COPY

X-9102

January 17, 1935

To: Governor Eccles

From: Mr. Currie

Subject: Recommendation that rates of interest be lowered on advances under Section 13b.

Present situation

The present rate schedule is given in detail on the accompanying sheet. In general, the rate charged on direct advances is six per cent and the rates charged on advances to financial institutions range from three to six per cent, being generally lower for that portion of the advance for which the member banks bear the risk. Rates on commitments vary widely. The Federal Reserve Board must approve all rates.

Arguments for a lower rate

1. Present rates are out of line with other rates. In this connection the following rates are of interest:

		December
Rates charged customers by banks in New York City		3.18
In eight other northern and eastern cities		3.98
Twenty-seven southern and western cities		4.92
Bond yields:		January
High grade municipals		3.45
Moody's Aaa corporate		3.80
" Aa "		4.25
" A "		4.83
Home Owners' Loan Corporation mortgages		5.00
Short-term paper	19/100 to	1.00 maximum
Maximum rate payable on time deposits		2.50

2. The rates charged customers of member banks, particularly in the West and South, have not fallen comparably with other rates. A cut in the rate on industrial advances would help to force all rates down.

3. It would aid in recovery to get all rates lower.

4. Pressure on member banks to lower rates would come with a bad grace from the Reserve banks so long as they maintain the present rates.

5. The present rate puts the Board on record as believing that at the present time six per cent is a "reasonable" rate on "sound" loans. The rates now charged on industrial advances are in effect 1929 rates.

6. It is advisable not to give Congress the chance to attribute the small volume of loans to the high rates charged.

7. The actual money loaned is costless money. The Reserve banks should not be motivated by the desire to make profits.

8. The psychological effect of a general lowering of the rates subject to the Board's control might be helpful. The favorable reception accorded the reduction of the rates payable on time deposits would also be accorded reductions on the rediscount rates and the rates on industrial advances.

9. Although a reduction cannot be regarded as an important action, the point is that there is very little the System can do at the present to aid recovery except to exert all the pressure it can to lower the general rate structure.

Objections

1. The Chairmen of the Industrial Advisory Committees have recently recommended that no change be made in the present rate structure. Undue weight should not be attached to this recommendation since it is to be expected that the members of the Advisory Committees would think in terms of ordinary business practice and local conditions rather than in terms of desirable national policy.

2. It is undesirable to compete with local banks for this class of business. This objection may be met by pointing out (a) that at present the rates charged are considerably higher than the average of rates charged customers, and (b) that the law provides that loans will be made only in cases where adequate accommodation at reasonable rates cannot be secured from local banks. In general, I feel that we should not give undue weight to the competition argument, since our duty is to initiate interest rate changes rather than follow interest changes.

3. The rates should be high to compensate for the risk element. This argument cuts two ways, since it says in effect that despite the mandate of Congress that the loans shall be "sound", despite the restrictions and safeguards the Reserve banks have imposed, and despite the high percentage of applications rejected on grounds of insufficient security, the loans that have been made should bear a rate applicable to relatively poor risks. Moreover, since the Treasury is supplying half the funds loaned and there is no provision for repayment to the Treasury, it is difficult to see how we can actually take a loss on advances under Section 13 (b).

4. The rate should be high to compensate for the heavy expense incurred in the making of such loans. This objection has real weight. Up to the present the Reserve banks report that their expenses have exceeded their income on this class of business. On the other hand, there is evidence that at the moment this state of affairs is being reversed. Moreover, in calculating expenses Reserve banks have included the expenses of their own credit departments, a part of which would have been incurred in any case, and some reserve banks have not included in current income accrued interest. It is worth noting that the bank which charges the lowest rate (Boston-five per cent) is earning more than its expenses.

Specific Recommendations

1. The rate on direct industrial advances should be reduced by one per cent.

2. The rate on that portion of the advances to financial institutions for which the latter assume the risk should correspond to the rediscount rate. The rate on that portion of advances for which the reserve banks assume the risk should be one per cent lower than the rate charged customers. An attempt might be made to insure that in most cases the rate charged customers should not exceed five per cent.

3. There appears to be undue diversity in the commitment rate. The subject is too complicated to be covered by a simple recommendation, and I suggest that a thorough study be made of commitment rates.

X-9102

C O P Y

December 31, 1934.

To Governor Eccles

From Mr. Szymczak

With reference to Mr. Currie's recommendation that rates on industrial advances by Federal Reserve banks be reduced, the following comments are submitted:

A. Rates on direct advances.

1. Current rates at all Federal Reserve banks, except St. Louis, are either 6 per cent or a range of from 4 or 5 per cent to 6 per cent. The rate at St. Louis is $5\frac{1}{2}$ per cent. Rates actually charged are 5 per cent at Boston, $5\frac{1}{2}$ per cent at St. Louis, and 6 per cent at all other banks except that the Federal Reserve Bank of New York has charged 5 per cent on a portion of the loans made.

