Operation of the National and Federal Reserve Banking Systems

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE COMMITTEE ON BANKING AND CURRENCY UNITED STATES SENATE

SEVENTY-FIRST CONGRESS

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PURSUANT TO

S. Res. 71

A RESOLUTION TO MAKE A COMPLETE SURVEY OF THE NATIONAL AND FEDERAL RESERVE BANKING SYSTEMS

PART 5

LETTERS AND DOCUMENTS

APPENDIX

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OPERATION OF THE NATIONAL AND FEDERAL RESERVE BANKING SYSTEM

APPENDIX

National Bank of Kentucky, Louisville, Ky.—Brief of Reports of Examination and Action Taken by the Office of the Comptroller of the Currency

Comptroller of the Currency,
Washington, February 9, 1931.

Hon. Carter Glass,
United States Senate, Washington, D. C.

My Dear Senator: At the request of the subcommittee of the Banking and Currency Committee of the Senate, of which you are the chairman, I am inclosing for the confidential use of the committee a brief report covering a period of about five and one-half years of the National Bank of Kentucky, Louisville, Ky.

You will observe that the bank was closed by the directors on account of heavy and anticipated withdrawals in order that all preferences may be avoided and the assets preserved for all creditors alike.

I think this complies in a general way with the committee's request.

Sincerely yours,

J. W. Pole, *Comptroller.*

[Reported to the subcommittee as a confidential paper, and subsequently released for inclusion in the record by sanction of Comptroller Pole.—C. G.]

The affairs of the National Bank of Kentucky took a change for the worse in 1925. The report of an examination made in April of that year disclosed losses of $109,000, which were written off during the course of the examination. The slow and doubtful assets amounting to $1,860,000 and $244,000, respectively, were criticized but no further action was taken.

The next examination of the bank was made in November, 1925, by Mr. John S. Wood, who at that time was chief national bank examiner of the eighth Federal reserve district, when the affairs of the bank were found to be in a decidedly more unsatisfactory condition.

The losses aggregating $334,000, estimated at that time, were promptly charged off, but the report of that examination contained 13 other items of criticism, the principal ones being slow and doubtful assets of $4,466,000 and $628,000, respectively; one loan in excess of the limit prescribed by law; large and unwarranted lines of credit and overdrafts.

Upon receipt of the report of examination the comptroller's office wrote a lengthy letter addressed to the board of directors covering each and every criticism, also urging the bank to take such steps that would increase the efficiency of the credit department of the bank as recommended by the examiner at the time of his examination.

The bank was examined again by former Chief Examiner Wood in May, 1926. The estimated losses amounted to $253,000 and were charged off during the course of the examination. The management was severely criticized for slow assets amounting to $4,360,000 and doubtful assets of $606,000; also on account of two loans in excess of the legal limit. Large unwarranted lines were again criticized and overdrafts, including one to the corporation in which the president of the bank was largely interested.

The examiner stated in this report that the institution was a 1-man bank and its affairs dominated by President James Brown. At that time the management promised the chief examiner to correct the criticisms and employ such persons as might be necessary to bring the credit department up to the standard required of national banks.

When this report of examination was received by the comptroller, and after the same had been analyzed, a letter was written to the bank in regard to the large amount of slow and doubtful assets, large lines of credit, large amount of overdrafts, and violations of law, and special attention was directed to the unwarranted line of credit to the Kentucky Wagon Co., requesting the management to charge off on account of this line periodically until it was reduced to a safe liquidating value.

The next examination was made in November, 1926, by National Bank Examiner C. A. Reinholdt, who estimated losses aggregating $168,000, and was successful in having the amount charged off during the examination.

The report of this examination showed seven other criticisms, including doubtful assets of $498,000 and slow paper aggregating $4,220,000. This examiner also stated in his report that President Brown dominated and directed the policies of the institution, and that while the bank still held a large volume of assets subject to criticisms he felt that if the present policy of charging off unsatisfactory assets continued the present earning capacity of the bank was so unusually large that no serious consequences would result. He further stated that the credit department showed improvement. No excessive loans were found in the bank at the time of this examination.

