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STATEMENT ON TITLES II AND III OF THE BANKING BILL OF 1935

BY

GOVERNOR MARRINER S. ECCLES

of the Federal Reserve Board

Before the

Committee on Banking and Currency

of the

House of Representatives

on

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In recommending banking legislation at this time, it is recognized that the Congress has before it an unusual number of urgent matters that are engaging its attention, and that legislation in order to deserve your consideration at this session must not only be important in general but must also be urgent at this particular time.

We are not unmindful of the fact that within the past two years you have passed the Emergency Banking Act, the Banking Act of 1933, the Securities Exchange Act, and other important pieces of legislation dealing with banks. One purpose of this legislation has been to meet emergency conditions, and it is now proposed to incorporate into permanent legislation the features of the emergency laws that have proved to be valuable.

Another purpose of recent banking legislation, and particularly of the Banking Bill of 1933 and of the portions of the Securities Exchange Act that deal with powers of the Federal Reserve Board, has been to prevent the recurrence of speculative excesses which preceded the recent breakdown of our banking machinery and were partly responsible for this collapse. These bills were largely inspired by the difficulties that came to a head in 1928 and 1929, and it is gratifying to know that we now have on our statute books measures that will go far toward preventing the recurrence of conditions such as prevailed during the speculative orgy of these years.

At the present time, however, there appears to be no immediate

danger of excessive speculation. The present need is to so modify our banking law as to encourage the banking system to give a full measure of cooperation to efforts at economic recovery. It is even more important from the longer time point of view to so modify our banking structure and administration as to have it become an influence toward the moderation of fluctuations in employment, trade and business. This would tend not only to avoid the particular evils that came to a head in 1928 and 1929, but to so regulate underlying conditions as to diminish the possibility of a speculative boom getting under way. For when speculation is once under way it is extremely difficult to control, and the only means of preventing excesses is to combat conditions that are favorable to their inception and early development.

In order to accomplish this it is necessary to improve our machinery of monetary control, which is the principal objective of Title II of the proposed bill.

More specifically these objectives are to increase the ability of the banking system to promote stability of employment and business in so far as this is possible within the scope of monetary action; as a necessary step in that direction, to concentrate the authority and responsibility for the formulation of national monetary policies in a body representing the nation; to modify the structure of the Federal Reserve System to the extent necessary for the accomplishment of these purposes, but without interfering with regional autonomy in matters of local concern; and finally to relieve the banks of the country of

unnecessary restrictions that handicap them in the proper performance of their functions and thus to enable them to contribute more effectively to the acceleration of recovery.

In my opening remarks I wish to direct your attention particularly to four proposals incorporated in Title II of the bill. Other provisions of the bill I wish to leave for your consideration, with the understanding that I shall be glad to answer any questions that you may wish to ask about them.

The four questions which I wish to discuss this morning are: (1) the proposal to combine the offices of chairman of the board of directors and governor of the Federal Reserve banks, and to have the appointments to this combined office subject to approval by the Federal Reserve Board (Section 201 (1) pp. 38-41); (2) modification of the machinery for determining open-market policies of the Federal Reserve System (Section 205, pp. 43-44); (3) transfer of the determination of eligibility requirements from the statute to the Federal Reserve Board (Section 206, pp. 45-46), and (4) liberalization of provisions relating to real estate loans. (Section 210, pp. 49-51).

1. Combining governors and chairmen

As you know, the present law provides that the Federal Reserve Board appoint three directors of each Federal Reserve bank and that one of the directors appointed by the Board be the chairman of the board of directors. It appears to have been the intention of the framers of the

Federal Reserve Act that the chairman of the board of directors be the principal executive officer of each bank and the law makes him also the official representative of the Federal Reserve Board at the bank. In practice, however, it has developed that the directors appoint an executive officer for whom they have adopted the title of Governor of the Federal Reserve Bank, a title that is not mentioned in the law, and that these governors have become the active heads of the Federal Reserve banks.