2. When it is considered that these loans must be to businesses that are unable to obtain the requisite financial assistance from the usual sources at reasonable rates; that they are for periods of up to five years; that the risk thereon is higher than that on ordinary bank loans; that the expense of investigating the applications, of maintaining the necessary records because of the character of the security offered, and of collection because of installment payments is substantial; and that the Federal Reserve banks should not enter into competition with member banks, it would appear that a rate of 6 per cent on these loans is entirely reasonable. In this connection it is understood that member banks in the smaller towns and cities charge 6 per cent or more on ordi-

nary loans involving a much smaller risk of loss. Incidentally a rate on direct loans below that charged by banks generally would be certain to result in many applications from would-be borrowers who could obtain accommodation from the usual sources and who are not, therefore, eligible to receive a direct loan from a Federal Reserve bank, with a consequent increase in complaints against the Federal Reserve banks, which would, of course, be obliged to decline such applications. Furthermore, to the extent that applicants existed whose ability to repay was so doubtful as to make member banks unwilling to grant them loans but to whom the Reserve banks made advances, there would be the situation of the better risks having to pay a higher rate of interest than the poorer risks.

B. Rates on advances to financing institutions.

(a) Rates on that portion of advances on which the Reserve bank assumes the risk of loss,

1. Current rates vary considerably with three Reserve banks, Richmond, Chicago and Dallas, having a 6 per cent maximum (nominal only in the case of Richmond where the maximum rate to banks is 5 per cent and in the case of Chicago where a 1 per cent deduction is allowed the financing institution for servicing the loan). In the case of advances in which a participation is taken by the financing institution, however, most of the Reserve banks charge the same rate on their own participation as is charged on a direct advance to a borrower. This practice would appear to be justified only in case the Reserve bank services its own participations. Only two Reserve banks, Philadelphia and Kansas City, have dis-

counted advances for financing institutions on which the latter obligate themselves for not less than 20 per cent of any loss and such transactions even by these banks have been in negligible amount.

2. A rate on this portion of advances materially below the rate charged by member banks is undesirable inasmuch as the profit that could be realized by transferring all advances immediately to the Federal Reserve bank would be an inducement to member banks to do this rather than to retain the paper as a permanent investment, protected by a commitment under which they could turn it over to the Reserve bank at any time if necessary. Such a rate would also be no inducement to member banks to assume more than the legal minimum liability of 20 per cent of any loss sustained.

3. A rate on this portion of advances identical with the rate charged the borrower, such as Philadelphia has, with perhaps maximum limits, appears to be justified. To the extent that financing institutions make loans under commitments providing for the Reserve bank taking a participation therein rather than the entire loans, a rate, corresponding with that charged the borrower, offers an inducement to the financing institutions to take a participation in excess of the minimum of 20 per cent required by law, on which a lower rate is charged by the Federal Reserve banks, and this would increase the volume of loans for working capital purposes that could be made under the provisions of Section 13b, since a larger portion than the minimum would be carried by financing institutions.

(b) Rates on that portion of advances on which the financing institution assumes the obligation for any loss sustained.

1. Current rates range from 3 per cent at Boston and New York to a possible 6 per cent at Chicago. As stated under (a)1, however, only Philadelphia and Kansas City have rediscounted any advances made by financing institutions where the latter obligated themselves for a portion of any loss that might be sustained, the usual practice being for the financing institution to retain a participation in the advance and to assume no liability on the participation taken by the Reserve bank.

2. Since the financing institution obligates itself for any loss sustained on this portion of advances rediscounted with the Federal Reserve bank, the rate of interest charged by the Federal Reserve bank should be substantially below the rate charged on the portion on which the Reserve bank assumes the risk, and, of course, below the rate charged the borrower. A rate not greatly, if anything, above the regular rediscount rate of the Federal Reserve bank, bearing in mind the fact that the rate granted may run for as much as five years during which time the rediscount rate may fluctuate widely, appears to be justified. In line with this principle the established rates at the Federal Reserve banks of Atlanta, Chicago, and possibly, St. Louis and Minneapolis as well, should be reduced.

C. Commitment rates.

1. Current rates vary considerably, some banks having a rate of $\frac{1}{2}$ per cent, others a rate of 1 per cent, and some a range of from $\frac{1}{2}$ or 1 per cent to 2 per cent.