The bank was examined in April, 1927, by Examiner V. E. Sailor, and again in October, 1927, by Chief Examiner John S. Wood. The institution was required to charge off estimated losses of $137,000 in April and $151,000 was charged off at the time of the examination in October. The management was again severely criticized on account of excessive loans, large and dangerous lines of credit, slow and doubtful assets, overdrafts, and other matters less serious were listed as criticisms. Both the examiner and chief examiner wrote splendid reports of examinations, setting forth in considerable detail all criticisms of the bank and matter needing correction, and stated in their reports, "The affairs of the bank are still being dominated by President James Brown." Although it was apparent to the examiners and to the comptroller that President Brown was not a safe banker and had shown an utter disregard for the law and regulations of the comptroller's office, and although considerable losses were being charged off at the time of each examination, this did not seem to shake the faith of the directors in the president of the bank.

Upon receipt of the reports of examination made in 1927, letters based on these reports were written to the directors, which letters covered all of the criticisms contained in the reports, requesting correction of same and urging the directors to pursue a more conservative policy, and, as usual, they were required to reply in detail over their individual signatures. They were also requested to forward similar reports at 60-day intervals until the next examination, and to forward copies of these reports to Chief Examiner John S. Wood in St. Louis, Mo.

Letters from the comptroller to the directors advised them that it was evident the affairs of the bank and criticisms had not been receiving sufficient attention. They were advised that the condition of the bank was such as to require close attention and a more conservative policy in making loans and investments and a more vigorous action in liquidating or improving the condition of those which had been criticized. They were requested to carefully review the report and letters from the comptroller at the time of their next board meeting, and to take such steps as would be necessary to correct the matters criticized and to place the affairs of the bank in a satisfactory condition. Thereafter letters were received from the directors advising that excessive loans had been reduced and reporting some progress made in other criticized assets.

The bank was examined in March, 1928, by Examiner W. W. Kane, jr., and in October of that year by Chief Examiner Wood. The examiners again criticized the large amount of slow and doubtful assets, the same large lines, excessive loans, unlawful real-estate loans, and overdrafts. The bank was required to charge off assets amounting to $177,000 in March and also charged off $115,000 at the time of the examination in October.

On March 28, 1928, the comptroller wrote to Chief Examiner Wood and stated that it was evident the affairs of the bank were still being dominated by President Brown and that it was important that every member of the board be advised of the unsatisfactory condition, and instructed Chief Examiner Wood to ascertain whether the reports of examinations and letters from this office were being actually and seriously considered by the board and whether they had any definite program for improvement being carried out or proposed to leave the situation in the hands of the active officers. On account of the delay of the directors in replying to his letters and giving detailed information as to the progress made, the chief examiner was instructed to bring the matter to the attention of the directors at the time of the next examination of the bank.

Upon receipt of the reports of examination made in 1928, letters were written to the directors covering every criticism in the reports, requesting that they give particular attention to the slow and doubtful assets and that certain lines be materially reduced and others entirely eliminated from the bank's assets with the least possible delay. Considerable pressure was being brought upon the management of the bank with respect to unwarranted lines of credit to the Cadet Knitting Co., Murray Rubber Co., Van Camp Packing Co., Consolidated Realty Co., and the Kentucky Wagon Co. The examiner advised the comptroller's office that negotiations were apparently under way for the refinancing of most of these companies, which, if accomplished, would relieve the bank of a very large amount of undesirable assets.

At the time of the examination in May, 1929, by Chief Examiner Wood, it was found that no refinancing had been accomplished and it was necessary to again severely criticize the management on account of an excessive loan and a very large amount of slow assets. At this time the management seemed to have definite plans for a consolidation of the bank with the Louisville Trust Co. under a State charter. The chief examiner stated in his report that he expected the bank to be functioning as a State institution within 90 days. After this examination the officers advised that plans were rapidly being developed whereby the national bank would be consolidated with the Louisville Trust Co. under a State charter.

