February 10, 1932.

C. S. Hamlin.

Proposed Substitute for Section 3 of the Glass Bill: -

Strike out Secs. 3 and 9, and substitute the following:

Section 3:

In order to secure a more effective supervision of banking in the interest of bank depositors and of the public, the Federal Reserve Board may prescribe regulations defining and regulating the use of the credit facilities of the Federal Reserve System within the limitations of this Act as amended.

Each Federal reserve bank shall keep itself informed of the loan and investment policies of its member banks, and for this purpose may call upon such banks from time to time for reports.

The Chairman of the Board of each Federal reserve bank shall report to his bank and to the Federal Reserve Board any use made by a member bank of Federal reserve facilities, directly or indirectly, in connection with any loans made by it, whether commercial, speculative, real estate, or otherwise, which is undue or excessive under this Act as amended, and the regulations of the Federal Reserve Board.

Each Federal reserve bank may, in its discretion, after due warning, suspend from the further use of Federal reserve privileges any member bank abusing said facilities, as above provided.

If, in the judgment of the Federal Reserve Board, any Federal reserve bank fails to take proper action under this provision, the Board may, by an affirmative vote of not less than five of its members, enforce this provision against any offending member bank or banks.

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February 10, 1932.

C. S. Hamlin.

Proposed Amendment Giving the Federal Reserve Banks and the Federal Reserve Board Power to Suspend Member Banks from Federal Reserve Bank Privileges:

In reviewing the period of speculative activity, beginning in the fall of 1927 and continuing up to the crash of October, 1929, - one fact stands out in bold relief, - the complete inability of the member banks, of their own accord, to restrain the wave of speculation which swept over the country.

As regards the Federal Reserve System, even the sale of 400 millions of Government securities, coupled with 3 increases of discount rates up to July 13, 1928, failed to stem the tide.

Between July, 1928, and January, 1929, a tidal wave of loans "for others" swept over the country providing fuel for the speculative fire. This wave would have overcome the influence of any discount rate increase, unless of such a drastic nature that it would be impossible to borrow money on any terms, which, of itself, would probably have turned speculative confidence into fear, and would have precipitated in May or June the crisis which finally came in October.

The Federal Reserve Bank of New York, however, believed that the whole question was a rate question, and asked the Board to agree upon an affirmative rate increase policy which, carried to the extreme, as above stated, would probably have brought on in May or June the crisis which took place in October, 1929.

The Federal Reserve Board insisted on keeping the discount rate at 5% - where it had been placed in July, 1928, - and issued a warning to the banks

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to restrain the growth of speculative activity. In other words, the Board took the position that the only effective way to restrain speculation was to cut off speculative credit, or at least to stop its growth, leaving the discount rate where it was, in order to protect business, agriculture, and commerce, which was even then suffering under existing rates, as pointed out by Governor Harrison in his letter of April 9, 1929, to the Federal Reserve Board.

That the question was not in essence a rate question, was shown clearly by the fact that during the period of direct pressure, from February 7 to about June 1, 1929, the total earning assets of the Federal Reserve Bank of New York steadily declined, while its reserve ratio, at the same time, steadily increased. Under ordinary canons of banking, this condition would have suggested a reduction rather than an increase of discount rates.

The claim is often made, however, that the direct pressure exercised by the Federal Reserve Board under the 5% rate, was a failure.

How can this be said, when, during its operation, total earning assets declined, and reserve ratios increased, total Federal reserve credit outstanding having been reduced 193 millions?

The fact is, that direct pressure went very far in eliminating the seepage of Federal reserve credit into speculative activities. It certainly succeeded so far as brokers loans were concerned, which were reduced 649 millions. On the other hand, customers' security loans, as distinguished from brokers loans, increased during that period from 4,971 to 5,267 millions, - an increase of 296 millions. Brokers loans and customers loans together, however, showed a net decrease of about 361 millions during this

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period.

If the member banks of the country had restrained the growth of their customers security loans, as well as brokers loans, the result would have been far better.

It is often stated that it is impossible to know whether a customer's security loan is one for speculative purposes or not. In this connection, it is interesting to note that Governor Harrison, in his letter to the Board of April 9, 1929, used the following language:

> "A rate increase will have a direct effect upon the possible use of Federal reserve credit for speculative purposes, because a large part of the credit now granted on the basis of securities consists of loans by banks directly to their customers, as distinguished from loans to brokers on the open call money market. Recent increases for credit for security operations have been almost entirely in this form of loan. In this district, many such loans are being made at rates between 5½ and 6%."