The proposal in the bill is to recognize the existing situation by giving the governor of a Reserve bank a status in the law and to combine his office with that of the chairman of the board of directors. It is, of course, essential that the holders of these combined offices be approved by the Federal Reserve Board. The Board, you will note, will no longer appoint a chairman of the board, but will merely have the power to approve or disapprove the appointment of the governor, who will also be chairman of the board. In this proposal there is no encroachment on the autonomy of the individual Reserve banks. It merely reestablishes the original principle of the Federal Reserve Act that the Federal Reserve Board, which has responsibility for national policies and for general supervision over the Reserve banks, shall be a party to the selection of the active heads of the twelve Reserve banks. This change will work towards smoother cooperation between the Board and the banks and will establish within the banks a greater unity of administrative control than now exists. It will also result in considerable saving through the elimination of one of the two highest officers in each Federal Reserve bank.

2. Open-market operations

From the long time point of view the recommendations dealing with changes in the machinery for determining and carrying out the open-market policies of the Federal Reserve System are essential. Open-market operations are the most important single instrument of control over the volume and the cost of credit in this country. When I say credit in this connection I mean money, because by far the largest part of money in use by the people of this country is in the form of bank credit, or bank deposits. When the Federal Reserve banks buy bills or securities in the open market, they increase the volume of the people's money and lower its cost; and when they sell in the open market, they decrease the volume of money and increase its cost. Authority over these operations, which affect the welfare of the people as a whole, must be vested in a body representing the national interest.

Under existing law open-market operations must be initiated by a committee consisting of representatives of the twelve Federal Reserve banks, that is, by persons representing primarily local interests. They must be submitted for approval or disapproval to the Federal Reserve Board, and after they have been approved by the Federal Reserve Board, the boards of directors of the Federal Reserve banks have the power to decide whether or not they wish to participate in the operations. We have, therefore, on this vital matter a set-up by which the body which initiates the policies is not in a position to ratify them; and the body which ratifies them is not in a position to initiate them or to insist on their being carried out after they are ratified; and still

a third group has the power to nullify policies that have been initiated and ratified by the other two bodies. In this matter, therefore, which requires prompt and immediate action and the responsibility for which should be centralized so as to be inescapable, the existing law requires the participation of twelve governors, eight members of the Federal Reserve Board and 108 directors scattered all over the country before a policy can be put into operation.

It requires no further explanation to show that the existing machinery is better adapted to delay and obstruction than it is to effective operation, and that it results in a diffusion of responsibility which prevents the necessary feeling of complete authority and responsibility by a small group of men who can be held accountable by the Congress and the nation for the conduct of this matter that is of national importance.

The proposal in the bill is to set up a committee of five, three of whom shall be members of the Federal Reserve Board and two governors of Federal Reserve banks. This proposal would have the advantage of creating a small committee with undivided responsibility. It is not clear, however, that this arrangement is the best that can be devised for the desired purpose. The Federal Reserve Board, which is appointed by the President and approved by the Senate for the purpose of having general responsibility for the formulation of monetary policies, would under this proposal have to delegate its principal function to a committee, on which members of the Board would have a bare majority, while governors of the banks would have two out of five members.

From the point of view of the Board the disadvantages of this arrangement are that a minority of the Board could adopt a policy that would be opposed to one favored by the majority. It would even be possible for one member of the Board by joining with the two governors to adopt a policy that would be objectionable to the seven other members of the Board.

The placing of this authority in such a committee would also have the disadvantage of giving one important power, the power of open-market operations, to the Open-market Committee, while other fundamental powers are vested in the Board. These powers could be utilized to nullify the actions of the open-market committee. For example, the committee might adopt a policy of easing credit, while the Federal Reserve Board would be in a position to tighten credit, either by raising discount and bill rates or by increasing member bank reserve requirements. Also the Board, through its power of prescribing regulations for open-market operations, could conceivably interfere with the carrying out of the policies of the committee. While it is not contemplated that such extreme situations would occur, it does not seem desirable to amend the law in a manner that might result in such unreasonable developments.