2. Rates on commitments should obviously be high enough on the average to cover the cost of making commitments and might properly provide some margin to cover a portion of any loss sustained on advances rediscounted under commitments, but the rate should be as low as practicable so as to offer an inducement to financing institutions to make advances protected by commitments and to hold such paper instead of turning it over to the Federal Reserve bank.

General Comments.

1. Loans for the purpose of providing working capital and with a maturity of up to five years would normally carry a rate higher than that charged on ordinary bank loans.

2. Member banks in the smaller centers have not reduced rates charged on ordinary bank loans, such rates not generally being less than 6 per cent.

3. The fact that Federal Reserve banks will assume 80 per cent of the loss on industrial advances made through financing institutions is no reason why borrowers for the purpose of obtaining working capital should be given a more favorable rate than ordinary borrowers receive, and commercial banks would not, of course, offer such borrowers a more favorable rate. Accordingly, whatever the Reserve banks do, borrowers through financing institutions will not get a lower rate than that charged on ordinary bank loans.

4. The Federal Reserve banks should not enter into competition with commercial banks by making direct loans at rates below rates that the banks may reasonably be expected to charge borrowers, especially

so since the law limits direct loans to applicants who are unable to obtain the requisite financial assistance from the usual sources on a reasonable basis.

5. That rates charged borrowers are not regarded by the borrowers themselves as excessive is indicated by the absence of complaints in regard to the rates--applicants in fact are probably quite generally of the opinion that they are fortunate indeed to obtain accommodation at the rates being charged.

6. "Reasonable and sound" is a requirement of the law that is interpreted very liberally; many of the loans being made are such as a commercial bank would not make no matter what the rate might be.

7. The risk of loss on industrial advances is substantial and the Federal Reserve banks will be fortunate if losses do not occur in material amount.

8. The cost of operations under Section 13b is very high--it is doubtful whether current rates will much more than cover expenses, altogether apart from losses.

9. The failure of the Reserve banks to make a greater volume of industrial advances and commitments has not been because of excessive interest rates, but is due to failure of commercial banks, and particularly member banks, to fully realize the obvious advantages of making such advances covered by commitments.

10. The volume of working capital loans possible to be made and transferred to the Federal Reserve banks is too small to be an effective inducement for member banks to reduce their rates on other loans.

HOWEVER,

I admit that the subject is one that should be considered by the Board, and I do not entirely oppose a general reduction of rates on industrial loans, but I do feel that the subject should be studied and thoroughly discussed by the Board members before any action is taken.

(Initialed) M. S. S.

X-9102

COPY

To: Governor Eccles December 24, 1934.

From: Mr. Currie

I am enclosing a recommendation that rates of interest be lowered on advances under Section 13b. You are probably too busy to go into this now, but Mr. Szymczak may be interested in it.

X-9102

COPY

December 24, 1934.

To: Governor Eccles

From: Mr. Currie

Subject: Recommendation that rates of interest be lowered on advances under Section 13b.

Present situation The present rate schedule is given in detail on the accompanying sheet. In general, the rate charged on direct advances is six per cent and the rates charged on advances to financial institutions range from three to six per cent, being generally, though not always, lower for that portion of the advance for which the reserve banks bear the risk. The Federal Reserve Board must approve all rates.

Arguments for a lower rate

1. Present rates are out of line with other rates. In this connection the following rates are of interest:

	Oct.	Nov.
Rates charged customers by banks in New York City	3.28%	3.22
In eight other northern and eastern cities	4.13	4.08
Twenty-seven southern and western cities	5.05	4.93
Bond yields:		
High grade municipals	3.81	
Moody's Aaa corporate	3.96	
" Aa "	4.42	
" A "	5.12	
Home Owners' Loan Corporation mortgages	5.00	
Short-term paper 19/100 to	1.00	
Maximum rate payable on time deposits	2.50	

2. The rates charged customers of member banks, particularly in the West and South, have not fallen comparably with other rates. A cut in the rate of industrial advances would help to force all rates down.

3. It is essential to recovery to get all rates lower.

4. Pressure on member banks to lower rates would come with a bad grace from the Reserve banks so long as they maintain the present rates.

5. The present rate puts the Board on record as believing that at the present time six per cent is a "reasonable" rate on "sound" loans. The rates now charged on industrial advances are in effect 1929 rates.

6. It is advisable not to give Congress the chance to attribute the small volume of loans to the high rates charged.

7. The actual money loaned is costless money. The Reserve banks should not be motivated by the desire to make profits.

8. The psychological effect of a general lowering of the rates subject to the Board's control might be considerable. The favorable reception accorded the reduction of the rates payable on time deposits would also be accorded reductions on the rediscount rates and the rates on industrial advances.

