proposed revision which are taken from drafts heretofore considered by Congress require no comment; but I shall comment briefly on certain of the proposed new features.

Subdivisions (b) and (c) of the second paragraph of the above draft are new and are intended to bring under the 10% limitation of the first paragraph the indirect liabilities of affiliated corporations and liabilities of the borrower on accommodation paper. The Board believes this is necessary in order to cover cases where the drawer and drawee or the maker and indorser are in effect a single interest.

The first and second exceptions are broadened so as to apply to liabilities arising out of the purchase of paper as well as the discount of paper. A provision is also inserted in the first exception excluding from the benefits of that exception paper on which the drawer and drawee, or the maker and payee, are affiliated corporations. The purpose of this provision is to exclude some portion of those notes and bills of exchange which are in substance nothing more than the obligations of a single interest.

Certain language is inserted in subdivision (a) of the second exception to exclude the holding of accepted demand obligations for an indefinite period of time by a bank, - a practice which involves making what is substantially an unsecured loan on single name paper.

A new subdivision (c) is added to the second exception, excluding from any limitation notes secured by not less than a like face amount of bonds, notes or certificates of indebtedness of the United States. This is based on the theory that, since banks may purchase an unlimited amount of these securities, it would seem logical to permit them to make loans in unlimited amounts on notes collateralized by such securities.

The third exception, which relates to liabilities on notes secured by shipping documents, warehouse receipts, or other such documents conveying or securing title covering readily marketable non-perishable staples, would permit such loans to be made in an amount equal to 15 per centum of the bank's capital and surplus in addition to the basic 10 per cent for periods not in excess of six months, and in an additional amount equal to 15 per cent of the bank's capital and surplus for a period of not more than three months. The provision requiring such staples to be insured is qualified in such a way as not to apply to such staples as pig iron, lead, zinc, etc., which are not customarily insured. The above draft of this exception is believed to be a fair compromise between the corresponding provisions of the various other drafts of this bill which have heretofore been introduced in Congress; and the Board believes that it will enable the banks to supply all proper financial facilities for the marketing of such staples.

The fourth exception, which relates to loans on live stock is changed so as not to apply to loans on dairy or breeder herds nor to the liabilities of any one borrower for more than nine months.

SUGGESTED AMENDMENTS DESIGNED TO STRENGTHEN THE BANKS.

The Board also desires to recommend the following additional amendments to the National Bank Act and the Federal Reserve Act and requests that these proposed amendments be incorporated in your bill:

1. That Section 5202 of the Revised Statutes as amended be further amended by adding at the end thereof a new paragraph to read as follows:

"All obligations of every nature both direct and indirect arising out of the sale, pledge, or hypothecation of any one of its assets by a national banking association shall be definitely recorded upon its books at the time such assets are sold, pledged, or hypothecated. For each failure to comply with this requirement a national banking association shall be subject to a fine of Five Hundred Dollars, to be imposed by the Comptroller of the Currency."

This proposal is designed to cover the rather common practice of the assumption of obligations by banks in an informal fashion, often in correspondence between bank officials. These obligations

frequently escape the notice of bank examiners because they are not definitely recorded on the books of the banks.

2. That Section 5240 of the Revised Statutes of the United States, as amended, be further amended by adding at the end thereof a new paragraph reading as follows:

