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"THE BANKING ACT OF 1935"

Address

by

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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A little more than three months ago I had the privilege of speaking before the New York Bankers Association at Lake George, and my subject then was the same as it is today - The Banking Act of 1935. At that time, however, the Act was not law. Today it is. Accordingly, it is possible to discuss it again, but from a different point of view - to speak not of what its provisions may be, but of what they are. I wish first to take up the changes made by the Act in the general organization of the Federal Reserve System, and then certain changes which most directly affect your operations as bankers and as members of the Federal Reserve System.

The changes that the law makes in the organization of the System may be described as fundamental, but not revolutionary. They are changes which closely follow the dictates of experience, and they are adaptations to present day needs which are too well supported by realities to be called experimental. Many conceptions which formerly prevailed have undergone a great change as a result of what has happened in more than twenty years of actual operation under the Federal Reserve System. In consequence, Congress has amended the law and certain readjustments have been made in the organization of the System. To make clear the purposes behind these changes let me mention some of the things we have learned from experience.

To begin with, we recognize today that the elasticity of the currency, while it is important, is not a governing factor in the supply of credit.

When people borrow they do not usually want currency, and when they want currency they do not always borrow to obtain it. Fluctuations in currency demand, except when there is hoarding, are largely seasonal, and reflect seasonal changes in the volume of retail trade and of payrolls. To meet currency requirements is not a major problem, for deposits have largely taken the place of currency, and the duties of the Federal Reserve System can not be regarded as entirely discharged merely by supplying commerce, industry and agriculture with the cash they require for retail transactions and payrolls. That is merely a beginning. The real tasks of the System are much greater and more complex.

Again, the idea that the Reserve banks lend to one bank the funds deposited by another is now found to be quite inaccurate. The lending power of the Reserve banks does not arise from the receipt of member bank deposits, except to the extent that those deposits consist of gold. On the contrary, member bank deposits with the Reserve banks are created by the Reserve banks. The reserve banks rediscount paper or purchase bills or securities and enter corresponding credits to the accounts of the member banks. The lending of funds and the creation of deposits is not dependent, therefore, on the previous deposit of funds. It depends upon the power of the Reserve banks to acquire assets by purchase or discount, and their power to issue notes or create deposits in payment for those assets.

Furthermore, the idea was once held that a discount by the Federal Reserve bank, say of $1,000, for example, made it possible for the member bank to extend that much more credit and only that much. If this were true the control of credit expansion would be a relatively simple matter. But it is not true. A thousand dollars borrowed and placed to the credit of a member bank enlarges its reserves by only that much, but it makes possible a much larger expansion of member bank loans and deposits. This is because the bank's reserves need be only a fraction of its deposits. In practice it works out that on the average, member banks need borrow only about one-fifteenth of what they create in deposits by loans to their customers.

Again, there is no necessary, direct connection between any particular piece of discounted paper and the use to which the proceeds thereof are placed. Yet this connection was formerly assumed to exist and it was considered an important factor of credit control. The thought was that the Reserve banks would shut off speculation by refusing to discount the notes of speculators. Of course, that is very far from the facts. In the first place, as I just said, you bankers do not borrow at the Reserve bank in order to lend, and even if you did, the kind of paper you borrowed on wouldn't necessarily indicate what kind of loan you expected to make. The fact that a banker borrowed on bills of lading would give the Reserve bank no assurance that he did not on the same day buy some mortgages or lend to a stockbroker, or employ his funds in some other way that might at the moment be contrary to general policy.

You are entirely familiar with these commonplace facts about your own business, for they have been repeatedly demonstrated in banking operations as you have known them under the Federal Reserve System. But they are things that could not be seen so clearly until we had the actual experience. In the absence of that experience it was natural to suppose that member banks would deposit their funds in the Reserve banks, that the receipt of those funds would give the Reserve banks power to lend, that as the demand for money increased member banks would borrow of the Reserve banks to meet that demand, that they would draw out currency for the purpose, that loans would be repaid by currency, and that the Reserve banks by discounting only commercial paper would insure that Reserve bank credit was being used for the legitimate requirements of commerce and not for speculation.