Upon receipt of the report of examination a letter was written to the directors with respect to the criticisms and unsatisfactory condition of the bank, but no reply was received until the comptroller had written three other letters requesting a full detailed report of the progress made in correcting matters of criticism listed in the report of examination. The cashier of the bank wrote the comptroller in September, 1929, advising that a $50,000,000 corporation, known as the Banco-Kentucky, had been formed and became operative on September 19 and that the bank would within 10 days make application to withdraw from the national system and would consolidate with the Louisville Trust Co. under a State charter.

There was apparently some doubt in the mind of the chief examiner as to whether or not the bank should be examined again in 1929 in view of the plans of the management for withdrawing from the national system. In reply to his letter concerning this matter the comptroller instructed the chief examiner to make the usual semiannual examination, which was made in December, 1929, and at that time the management was more severely criticized than at previous examinations.

The report disclosed slow assets aggregating $5,000,000, doubtful paper of $725,000 and losses estimated aggregating $386,000. The examiner stated in his report that President Brown continued to dominate. Loans to directors, officers, and employees and loans to corporations in which directors were interested were criticized. Immediately after this examination the comptroller wrote the directors calling their attention to the conditions of the bank and the various criticisms, requesting them to carefully review the report of examination and to advise him over their individual signatures. Two other letters were written the directors as the result of the examination in December, 1929.

At the time of the next examination in April, 1930, made by Chief Examiner Wood, estimated losses of $139,000 were charged off and the directors promised to eliminate assets amounting to $128,000 on or before June 16, 1930, and $976,000 on September 1, 1930. The examiner criticized assets amounting to $5,000,000 as slow and a much larger amount as doubtful than at previous examinations, the aggregate being $1,161,000.

At this time the bank was found to be holding a large number of loans to various individuals, including loans to officers and employees, collateraled by stock of the Banco-Kentucky Corporation. The examiner was instructed by the comptroller to return to the bank on July 16 and again on September 1, for the purpose of ascertaining whether or not the directors had kept their promise to eliminate unsatisfactory assets amounting to $1,104,000.

On May 9, a letter was written to the board of directors based on the report of examination and covering all matters of criticism as shown by the report and as discussed with them in detail by the examiner at the time of his examination. It was requested that the report and the letter from the comptroller be read by each of the directors and that at the next board meeting a letter be forwarded to the comptroller, advising him of the action taken in connection with each of the matters brought to their attention. The letter also called special attention to the practice of making loans collateraled by stock of the Banco-Kentucky and that the practice met with the disapproval of the comptroller's office. The directors were requested to make an immediate and material reduction in the volume of such loans with a minimum of delay.

The directors were also written on August 9, to which the cashier replied on August 23, stating that the management had been working continuously on the criticized items and had made considerable progress. The comptroller wrote to the directors again on September 9, advising that a satisfactory reply to his letter based on the last report of examination had not been received and requesting that the letter be given immediate attention.

While the stock of the Banco-Kentucky, held as collateral, was entirely unsatisfactory to the examiners and to the comptroller's office, it had a definite market value, being listed on the Louisville and Chicago exchanges. Therefore, loans collateraled by such stock could not be listed by the examiners as losses.

The comptroller's office was informed that a deal had been consummated whereby the Banco-Kentucky had acquired a one-half interest in Caldwell & Co., of Nashville, Tenn., and for this interest had given 900,000 shares of its stock. On September 12, 1930, Mr. Robert Neill, who had recently been appointed chief examiner of the eighth Federal reserve district, informed the comptroller's office that Examiner Mooney had been to the National Bank of Kentucky for the purpose of ascertaining if the directors had kept their promise to eliminate certain large objectionable items in the assets and reported that a large number of shares of Banco-Kentucky had been substituted for part of the objectionable assets which the directors promised to eliminate and also stated that the bank was lending Caldwell & Co. a large amount through its various connections.