The member banks, however, were not willing to impose restraints on customers seeking to borrow for speculative purposes. On the contrary, it seems to have been an established banking practice, that when a customer maintaining a good balance, and offering good security, applied for accommodation for speculative purposes, he was given all he wanted, provided only he was willing to pay the discount rate fixed by the bank.

In times of speculative craze, however, rapidly increasing stock prices and even increased discount rates seem to whet, rather than to reduce, wild speculation.

The above practice of bankers is not in accord with sound banking practice. It disregards the rights of depositors, and is against the public interest.

If the Federal reserve banks had power, explicitly stated, to insist

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on reduction of member bank customers speculative loans, and had used that power, the result would have been a much better control of speculative activity.

Even with this limitation, however, direct pressure was so successful that, as above stated, during its operation Federal reserve credit was reduced 193 millions, although during this period discounts of paper, largely commercial, increased 444 millions, the resulting gain being brought about largely by the reduction of total security loans, brokers and customers loans, of 361 millions of dollars.

Direct pressure under the 5% rate during this period was, in fact, so successful that about June 1, the Federal Reserve Bank of New York said that the banks needed credit for commercial purposes, but were afraid to borrow, and they begged the Board to consider a policy of easier money.

There seems to be little doubt that, but for the loans "for others" the direct pressure exercised under the 5% rate, would have brought about such a material liquidation of speculative credit that the crash which came in October, 1929, might have been at least greatly minimized in its effect.

Such would assuredly have been the result, had the Federal reserve banks been given express power to suspend from the privileges of the Federal reserve bank, member banks making undue use or abuse of its facilities for speculative purposes.

The Federal reserve banks, to be sure, have this power now, as we have been advised by Counsel, but it is not explicitly stated, and it would be far better to have this power stated in express terms, so that there can no longer be a doubt as to it.

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The Federal Reserve Bank of New York, at the hearings before the Glass Sub-committee, denied its power to examine into the loan practices of member banks, especially customers loans, except possibly where one bank might be out of line with other banks of the same class. The duty of knowing the loan policies and practices of the member banks should be directly imposed upon the Federal reserve banks, and they should be explicitly directed, in case of abuse, to suspend the member bank from Federal reserve facilities, so long as the abuse continues.

It is interesting in this connection to note that the Federal Advisory Council, on February 17, 1931, unanimously passed the following resolution:

> "There should be imposed upon the Federal reserve banks the requirement to keep themselves informed of the quality of the investments and loans, and the policy of the management of all member banks."

In this connection, also, it is interesting to note that Mr. Owen D. Young, in his testimony before the Glass Sub-committee, as contained in the New York Times of February 5, 1931, stated unequivocally that the Federal Reserve System should have certain powers to see that banking practices inimical to the safety of depositors should not be indulged in by member banks; that the Federal Reserve should have power to examine and discipline all its member banks; that the Federal reserve banks should have the power to limit or refuse rediscounts even if the paper is eligible, or suspend other privileges of membership, if the banking practices of any particular bank were, in its judgment, unsound, and therefore subjected its depositors to unreasonable risk, either as to liquidity or security; that in case the reserve bank exercises such power unfairly, an appeal might be taken to the Federal Reserve Board; that if the unsound practices were persisted in,

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the Federal Reserve Board, on complaint of any Federal reserve bank, might expel the bank from membership.

Section 3 of the proposed Glass bill, if literally construed, would bar a member bank from rediscount privileges if it had at the time a single loan outstanding based on stock exchange collateral.

Such was not the intent of the Federal Reserve Act as originally enacted. The intent of that Act was that banks should confine themselves primarily to commercial transactions, but there was nothing in the Act forbidding a reasonable use of Federal reserve rediscounts for building up reserves against deposit liabilities growing out in part from loans for purposes other than those strictly commercial or agricultural.

The whole question devolved upon a reasonable as opposed to an undue and unreasonable use of Federal reserve facilities for so-called speculative purposes.

That reasonable, as opposed to undue use, is the real question, will clearly appear from the following taken from articles and addresses of Dr. H. P. Willis, who presumably was the author of that part of Section 3 of the Glass bill above referred to:

Annalist, Nov. 26, 1926:

We long ago came to the conclusion that the amount of funds advanced for stock market use should not be excessive. 28.

The measure of that excess has been found in the degree to which such loans infringe upon the reserve funds of the actual deposit banks of the country. 28.

Federal reserve credit represents the ultimate reservoir of credit in the United States, the source from which banking credit must eventually be drawn. 31.

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<u>Magazine of Wall Street, May 7, 1927</u>:

Speculation or margin trading should be recognized, legitimatized, by every proper means, and liberally provided with funds. 36.