As a result of experience, however, it has become clear that things do not work just that way. The relationships and the sequences are different. Accordingly, our legislation has had to be amended. A good many minor changes have been made in the Federal Reserve Act over a long period of time, but in the last few years circumstances have demanded more thorough revisions of the original Act than before. Congress has made these revisions in the Banking Act of 1933 and in the Banking Act of 1935. These two measures, without any violent break with the past, but in obedience to economic developments, have adapted the original Reserve System legislation to the needs of the present, and also to the needs of the future, insofar as those needs can be foreseen. The effort has been to modify the mechanism so that it may perform the functions which time and change have thrust upon it. It has been recognized that in meeting the requirements of contemporary business life the Federal Reserve System can not rely principally on the power to furnish currency when it is needed and to retire it when it is not; nor can it rely on discrimination against one class of paper or another - when and if offered for discount - on the theory that by so doing it is diverting credit away from speculative uses and toward commerce. It has been recognized that the Federal Reserve System's power over credit lies primarily not in the things I have mentioned, but arises chiefly out of its ability to influence the total volume of bank deposits. And it has been recognized that the System must not be thought of as waiting more or less passively, like the fire department, until a crisis arises and it receives an application for help. The Banking Act of 1935 is based on a recognition of these facts. Perhaps the most important thing attempted in it is a more definite fixing of responsibility for the country's credit policy. If the System is expected to act, it must be given the power to act effectively. This principle has been followed in the authorization of a new Open Market Committee.

Open Market Operations are, of course, not new, but they were not of established or recognized importance when the Federal Reserve Act was adopted. For years, ever since the war, they have had a powerful and direct bearing on the volume and cost of money. They are the means of controlling, in the mass and in the most practicable way, the credit operations of the banks of the country. Until the new law was adopted, however, the machinery for the formulation and execution of open-market policies was ineffective. The Open Market Committee, comprising representatives of the 12 Reserve banks, might propose purchases or sales of United States Government securities in the open market, and the Board might approve those proposals; but any Reserve bank might refuse to participate in the proposed program. A policy might be adopted, but its execution depended on the independent action of twelve boards of directors comprising in the aggregate 108 persons. Such an arrangement was likely to result in delay and to afford opportunities for obstruction in matters where prompt and decisive action was required in the public interest.

Under the Act of 1935, beginning March 1, 1936, authority over open market operations will be vested in a new Open Market Committee consisting of the seven members of the Board of Governors of the Federal Reserve System and five representatives of the Reserve banks selected regionally: one from the Boston and New York districts, one from the Philadelphia and Cleveland districts, one from the Richmond, Atlanta, and Dallas districts, one from the Chicago and St. Louis districts, and one from the Minneapolis, Kansas City and San Francisco districts. The Reserve banks will have representation on the Committee, but a majority of the Committee will be made up of Board members. Open market transactions, as under the old Act, are to "be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country". The Committee, in the language of the new act, is to "consider, adopt, and transmit to the several Federal Reserve banks, regulations relating to the open market transactions of such banks". Not only will Federal Reserve banks be forbidden to engage in open market operations, except in accordance with the regulations of the Committee, but they also will be forbidden to "decline to engage" in such operations except in accordance with the directions and regulations of the committee. Open Market policy will now be determined, therefore, by a responsible statutory body, able to give it the consistency and definiteness that the importance of the function makes necessary.

It is also required by the law that complete records be kept of the action taken by the Board and by the Committee in all matters of policy. These records are to show the underlying reasons for the action, and are to be published in the annual reports of the Board. They will give the public an opportunity to study the decisions of the Federal Reserve System, in much the same way that Supreme Court opinions may be studied. This opportunity should be extremely helpful in clarifying the public discussions of national credit policy. It will also accentuate the individual sense of responsibility, for members will be called on not only to take firm positions on matters of national policy, but to explain those positions to the public.

In the matter of discount rates, the law prescribes a new procedure under which rates must come up for consideration by the Reserve banks and by the Board every fourteen days or oftener. In effect this means that rates must be newly established every two weeks at least, though the new rates may, of course, be the same as the old.

Under the new law, the authority of the Board to alter the amount of reserves which member banks must carry against their demand and time deposits is restated in clearer terms than before. The old law authorized the Board to change required reserves only when an emergency existed as a result of credit expansion, and the approval of the President of the United States was necessary. The new law authorizes the Board to make changes on the vote of four of its seven members "in order to prevent injurious credit expansion or contraction". The legal reserves can not in any event, however, be reduced below present requirements, nor can they be increased to more than twice what they now are.

