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THE BANKING ACT OF 1935 - TITLE II

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BANKING ACT OF 1935

TITLE II

The Banking Act of 1935 is divided in three parts. The first part, Title I, deals exclusively with Federal Deposit Insurance. The third part, Title III, comprises almost exclusively amendments intended to clarify and correct previously existing provisions of the law, and is chiefly of technical importance. The second part, Title II, makes changes in the organization of the governing board of the Federal Reserve System and in its authority to control credit. I shall limit myself to discussion of the provisions of Title II.

In general terms, I think the most important accomplishment of the Banking Act of 1935 so far as the Federal Reserve System is concerned is that it strengthened and clarified the lines of credit control. A few changes affecting the organization and functions of the Federal Reserve banks were made, but they were not changes in essentials. The most conspicuous of these changes was that the title of President was given to the principal executive officer. Formerly his title was Governor. The title of Vice President now replaces the former title of Deputy Governor. As you know, the former titles, Governor and Deputy Governor, were not mentioned in the Federal Reserve Act. The office of Governor was originally created under the general authority which the Federal Reserve Act gave the directors of the Federal Reserve banks to arrange for such officers as were necessary for the administrative work of the banks. Originally, the only office specifically mentioned by the Act, other than that of director, was that of Federal Reserve Agent and Chairman, with assistant agents and deputy chairmen. The Banking Act of 1935 in designating the President of the Federal Reserve bank as its chief executive officer merely recognized an arrangement that had developed under general authority and that had proved itself desirable from the point of view of Federal Reserve Bank administration.

The organization of the governing board of the System was changed considerably by the Banking Act of 1935. In the first place, the old name "Federal Reserve Board" was changed to "Board of Governors of the Federal Reserve System". At the same time, the chief executive officer of the Board was designated as Chairman. Furthermore, the number of members of the Board was changed from eight to seven and all of these members were made appointive. Formerly, as you know, the Secretary of the Treasury and the Comptroller of the Currency were ex officio members of the Board.

The term of office of the members of the Board was formerly 12 years. Under the new law, the terms of members now in office range from 2 to 14 years and their successors in office will have terms of 14 years so arranged that the term of one member will expire every 2 years. Since a member who has served a full term of 14 years is not eligible for reappointment, there will be a regularly recurring change in membership; one member leaving the Board and a new one being appointed every 2 years, unless more frequent changes occur from deaths or resignations.

The more important changes effected by the 1935 Act, however, have not to do with these matters of organization so much as with the function and authority of the governing Board in the field of credit.

The instrumentality that is now considered the most important for the control of credit is one that in the original reserve act was given only rudimentary attention. I refer to open market operations, with respect to which very significant changes were made by the Banking Act of 1935.

The principle of open market operations is of course simple. If securities are sold in the market by the Federal Reserve banks, they must of necessity be paid for with bank funds, for they will be bought either by the banks themselves or by bank customers. Consequently, in the process of paying for them there will necessarily be debits to be entered against the reserve accounts maintained with the reserve bank by the member banks. Upon completion of these entries, the reserve bank will have disposed of certain assets and simultaneously will have decreased the total amount outstanding to the credit of member banks in their reserve accounts. The Reserve bank does not know in advance of its transactions what particular member bank accounts will be affected nor by how much, but it knows that if it sells securities available member bank credit will be diminished.

If, as a consequence, reserves are reduced to a minimum, the member banks are immediately impelled to restrict their extensions of credit, for they cannot continue making loans and increasing the deposit credit outstanding on their books without incurring a deficiency in their reserves. The result of the Reserve bank's action in selling securities, therefore, is to curtail the lending power of member banks and to tighten the money market.

On the other hand, if securities are bought by the Reserve bank, the result will be that in the process of paying for them the Reserve bank will have to credit the reserve accounts of member banks. Again it does not know to what extent particular member banks will be affected, but it does know that reserves in general will be increased. By the same token the lending power of the member banks will be increased and general credit conditions will be eased. In the first stages of a buying program, the effect will be to enable banks to pay off any obligations they may owe, but if a buying program is continued long enough it may result in an accumulation of excess reserves.