It is an essential adjunct to modern business, which is in itself speculative in many of its branches. 36.

The central bank function is to determine exactly where the line should be drawn in granting of credit to various types of business. 37.

Duty of every central banking system to see to it that its policy prevents an undue amount of the country's liquid funds from being absorbed in speculation. 37.

Federal Reserve System should exercise its authority through a satisfactory control of the money market. 37.

<u>District of Columbia Bankers Association.</u>
<u>Address. Jan. 24, 1929. (187-50 scrap book)</u>.

Immediate problem is to bring about a readjustment in our use of credit, which shall restore some portion of it now diverted, to the channels where it is needed, at the same time making a proper provision for the legitimate requirements of security operations. 51.

The principal bankers must undertake definitely to reduce their commitments in purely speculative or trading accounts to some figure taken as basic or normal. 51.

<u>New York World. Article. Feb. 17, 1929</u>:

An undue share of the country's resources had been involved in supporting speculative transactions, which, though beneficial when kept within limits, may be exaggerated and rendered dangerous. 55.

Necessary to obtain an agreement that no greater amount of credit should be used for stock exchange purposes than is now employed. 56.

The suggestion that Federal reserve banks should refuse further credit to borrower banks who are lending in the stock market would merely bring on a crash which would aggravate existing conditions. 57.

In this connection it is interesting to read what Governor Harrison stated during the hearings before the Glass Sub-Committee:

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Testimony of Governor Harrison.

Hearings - Glass Sub-Committee.

January 20, 1931:

Governor Harrison:

I think the Committee may wish to consider . . . whether the Federal Reserve System can do something short of expelling a bank from membership in the System. Of course the actual expulsion, which becomes public notice, will, of itself, precipitate the very thing you want to avoid - closing the bank. Page 46.

Query:

Whether it would be possible and proper - and I throw this out as a suggestion to the Committee, - to give to the Federal Reserve Board or to the Federal reserve banks, the right to suspend a member bank from any or all of the privileges of membership during a given period in the event that the bank has not, in our judgment, conducted itself in the safest way for the depositors.

If that could be done in some fashion that would not involve publicity, and would not then necessarily invite what you are trying to avoid by expelling the bank from membership, which necessarily becomes public, it would give us a very much stronger hand in dealing with a recalcitrant bank than we now have.

The Chairman:

You are speaking of member banks?

Governor Harrison:

Yes, of course, only member banks, - and by recalcitrant banks, I do not mean a bank violating the law, which is in a category of its own, but one which we believe is getting itself into a position demanding more and more, or a bigger and bigger proportion of our assets in loans.

It has been asserted that we have the authority of denying borrowing privileges.

The Chairman:

You have that authority complete.

Governor Harrison:

I think that myself. I agree with you that legally we have. The only difficulty with the exercise of that sort of power, is this, that a bank borrows from the Federal reserve bank not for the purpose of taking the money and applying it to a particular loan, or to a particular purpose, but rather to make good an already existing deficiency in its reserves.

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Governor Harrison then explained the matter of reserves against deposit liabilities, and stated the case of a bank which at the end of the day finds itself with a deficiency of 10 million dollars, and that the bank comes with perfectly eligible paper and asks the Federal reserve bank to give them 10 million dollars.

We have two alternatives: - We can say, 'Yes, you can have that at our discount rate because you have eligible paper and need it to repair your reserves' or, if we exercise the authority to refuse to make that loan, which right has been questioned by many people, the only thing that happens is that they are deficient in reserves, and they borrow the money in a way, by having a shortage in their reserves, rather than by a straight loan.

It is true that the shortage carries with it a higher rate, because they have to pay a penalty on the deficiency, but that is not the sound way of trying to correct the bank in its management, even if we thought it was wise, - that is, force them to be deficient. 47.

My thought was that if the Committee could consider the possibility and propriety of giving to the reserve bank, subject to the approval of the Federal Reserve Board, the right of suspension from any or all of the privileges of membership so that we can have the decision, in given circumstances, of what privileges we will deprive them, there would be no question about that, and it could be handled with such dexterity that it would avoid certain undesirable consequences that we might otherwise precipitate. 47, 48.

The Chairman:

We can't conceive why you should say or think that you have not complete authority to refuse the rediscount privilege.

Governor Harrison:

When I was Counsel for the Federal Reserve Board, I gave an opinion to the effect that we had complete authority, and I have not changed my mind about it. 48.

The Chairman:

I understood you to suggest that there was good reason to oppose that view.

Governor Harrison:

No. I merely meant to suggest that I saw the points that some on the opposite side raised. I do not agree with them. 48.

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