Since the Board of Governors constitutes a majority of the Open Market Committee, and since it also has authority over discount rates, over member bank reserve requirements, and over margin requirements on securities loans, it is under more definite responsibility with respect to the national credit policy than ever before. At the same time, the law preserves the regional autonomy of the Reserve banks in their relations with member banks. Generally speaking, it leaves the Reserve banks with responsibility for member bank relations, and gives the Board, with the help of representatives of the Reserve banks, responsibility for national credit and monetary policies.

The law also makes important changes in the constitution of the governing body of the Federal Reserve System, which is no longer known as the Federal Reserve Board, but as the Board of Governors of the Federal Reserve System. The Secretary of the Treasury and the Comptroller of the Currency cease to be ex officio members February 1, 1936, and thereafter the Board is to consist of seven members appointed by the President. The term of office is to be fourteen instead of twelve years. As at present, not more than one member may be appointed from any one Federal Reserve district, and the President, in selecting the members, is to "have due regard to a fair representation of the financial, agricultural, industrial and commercial interests and geographical divisions of the country".

After March 1, 1936, the chief executive officer of each Federal Reserve bank will be a "president", instead of a governor, and the title "vice-president" will replace that of deputy governor.

I think I have covered sufficiently the more prominent changes which the Banking Act of 1935 makes in the organization of the Federal Reserve System. Those changes in general tend to place more definite responsibility where it belongs. Changing conditions in our economic life have thrown greater responsibilities upon the System; and in order to meet those responsibilities in a direct and positive way, the System's organization has been made more closely knit and more effective.

I wish to speak now of those features of the Banking Act of 1935 which more directly affect your individual operations as bankers.

The first of these is the broadened lending powers which the Act gives you, both directly and indirectly.

Indirectly, the Act tends to broaden your powers by giving the Reserve banks authority to make advances to member banks on any satisfactory security. The former provisions still stand as to the character of paper that is eligible for discount - paper that must originate in connection with industrial, commercial or agricultural transactions - and they also still stand as to advances to member banks on notes secured by Government obligations or by eligible paper. The new provisions do not alter the old ones, except by adding to them. The only conditions aside from the requirement that advances under the new law be secured to the satisfaction of the Reserve bank, are that they bear a rate of interest at least one-half percent above the Reserve bank's discount rate and have maturities of not more than four months. At a time like the present, when you have excess reserves, this new provision in the law may not seem very important. But times may change. If they do, this new provision means that, assuming your assets are good, the Federal Reserve bank will be able to advance you money on them, no matter what the type of paper, or in what kind of transaction they originated. Borrowing from the Federal Reserve bank is now possible on other than technical conditions of eligibility alone. And this is very important. Many banks in recent years would have had much less trouble if they could have taken to the Reserve bank some of their assets which were good, but not legally eligible, instead of having to sacrifice them on a demoralized market.

Apart from its practical bearing upon what paper individual banks may use in borrowing at the Reserve bank, the new provision of the law is significant in that it recognizes an actual condition of American banking. This is that American banks do not specialize in one type of credit as against another. They deal in credit of all sorts. They combine long term and short term functions. They cannot confine themselves to short term commercial paper, for there is not enough of such paper to fill more than a small part of their portfolios. They accept the savings and time deposits of their communities and under such circumstances it must be expected that they will also hold the long term obligations of their communities. To disregard these living facts of American banking is futile; and the new provisions for eligibility simply make the Federal Reserve Act cognizant of the realities and adapt the powers of the Reserve banks to those realities.

In a more direct way, the new Act broadens your powers by liberalizing the conditions under which National banks may make real estate loans. The old stipulation that the real estate upon which such loans are made must be situated in the bank's Federal Reserve district or within a hundred miles of the bank, is removed; and loans which are amortized are permitted in amounts up to 60 percent of the appraised value of the property and for as much as ten years, provided installment payments are sufficient to repay at least 40 percent of the principal in ten years.

The permissible aggregate of real estate loans which a national bank may hold is changed by the new law from 25 percent of its capital and surplus or 50 percent of its savings deposits, whichever was greater, to 100 percent of its capital and surplus or 60 percent of its time and savings deposits, whichever is greater.

In general connection with this subject of enlarged lending powers I wish to mention also the provisions of section 13b of the Federal Reserve

Act relating to loans which you may make for working capital purposes. This section is a year older than the new act, but its provisions belong logically with these more recent ones I have just been discussing.