Upon further study it would appear that the best way in which to handle this proposal would be to place the responsibility for open-market operations in the Federal Reserve Board as a whole and to provide for a committee of five governors of Federal reserve banks to advise with the Board in this matter. The Board should be required to obtain

the views of this committee of governors before adopting a policy for open-market operations, discount rates, or changes in reserve requirements. Such an arrangement would result in the power to initiate open-market operations by either a committee of the governors or by the Board, but would place the ultimate responsibility upon the Federal Reserve Board, which is created for that purpose. In this connection I should like to quote President Woodrow Wilson, who in his address to the joint session of Congress on June 23, 1913, said: "The control of the system of banking and of issue .... must be vested in the Government itself, so that the banks may be the instruments, not the masters, of business and of individual enterprise and initiative."

3. Eligibility of paper

It is proposed to give the Federal Reserve Board authority by regulation to determine the character of paper that may be eligible as a basis of borrowing at the Federal Reserve banks. This is particularly important at this time because it would encourage member banks to pay less attention to the form and maturity of paper that is offered by would-be borrowers and to concentrate their attention on the soundness of such paper. At present many banks are unwilling to extend loans to borrowers who have assets that are unquestionably sound because they lack the assurance that in case of a withdrawal of deposits they would be able to liquefy these assets at the Federal Reserve banks.

In times of emergency it has been necessary to remove existing restrictions and to give discretion in the matter to the Federal Reserve authorities, as was done under the Glass-Steagall Act of 1932. This act, however, was passed after a great many banks had gone to the wall

at least partly because of lack of eligible paper and its provisions in so far as they relate to borrowing from the Reserve banks, have now expired. What is proposed is not, as has been sometimes alleged, a policy of opening the doors of the Federal Reserve banks to all kinds of paper, regardless of its soundness. On the contrary, it is proposed to place emphasis on soundness rather than on the technical form of the paper that is presented.

Experience under emergency laws shows that the Federal Reserve banks and the Federal Reserve Board have exercised caution and, though they have extended credit on inelgible assets to the extent of $300,000,000, all but $1,500,000 of this has been paid back and the banks have suffered no considerable losses. It would appear safe, therefore, to intrust discretion in the matter to the Federal Reserve Board, which is always in session and, therefore, in a position to consider emergencies promptly without being under the necessity of proclaiming them by an appeal to Congress and thereby aggravating the situation, and being obliged to wait for Congress to be in session and to act on the matter.

Another phase of this problem is that the total volume of paper eligible for discount held by member banks at the present time is only about $2,000,000,000, and even in 1929 it was only about $4,000,000,000. While this amount is sufficient in the aggregate to provide access to the Federal Reserve banks, there were many individual banks that did not possess sufficient eligible paper. Even more

important than that is the fact that in a period of timidity the banks tend to refrain from making loans, except on paper eligible for discount at Federal Reserve banks. This is even now a factor causing liquidation in many communities and preventing adequate expansion of credit in others.

A bank that would conduct its business on the theory of having only such assets as can be disposed of at will in times of crisis, when the national income has been cut in two, cannot serve its community adequately. Such a bank would confine its operations to the purchase of the most liquid open-market paper, with the consequence that it would neglect its local responsibilities and would nevertheless find it difficult to earn enough from the low returns on such paper to cover expenses and dividends. The banks should be in a position to meet the needs of their communities for all kinds of accommodation, both short and long-term, so long as the credits are sound, and they ought to have the assurance that all sound assets can be liquefied at the Federal Reserve bank in case of an emergency.

4. Real estate loans

Closely allied to this matter of eligibility is the proposal that the limitations on real estate loans be modified so as to permit member banks better to supply the needs of their communities for mortgage loans. This proposal does not introduce a new character of loan, it merely relaxes existing limitations on real estate loans, which national banks

have made for twenty years. What the bill proposes is to modify the requirements so as to make them more realistic and to enable the member banks better to serve their communities. Coupled with the provisions in regard to eligibility, these proposals ought to result in greater willingness of member banks to lend on real estate and, therefore, to an improvement in the mortgage market and a stimulation of construction which is essential to business recovery.