In addition to the effect upon the reserves of member banks, there is also an effect upon bank deposits in general - even non-member bank deposits; because, if an investor or an institution buys some of the securities sold by the Reserve bank, payment will ordinarily be made out of a checking account and deposits will be decreased by so much. If, on the other hand, the Reserve bank is buying securities, and institutions and individuals are selling to it, the payments made by the Reserve bank will increase the deposit credit outstanding on the books of banks. Accordingly, banks which are not members of the

Federal Reserve System and banks which themselves have not purchased or sold securities as a result of the Reserve bank's action, will nevertheless be affected by it, either in their reserves or in their deposits, or in both. The money market as a whole will be influenced.

In the early days of the System the Federal Reserve banks at first attempted to carry on their open market operations independently of one another, but it soon became clear that their actions must be coordinated. Otherwise they might find themselves competing with one another, and in conflict as between their own transactions and those transactions which as fiscal agents of the Government they were conducting for the United States Treasury. Accordingly, in 1922 a committee of Reserve bank officers was appointed for the purpose of coordinating the operations. About the same time the purpose of the operations was clarified. The principle laid down was: "That the time, manner, character, and volume of open-market investments purchased by Federal Reserve banks be governed with primary regard to the accommodation of commerce and business and to the effect of such purchases or sales on the general credit situation."

For some time prior to this there had been a tendency to allow purchases and sales of securities to be influenced by profit as an objective. The statement of principle which I have just quoted meant a definite abandonment of that objective. This was in line with the general policy of central banks in conducting open market operations; they do so definitely with the idea of correcting market tendencies and not for the purpose of making earnings.

The Banking Act of 1933 gave open market operations more specific recognition than they had had in the original Act. It gave statutory standing to the Federal Open Market Committee, which by then comprised one representative from each Federal Reserve bank. No Reserve bank could engage in open market operations except in accordance with regulations of the Board. At the same time the Act adopted substantially the same statement of purpose which had already governed open market operations.

The Banking Act of 1935 gave still further attention to the machinery of open market operations and to recognition of their importance. The Federal Open Market Committee was reconstructed to comprise the members of the Board of Governors of the Federal Reserve System and five representatives chosen regionally by the twelve Federal Reserve banks. This made the members of the Board constitute a majority of the Committee, and marked considerable development away from the original informal arrangements by which the Federal Reserve banks first conducted open market operations on their own initiative and then under the direction of a Committee on which the Board was not specifically represented. Furthermore, under the terms of the Banking Act of 1935, the Federal Reserve banks may neither engage nor decline to engage in such operations except in accordance with the directions and regulations of the Committee.

Another requirement of the Act is that a complete record be kept of the action taken on all questions of policy relating to open market operations, including a record of votes taken in connection with the determination of open market policies and a statement of the reasons underlying the action taken, and that this record be included in the Board's annual report. The publication of this record will give the public an opportunity to study the decisions as to open market policy and credit policy in general, and should help clarify public discussions of national credit policy. It will also accentuate the individual sense of responsibility, for members of the Committee will be called on not only to decide on credit policy, but to give publicly the reasons for their decisions.

It is clear, I think, that as a result of experience and statutory amendments, open market operations have taken a far more important place in general credit policy than they formerly had. It is also clear, I think, that open market operations have become a more important or at least a more positive device of credit control than discount rates. When the Federal Reserve Act was adopted the prevailing idea probably was that discount rates were not only the most definite means of credit control, but the most important. The thought was that as banks felt more and more demand from borrowers and went to the Reserve banks to procure the funds to meet it, they would encounter a rising discount rate, which would have the effect of tempering the demand and preventing an excessive use of credit. Conversely, as conditions improved, business activity would be encouraged by the fact that banks could procure funds to lend at a progressively lower rate. The most obvious difficulty with this theory, however, is that banks have not shown a disposition to borrow from the Reserve banks in order to relend. Banks don't like to borrow, and as a general thing they won't borrow unless they have to, no matter how low the discount rate is. Consequently, the effectiveness of the Federal Reserve discount rate is, by itself, rather limited. It is significant as an index of the cost of credit, but it does not come into action otherwise until a member bank finds it necessary to replenish its reserves. As I have already indicated, however, a member bank may be forced into such a position as the result of sales of securities by the Reserve bank, and the discount rate then becomes effective.

In other words, an important difference between discount rates and open market operations in practical effect is that open market operations give the central banking organization the initiative in the control of credit, whereas the discount rate by itself offers the controlling authority no handles to seize; it must bide its time passively until the situation is so bad that demand for funds is voluntarily made. This delay may seriously impair the power of the Federal Reserve bank to help the situation.