Under this section you may make loans with maturities not exceeding five years to established industrial and commercial businesses in need of working capital. These loans are eligible for discount at the Federal Reserve bank. Nor is that all. If you wish to hold the loan yourself, but wish to be assured that you can dispose of it at any time if need be, you can procure a commitment binding the Federal Reserve bank to take it off your hands. Moreover, if and when you dispose of the loan you can do so without recourse for as much as 80 percent. In other words you have a loan which is insured 100 percent as to liquidity and 80 percent as to loss. This arrangement is not restricted to member banks; it is open to non-members as well.

As of September 11, the Federal Reserve Bank of New York had received and acted on 881 applications for working capital loans aggregating $63,000,000. Of these, 330, aggregating $29,000,000, had been approved. Of the amounts outstanding, $7,500,000 was in the form of loans made by the Federal Reserve Bank itself direct to the industrial or commercial borrower, because you local bankers refused to make them. There was also outstanding about $10,000,000, which local banks and other financing institutions in the Second Federal Reserve District had made, and which were protected by the commitments I have just described.

These loans have been made to all kinds of enterprises, industrial and commercial. In many cases they have been loans which bankers have not been accustomed to making, and which would not be made were it not for the fact that the Reserve bank stands behind the bank which makes them. But as it is, they constitute secure and liquid assets, yielding a good rate of interest.

Here again as in the case of the advances made by the Reserve banks on any good assets, and as in the case of real estate loans, the present legislation recognizes two important principles. One is that the local bank may be called on to meet the general credit needs of the community; the other is that the assets the local bank acquires should meet the general criterion of soundness, rather than technical limitations as to maturity, origin, and nature of the underlying transaction.

I think I have now covered the changes of most general interest, that have been brought about by the Banking Act of 1935, but there are numerous other provisions that it may be worth while to run through even though you may be familiar with them.

First there is the matter of deposit insurance, which is continued on what was originally intended as the temporary plan. Insured banks are subject to an annual assessment at a fixed rate - one-twelfth of 1 percent of deposits - instead of being under an unlimited liability as would have been the case under the old permanent plan. Insurance covers deposits up to $5,000 for any one depositor, instead of $10,000, as the old permanent plan contemplated.

After July 1, 1942, no state bank with average deposits of $1,000,000 or more may be an insured bank without becoming a member of the Federal Reserve System. This postpones required membership for seven years. In this connection the term "state bank" does not include mutual savings banks or Morris Plan banks.

The former prohibition against a member bank's purchasing and holding more than 10 percent of a particular issue of investment securities has been eliminated, but the total of the obligations of one obligor which may be purchased and held by a member bank is reduced from 15 percent of the bank's capital and 25 percent of its surplus to 10 percent of its capital and surplus. Banks are not required to dispose of securities lawfully held at the time the law was enacted. It is also made clear, in conformity with previous rulings of the Board and of the Comptroller of the Currency, that member banks may purchase and sell stocks for the account of their customers. They may not purchase and sell stocks for their own accounts.

There are several important provisions in the new Act with respect to affiliates and holding company affiliates. These modify considerably the original requirements. When the first legislation defining affiliates and requiring reports of them was adopted in the Banking Act of 1933, it was undoubtedly directed primarily at securities affiliates and affiliates formed for the purpose of engaging in activities in which member banks were not authorized to engage or for the purpose of supplementing the activities of member banks. The definitions, however, were made extremely comprehensive, and as a result a very large number of organizations were caught in a net that was never intended for them. It frequently happened that banks were surprised to discover that under the law they had "affiliates", when as a matter of fact no such idea was in their minds. A bank might find that it had as an affiliate a corporation which belonged to an estate of which it was trustee; or it might find that it had as an affiliate a corporation whose stock was accidentally owned by the bank's own stockholders. There might be no financial connection between the two and yet at every call date a report would have to be procured from the affiliate and published. The original purpose of the law had been accomplished so far as securities affiliates were concerned, for they all disappeared, but the number of other affiliates reported to the Board was increasing - not because banks were forming new affiliations, but because unknown and unintended affiliations, quite accidental in fact, were constantly coming to light. The effect of the new provisions of the law will be to exclude a large number of such organizations from the requirement imposed originally. The Board and the Comptroller of the Currency are now authorized to waive reports which are not necessary to disclose fully the relations between a member bank and its affiliate, and the effect thereof upon the affairs of the bank, and the conditions of waiver have been announced. Roughly speaking, organizations which are affiliates under the terms of the law need not submit reports unless they are indebted to the affiliated member bank or unless the member bank owns their stock or other obligations. Reports of affiliations which have arisen as a result of ownership or control of an organization's stock by a member bank in a fiduciary capacity are also waived. This, it is believed, will be welcome news to many banks.