Upon receipt of this information it was deemed that an immediate examination of the bank was essential. Chief Examiner Neill was so instructed and began his examination of the bank on September 17, 1930.

Despite the severe criticisms of the bank and its management by the comptroller and the examiners and despite the fact that the bank had been required to charge out of its assets large amounts at previous examinations covering a considerable period, President Brown was allowed to continue dictating the bank's policies and dominating its affairs. His large transactions with Caldwell & Co. proved disastrous.

The examination which was begun on September 17 by Chief Examiner Neill was not completed until October 24, 1930. At that time the bank had capital of $4,000,000 and surplus, undivided profits and reserve aggregating $2.849,000. The examiner estimated losses aggregating $1,356,000, in addition to slow and doubtful assets amounting to $4,542,000 and $686,000, respectively.

The bank was found to be carrying 100,000 shares of stock of the Banco-Kentucky on its books at $1,870,000, which had previously been substituted for criticised loans. It was also found that the bank had loans to Caldwell & Co., Rogers Caldwell and to his affiliated companies, aggregating $2,065,000, collateraled largely by stock of the Inter-Southern Life Insurance Co.

During the course of this examination the examiner used his best efforts to have the losses eliminated. He held two meetings with the board of directors and one with the executive committee. He succeeded in having formed an executive committee and placing the affairs of the bank in its hands. He had $850,000 of the most objectionable assets eliminated and the promise to correct other matters of criticism.

Although the loan to Caldwell & Co. exceeded the limit prescribed by law, the examiner ascertained before he left Louisville and after the executive committee had been appointed that President Brown granted another loan of $300,000 to Caldwell & Co. without the approval or knowledge of the executive committee or the board of directors. The examiner brought this matter to the attention of the board of directors.

The report of examination was received from the chief examiner on October 28, accompanied by a letter signed by the directors, dated October 24, advising of the action taken during the course of the examination with respect to the elimination of criticised assets, confirming the creation of an executive committee and containing promises to correct various other matters criticised and placing the responsibility for unauthorized loans to Caldwell & Co. on President Brown.

Upon receipt of the report of examination by the comptroller a letter was written to the directors based thereon, calling special attention to the matters of criticism and to the dangerous and unlawful loans to Caldwell & Co. The letter requested the directors to forward frequently detailed reports over their individual signatures, showing the progress made.

On account of President Brown's transactions with Caldwell & Co. and Rogers Caldwell, the comptroller was in almost constant communication with chief examiner Neill in an effort to have the Caldwell loans eliminated, to prevent any further extension of credit and to correct other matters subject to severe criticism.

While the loans to Caldwell & Co. and its affiliated interests were unlawful and were believed to be a dangerous concentration, the comptroller could only demand that they be eliminated. The examiners could not estimate them as losses inasmuch as they were collateraled at the time of examination by stocks, although undesirable but with a market value.

Within a short time after the failure of Caldwell & Co. it was evident that the National Bank of Kentucky was experiencing a slow run which could not be checked. Within a few days the bank lost several million dollars and it was evident that the bank's cash resources were being rapidly exhausted.

A careful analysis of the situation on the evening of Saturday, November 15, clearly showed that withdrawals had developed to such proportions that there was nothing left to do but to close the bank and in order to preserve its resources the bank did not open for business on Monday, November 17.

Senator Norbeck submitted for the record the following letters from independent bankers:

CITIZENS STATE BANK,
Castlewood, S. Dak., February 4, 1931.

Hon. PETER NORBECK,
Washington, D. C.

MY DEAR SIR: * * * I have no quarrel with the group and chain bankers, but I do believe that there are many false and misleading statements made about the unit bankers. When 50 unit banks fail the press heralds the fact that 50 banks have closed as a most terrible calamity. When a bank with a large number of deposit branches fail with possibly many times the deposits, such as the Bank of the United States in New York, it is noted in the records as only one bank failure, but, in reality, there was in that case about 60 banking institutions or banking offices that ceased business in that failure. You might just as well say that 60 banks in New York City failed in one day. The only difference is that they take it square on the nose in one day while we out here drag it out a little longer. I noticed, too, that the press was careful to say it was one of the smaller institutions in New York City. The American Banker daily list of New York bank-stock quotations lists only six large banks in New York City in the amount of capital stock.