With respect to discount rates the Banking Act of 1935 made only one change. This was to require that they be established every fourteen days or oftener. It is not necessary that the rates be changed every time, but they must at least be reviewed and reestablished.

With respect to the reserves which member banks are required to maintain, the Banking Act of 1935 simplified the conditions under which the Board of Governors of the Federal Reserve System may alter the amount of reserves which is prescribed in the law. Prior to 1933, there was no authority to change reserve requirements administratively, but an act of May 12 of that year empowered the Board, with the approval of the President, to declare that an emergency existed and during the emergency to increase or decrease the reserve balances to be required. The Banking Act of 1935 allows reserve requirements to be changed by the Board without declaration that an emergency exists and without approval of the President. It does not permit, however, requirements to be reduced below the percentages stated in the statute nor to be more than doubled. The purpose of any change made in the requirements must be, in the words of the law, "to prevent injurious credit expansion or contraction."

I mentioned the requirement of the Banking Act of 1935 that a record be kept and published of the action taken with respect to open market operations. The Act also makes a similar requirement with respect to all questions of policy determined by the Board. A record of action taken, of votes upon policy, and of reasons underlying decisions is to be included in the annual report of the Board.

The responsibilities of the Federal Reserve banks as fiscal agents of the United States were not changed by the Banking Act of 1935, except for a provision which permits the Reserve banks to buy government obligations only in the open market; direct purchases from the Treasury are not authorized.

I think that the foregoing covers sufficiently the more prominent changes which the Banking Act of 1935 made with respect to Federal Reserve functions. There are also two provisions of Title II which bear on member bank lending powers.

Indirectly, the Act tends to broaden these powers by giving the Reserve banks authority to make advances to member banks on any satisfactory security. The former provisions still stand as to paper that is known under the original terms of the Federal Reserve Act as "eligible" for discount - paper, that is, which originates in connection with industrial, commercial or agricultural transactions - and they also still stand as to advances to member banks on notes secured by eligible paper or by Government obligations. The new provisions are added to these old ones without altering them. Advances authorized by the new provisions are simply required to be secured to the satisfaction of the Reserve bank, to bear a rate of interest at least one-half percent above the Reserve bank's discount rate, and to have maturities of not more than four months. At present, when the banks have large excess reserves, this new provision in the law may not seem very important. But times may change. If and when they do, the new provisions mean that, assuming a bank's assets are good, the Federal Reserve bank will be able to advance money on them, no matter what the type of paper, or the nature of the transactions in which they originated. In other words, borrowing from the Federal Reserve bank has now been made possible on other than technical conditions of eligibility alone. 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 under the old terms of the law, instead of having to sacrifice them on a demoralized market. Provision for such advances was first adopted as a temporary, emergency measure in 1932, but the Banking Act of 1935 made it permanent.

The original provisions of the law with respect to eligible paper were based on the principle that since the liabilities of banks were payable on demand they should be offset by short-term self-liquidating paper based on specific transactions involving the exchange of goods. The amendments added by the Banking Act of 1935 are based on the principle that in fact 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 credit functions. There is not enough short-term commercial paper to fill more than a small part of their portfolios. They accept the savings and time deposits of their communities and they also hold long term obligations of their communities. The new provisions for eligibility make the Federal Reserve Act cognizant of these realities and adapt the powers of the Reserve banks to them.

In a more direct way, the Banking Act of 1935 broadened lending 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, has been removed; and loans which are amortized are now permitted in amounts up to 60 percent of the appraised value of the property and with maturities of as much as ten years, provided installment payments are sufficient to repay at least 40 percent of the principal in that time. The Act also increased the permissible aggregate of real estate loans which a national bank may hold.

I think the principal effects of the Banking Act of 1935 may be summarized as follows:

In the first place, while the Federal Reserve banks remain essentially unchanged in organization and function, the importance of their central banking activities has been more clearly recognized.

Second, the Federal Open Market Committee has been given a more effective position in the System and more definite authority.

Third, the Board of Governors has been given larger powers and more direct responsibilities, and the principles upon which the System is to be administered have been more clearly developed.

Fourth, the 6,400 member banks have been given broader lending powers, and the facilities of the Federal Reserve banks have been made available to them on less technical and restrictive terms.