"Whenever in the judgment of the Comptroller of the Currency any national banking association is so closely related in management, operation or interest to any other bank, banking association, trust company, securities company or investment company that an examination of such national banking association fails to disclose its true condition in the absence of detailed information regarding such other related institution, such national banking association shall (a) obtain from such related institution and furnish to the Comptroller of the Currency a copy of a report of an examination of such related institution made by the State authorities simultaneously with an examination of such national banking association made by examiners appointed by the Comptroller of the Currency, or (b) by such other means as may be deemed satisfactory by the Comptroller of the Currency, furnish to the Comptroller of the Currency detailed information regarding the condition and operation of such related institution. In such cases the Comptroller of the Currency may, upon request, furnish the State Supervisor of Banking, or other similar officers, copies of reports of examination of such related national banking association. If any national banking association shall fail to comply with the requirements of this paragraph after a demand for such compliance has been made by the Comptroller of the Currency, the Comptroller shall report the facts in the case to the Federal Reserve Board, which may, after a hearing, issue an order depriving such national banking association of the privilege of receiving any discounts, advancements or accommodations from the Federal reserve bank of which it is a member until it has complied fully with all demands made by the Comptroller of the Currency pursuant to the provisions of this paragraph. The Federal Reserve Board shall send a copy of such order by registered mail to such national banking association and a copy to the Federal reserve bank of which it is a member; and, after receipt of said order, such Federal reserve bank shall not rediscount any paper for, or make any loan, advancement, or other extension of credit to, such national banking association until said Federal reserve bank has been notified by the Federal Reserve Board that such national banking association has complied fully with the requirements of this paragraph."

This proposal is designed to secure adequate information regarding national banks which are related to other institutions and in particular to afford some check upon certain abuses frequently engaged in by chains of banks. During the last few years a number of such chains have collapsed,

and investigation shows that when a national bank is in such a chain an examination of it fails to disclose its true condition, due to the shifting of assets back and forth between the various institutions which make up the chain.

3. That Section 9 of the Federal Reserve Act as amended be further amended by inserting therein, immediately after the sixth paragraph thereof, a new paragraph reading as follows:

"Whenever in the judgment of the Federal Reserve Board any member bank is so closely related in management, operation and interest to any other bank, banking association, trust company, securities company or investment company that an examination of such member bank fails to disclose its true condition in the absence of detailed information regarding such other related institution, such member bank shall (a) obtain from such related institution and furnish to the Federal Reserve Board a copy of a report of an examination of such related institution made by the State authorities simultaneously with an examination of such member bank, or (b) by such other means as may be deemed satisfactory by the Federal Reserve Board, furnish to the Federal Reserve Board detailed information regarding the condition and operations of such related institution. In such cases the Federal Reserve Board may, upon request, furnish the State Supervisor of Banking, or other similar officers, copies of reports of any examination of such related member bank which has been made by direction of the Federal Reserve Board or of the Federal reserve bank by examiners selected or approved by the Federal Reserve Board. If any member bank shall fail to comply with the requirements of this paragraph after a demand for such compliance has been made by the Federal Reserve Board, said Board may, after a hearing, issue an order depriving such member bank of the privilege of receiving any discounts, advancements or accommodations from the Federal reserve bank of which it is a member until it has complied fully with all demands made by the Federal Reserve Board pursuant to the provisions of this paragraph. The Federal Reserve Board shall send a copy of such order by registered mail to such member bank and a copy to the Federal reserve bank of which it is a member, and, after receipt of said order, such Federal reserve bank shall not rediscount any paper for, or make any loan, advancement, or other extension of credit to, such member bank until said Federal reserve bank has been notified by the Federal Reserve Board that such member bank has complied fully with the requirements of this paragraph."

This proposal is similar to the preceding and is intended to apply to State banks and trust companies which are members of the Federal Reserve System. At present the only penalty for non-compliance with any provision of the Federal Reserve Act by State member banks is that provided for in the seventh paragraph of Section 9 of the Federal Reserve Act, which authorizes the Federal Reserve Board to expel from the Federal Reserve System any State member bank which fails to comply with the provisions of that Section. The penalty suggested above is less drastic but is nevertheless thought to be sufficient.

4. That Section 5146 of the Revised Statutes of the United States, as amended, be further amended to read as follows:

"Sec. 5146. Every director must, during his whole term of service, be a citizen of the United States, and at least three-fourths of the directors must have resided in the State, Territory, or District in which the association is located, or within fifty miles of the location of the office of the association, for at least one year immediately preceding their election, and must be residents of such State or within a fifty-mile territory of the location of the association during their continuance in office. Every director must own in his own right at least ten shares of the capital stock of the association of which he is a director, unless the capital of the bank shall not exceed \$25,000, in which case he must own in his own right at least five shares of such capital stock. Any director who ceases to be the owner of the required number of shares of the stock, or who pledges or hypothecates the same, or who becomes in any other manner disqualified, shall thereby vacate his place.