In addition, organizations which own or control the stock of a bank, but are found by the Board of Governors of the Federal Reserve System not to be engaged as a business in holding bank stock, are exempted by the new law from the requirements imposed on holding company affiliates except as to indebtedness of affiliates to member banks. This provision makes possible a distinction between holding companies organized for the purpose of holding bank stock, and companies which happen to own control of a bank, though their real business lies in a different field.

The Banking Act of 1935 ended double liability on National bank stock issued after June 16, 1933. Under the new Act National banks are permitted to terminate the double liability on stock issued prior to that date. After July 1, 1937, therefore, it is possible that all shareholders of active National banks may be relieved of personal liability on their shares. At the same time National banks are required to accumulate a surplus equal to the amount of their common capital. This change should be better both for bank shareholders and for the public. Personal liability for bank shares has never been a satisfactory protection to depositors, and it has placed a burden on shareholders of banks not borne by shareholders of other corporations.

There are several provisions which are of importance in connection with deposits and the interest payable thereon. In the first place, the rate of interest paid by the Postal Savings system is not to exceed that paid on savings deposits by member banks in the same place; and postal savings depositories may deposit funds on time with member banks subject to the provisions of the Federal Reserve Act and regulations of the Board of Governors of the Federal Reserve System regarding payment of interest on time deposits. In addition, the Federal Deposit Insurance Corporation is required to forbid the payment of interest on demand deposits by insured non-member banks, and to regulate the rate of interest paid on time and savings deposits by insured non-members. This provision explicitly gives the Federal Deposit Insurance Corporation authority similar to that which the Board of Governors of the Federal Reserve System has. In the same general connection, the definitions of deposits in the old Act are stricken out and the Board of Governors is authorized to define various types of deposits, and to determine what is to be deemed a payment of interest. For purposes of computing the reserves member banks are required to carry, amounts due from other banks (except Federal Reserve banks and foreign banks) and certain cash items in process of collection may be deducted from gross demand deposits. Formerly amounts due from other banks could be deducted only from amounts due to other banks. This will place country banks which have no balances of other banks, on a basis of equality in this respect with city banks that carry a large volume of bank balances.

I think it is not necessary to go further into details of the new banking legislation. I have described the major changes effected in the organization of the Federal Reserve System and I have mentioned certain provisions which affect you most directly as bankers.

You will realize from this partial account that a large number of changes have had to be made in the Board's regulations. This work has been pushed as rapidly as possible, but it will be some weeks before the Board will be able to complete the publication of all regulations in revised form.

Personally I feel that the new Act places us on a better footing than we have ever been on before. To be sure, it involves many points of compromise, as is inevitable in a democracy, and no two people will agree that it is perfect. Moreover, it is to be expected that unforeseen problems will arise, and that our resources and ingenuity will be taxed to meet them. But perhaps the greatest virtue of the Banking Act of 1935 is that it confers more definite responsibilities and more flexible powers. We are better prepared than in the past to meet the unexpected.

In particular I trust that membership in the System will be more valuable to you bankers under the new Act and more highly esteemed by you than ever before. I trust that you will find yourselves better able to meet the credit needs of your communities, and better able to maintain profitable operations. The new Act, as I have described it, should make that easier to do. The Federal Reserve Bank has broader powers than ever before to discount your paper and to lend to you. In the case of industrial loans for working capital purposes authorized by Section 13b it has the very unusual power to grant you commitments under which you may be assured of the perfect liquidity of your loan and have it virtually guaranteed up to 80 percent. I suggest that, considering the idle funds you have, you fully acquaint yourselves with what the Federal Reserve Bank is able and glad to do in cooperation with you, and that you canvass your territories for loans which you might formerly have felt were outside your field, but which you may now make with safety and profit. I thank you for this opportunity to discuss with you measures and matters of such moment to us all.