Member banks hold about $10,000,000,000 of the people's savings, and it is therefore proper and necessary that they invest a part of their funds in long-time undertakings. The separation of commercial banking from savings banking may be theoretically desirable, but it cannot be accomplished in this country without disrupting existing machinery, while the need for increased activity in building is urgent. Member banks are suffering from the competition of many Government and other agencies that are entering the field of real estate loans, and it is a matter of self-preservation for the banks to be able to hold and expand their activities in this field.

The details of the bill as proposed may have to be modified. The problem is a difficult one because the laying down of specific percentages of value presents many perplexities. In some regions and at some times a 75 per cent loan on real estate is conservative, while at other times a 50 per cent loan may be too liberal. It may be best in this matter, as in others, to vest discretion in the Federal Reserve Board to prescribe such rules and regulations about real estate loans as in its judgment would operate most effectively in the public interest.

Other proposals In Title II

Other sections of Title II of the bill which I have not discussed may be briefly enumerated: provision that directors of the Federal Reserve banks shall not serve for more than six consecutive years. This would prevent crystallization of any one interest in the management of a Reserve bank. A change in the qualifications of members of the Federal Reserve Board to make these qualifications more descriptive of the functions of the Board. An increase in salary of future appointive members of the Board and provision for pensions. Grant of power to the Board to assign specific duties so as to be relieved of detail. Placing of obligations guaranteed by the United States Government on the same basis as direct obligations of the Government. Repeal of collateral requirements against Federal Reserve notes; these requirements serve no useful purpose and have been sources of serious trouble at critical times. Clarification of the authority of the Board to raise or lower reserve requirements; the bill as introduced authorizes changes in reserve requirements for different districts or classes of cities; it might be modified by eliminating changes by districts and classifying cities into two groups: (1) reserve and central cities, and (2) other cities. Authority for the Federal Reserve Board to waive capital requirements for admission of insured banks into the System prior to July 1, 1937, when all banks in order to be insured must be members of the Federal Reserve System; this might be broadened so as to authorize the Board to waive not only capital but all requirements, and to permit existing banks to continue permanently with their present capital, provided it is adequate in relation to their liabilities.

Technical provisions

Title III of the bill contains a number of sections proposed by the Comptroller of the Currency and by the Federal Deposit Insurance Corporation. Sections in which the Federal Reserve Board is interested are in the nature of technical improvements of a non-controversial

nature of the same general character as those contained in the so-called "Omnibus Banking Bill" which was reported favorably by the Banking and Currency Committees of both Houses of Congress in June 1934, but failed of enactment in the closing days of the 73rd Congress.

For example, a provision that a holding company affiliate, which is a holding company by accident and is not engaged in the business of holding bank stock, shall be exempted from the requirement of obtaining a voting permit. Another example is the provision that member banks for the purpose of calculating reserve requirements shall be allowed to deduct from gross deposits the amounts that are due them from other banks rather than be allowed to deduct these amounts only from the deposits they hold for other banks. The existing provision has resulted in injustice to country banks, which hold no deposits for other banks, and are, therefore, unable to get the benefit of the deduction which city banks can make. There is also a proposal intended to simplify the provisions of the Clayton Anti-trust Act in regard to interlocking bank directorates and to facilitate the administration of these provisions by the Federal Reserve Board.

Provisions in Title III, as well as in Title II, are still being studied and improvements and modifications in technique and in phraseology are being developed. I shall, therefore, appreciate an opportunity to submit to the Committee for its consideration a number of amendments to the bill before final action is taken. It would also be helpful if the Committee would permit the Board's counsel to cooperate with the Committee's counsel in the final perfecting of the phraseology of the bill.