"No national banking association shall make a loan or loans aggregating more than Five Hundred Dollars to any salaried officer of such national banking association or to any corporation in which such officer or any director of such national banking association owns or controls a majority of the stock or of which he is an officer or director, unless (a) such loan is fully secured by readily marketable collateral, or (b) such officer or director has first made available to the board of directors of such national banking association by filing with such national banking association in approved form a financial statement of such officer or of such corporation, as the case may be, which financial statement shall accurately show the financial condition of such officer or corporation at the close of the last fiscal or calendar year preceding the loan. A violation of this provision shall disqualify any such officer or director from serving as such and vacate his place."

This would amend Section 5146 in two respects: (1) The last sentence of that section as it now reads would be amended so as to disqualify a director who pledges or hypothecates his stock. This is intended merely to meet an apparent oversight in the law. (2) A new paragraph would be added relating to loans to officers of national banks and to corporations the majority of the stock of which is owned or controlled by officers or directors of national banks.

5. That Section 5205 of the Revised Statutes of the United States, as amended, be further amended to read as follows:

"Sec.5205. Every association which shall have failed to pay up its capital stock, as required by law, and every association whose capital stock shall have become impaired by losses or otherwise, shall, within two months after receiving notice thereof from the Comptroller of the Currency, pay the deficiency in the capital stock, by assessment upon the shareholders pro rata for the amount of capital stock held by each; and the Treasurer of the United States shall withhold the interest upon all bonds held by him in trust for any such association, upon notification from the Comptroller of the Currency, until otherwise notified by him. If any such association shall fail to pay up its capital stock, and shall refuse to go into liquidation, as provided by law, for two months after receiving notice from the Comptroller, a receiver may be appointed to close up the business of the association, according to the provisions of section fifty-two hundred and thirty-four: And provided, That if any shareholder or shareholders of such bank shall neglect or refuse, after two months' notice, to pay the assessment, as provided in this section, it shall be the duty of the board of directors to cause a sufficient amount of the capital stock of such shareholder or shareholders to be sold at public auction (after thirty days' notice shall be given by posting such notice of sale in the office of the bank, and by publishing such notice in a newspaper of the city or town in which the bank is located, or in a newspaper published nearest thereto), to make good the deficiency, and the balance, if any, shall be returned to such delinquent shareholder or shareholders: Provided, however, That the Comptroller of the Currency may extend the time for payment of such assessment whenever in his judgment it may be deemed advisable."

The only effect of this amendment would be to shorten from three months to two months the period allowed for the payment of assessments to restore the capital of a national bank which has become impaired, with a provision authorizing the Comptroller of the Currency

to extend the time for the payment of such assessment when in his judgment it may be deemed advisable.

The Board has taken no definite action upon those provisions of your Bill which are not specifically mentioned above, but if it does so I shall advise you promptly of the action taken. The Board is also considering the advisability of recommending the enactment of certain other amendments to the National Bank Act and the Federal Reserve Act, but has not yet taken definite action upon the matter. If it decides to recommend any further amendments, I shall advise you at a later date.

It may be of interest to your Committee to know that this letter was considered in detail at a meeting of the Federal Reserve Board at which all members except the Secretary of the Treasury and the Comptroller of the Currency were present and was approved by all those members who were present.

If there is anything further that the Board can do to be of any assistance to you in this or in any other matter, please do not hesitate to call upon us.

Very truly yours,

D. R. Crissinger,
G o v e r n o r.

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P.S. If you so desire the Board will be glad to furnish you with additional copies of this letter for the use of the other members of your Committee.