Objections

1. The Chairmen of the Industrial Advisory Committees have recently recommended that no change be made in the present rate structure. Undue weight should not be attached to this recommendation since it is to be expected that the members of the Advisory Committees would think in terms of ordinary business practice and local conditions rather than in terms of desirable national policy.

2, It is undesirable to compete with local banks for this class of business. This objection may be met by pointing out (a) that at present the rates charged are considerably higher than the average of rates charged customers, and (b) that the law provides that loans will be made only in cases where adequate accommodation at reasonable rates cannot be secured from local banks.

3. The rates should be high to compensate for the risk element. This argument cuts two ways, since it says in effect that despite the mandate of Congress that the loans shall be "sound", despite the restrictions and safeguards the Reserve Banks have imposed, and despite the high percentage of applications rejected on grounds of insufficient security, the loans that have been made should bear a rate applicable to relatively poor risks.

4. The rate should be high to compensate for the heavy expense incurred in the making of such loans. This objection has real weight. Up to the present the Reserve banks report that their expenses have exceeded their income on this class of business. On the other hand, there is evidence that at the moment this state of affairs is being reversed. Moreover,in calculating expenses Reserve banks have included the expenses of their own credit departments, a part of which would have been incurred in any case, and some reserve banks have not included in current income accrued interest. It is worth noting that the bank which charges the lowest rate (Boston-five per cent) is earning more than its expenses.

Specific Recommendations

1. The rate on direct industrial advances should be reduced by one per cent.

2. The rate on advances to banks and other financial institutions should be lowered sufficiently to allow banks to loan to their customers at five per cent and at the same time make a profit.

DIRECT ADVANCES UNDER SECTION 13b BY RATES OF INTEREST CHARGED - ($000 omitted)

(up to around the middle of December, 1934)

	4 Per Cent		5 Per Cent		5½ Per Cent		6 Per Cent		Total		Range of Rates approved
	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	
Boston	-	$ -	7	$1,678	-	$ -	-	$ -	7	$1,678	4 - 6 per cent
New York	-	-	7	90	-	-	44	630	51	720	4 - 6 " "
Philadelphia	-	-	-	-	-	-	14	1,221	14	1,221	4 - 6 " "
Cleveland	-	-	-	-	-	-	45	683	45	683	6 " "
Richmond	-	-	-	-	-	-	29	1,220	29	1,220	6 " "
Atlanta	-	-	-	-	-	-	62	759	62	759	6 " "
Chicago	-	-	-	-	-	-	(a)15	(a) 486	(a)15	(a) 486	5 - 6 " "
St. Louis	-	-	-	-	(b)19	(b)432	-	-	(b)19	(b) 432	5½ " "
Minneapolis	-	-	-	--	-	-	(c)49	(c) 802	49	(c) 802	6 " "
Kansas City	-	-	-	-	-	-	5	75	5	75	6 " "
Dallas	-	-	-	-	-	-	28	709	28	709	5 - 6 " "
San Francisco	-	-	-	-	-	-	5	235	5	235	5 - 6 " "
Total	-	-	14	$1,768	19	$ 432	296	$6,819	329	$9,018	

(a) Includes one discounted item of $1
(b) " " " " " 2
(c) " two " items " 13

RATES ON COMMITMENTS AND INDUSTRIAL ADVANCES.

Federal Reserve Bank	Commitments	Advances to banks and other financing institutions		Direct
		Financial institution portion	Federal Reserve bank portion	
Boston	½ - 2	3	3½ - 5	4 - 6
New York	1 - 2	3	4--5	4 - 6
Philadelphia	No general rate established	3½ 1/	Same as to borrowers but not less than 4%	4 - 6
Cleveland	½ - 2	4	1% below rate to borrowers but not less than 4%	6
Richmond	1 - 2	4 - 6 2/	4 - 6 2/	6
Atlanta	½	5	5	6
Chicago	1 - 2	5 - 6	4 - 6 3/	5 - 6
St. Louis	½ flat	4½	4½	5½
Minneapolis	1 flat	4½ - 5 4/	4½ - 5 4/	6
Kansas City	½ - 2 flat	4	4	6
Dallas	1 flat	4	5 - 6	5 - 6
San Francisco	1 - 2	3 - 4	4 - 5	5 - 6

1/ 1% above prevailing Federal Reserve bank discount rate.
2/ To banks, 1% less than rate charged borrower, but not less than 4%; to other financing institutions 6%.
3/ Established rates 5-6%, but 1% allowed on unobligated portion for servicing.
4/ To member banks, 4½%; to other banks and financing institutions 5%.