We here at Castlewood are competing with group bankers every day. They have two of them at Watertown, only 16 miles from here. So far they have not hurt us any that we know of, so that I am not writing this because I have any grievance against them. The people do not like the group banking institutions and when they are assured of equal safety in a unit bank they prefer the unit institutions. We have had deposits come to us because of the fact that they are group institutions.

The statement recently made by the Comptroller of the Currency, Pole, that good management of a small unit bank would not prevent a bank failure, I believe, was pretty far fetched and certainly most unfair to the many good little banks over the entire United States. There are many banks in South Dakota that are small, but, nevertheless, weathered the storm the past few years. I will agree that good management may not prevent an operating loss if the territory is too small to support a bank, but certainly good management will prevent a loss to depositors, and that is the most important part and what the public is chiefly interested in. Good management of an unprofitable point will not lose the assets of the bank by making poor investments, and good management would prevent the bank from continuing to operate at a loss sufficiently long to cause any loss to depositors, as good management would close the affairs of the bank, pay off the depositors, and return the excess to the stockholders. I therefore believe that Mr. Pole was very unfair to the small unit bankers in making the statement that he did, and it certainly was not one that would help the small banks, but rather tend to undermine the confidence in the small banks.

It seems to me that most of the evidence that has come before the investigating committee has come from the large centers, possibly many of which has had no experience in the small communities, and no evidence has come from the many small-unit bankers that are operating profitable small banks over the country. In order to disprove some of the things that have been said about us little fellows I should like to mention a few things about this bank. I believe it is a typical small-unit bank and I believe the facts that I am about to recite will prove that a small-unit bank properly managed can make a profit and render real service to the community it serves both in safeguarding the deposits of the community as well as extending the necessary credit.

As you know, Castlewood is a town of about 500 people. It is a strictly agricultural community. The territory is limited, Watertown being only 16 miles to the north, Hayti, the county seat, 13 miles west, Estelline (banking town) 16 miles to the south, with Dempster village between us, Clear Lake (banking town) 19 miles east, with the village of Bemis between us.

This bank opened on March 7, 1927, as a successor to the old bank here that failed. This bank took over 50 per cent of the deposit liabilities of the old bank, amounting to about $60,000, besides some public funds which were paid in full. In addition the old bank trust assets have paid another 25 per cent, so that the depositors of the old bank have received 75 per cent on the dollar, with the prospects of at least 15 per cent more.

The bank opened with a capital of $25,000 and $2,500 surplus. The inclosed statement now shows deposits of $188,294.60 and the capital investment has grown to about $40,000. In addition ample reserves have been provided for all accrued interest and expenses.

I also inclose an analysis of the profit and loss account for the period of March 7, 1927, to December 31, 1930. The first part shows the yearly earnings, being $3,230.60 for the short year 1927; $4,485.29 in 1928; $5,380.57 in 1929; and $5,447.37 the last year, with a total net amount earned since the bank opened less than four years ago amounting to $18,543.83. The total earned per share for the period amounted to $74.17 a share, which should look like a reasonable profit for a small-unit bank. Many New York bankers can not equal this with their investment affiliates floating speculative bonds to sell to the unit bankers. The next part shows the disposition of these earnings. The policy of this bank has been to use the greater part of the net earnings for the protection of the depositors and declaring only a nominal dividend; but even so, the stockholders have received a fair rate of interest on their investment. The lower part of the analysis shows the growth of the capital investment, showing that from an original investment of $27,500 it has now grown to $41,140.68 after paying three dividends of $4,750 to the stockholders.

I also inclose an analysis showing the average statement for the year just closed and what each item has earned or cost. I believe that this analysis shows what a small-unit bank can earn and still operate a conservative institution. The first column shows the average of each item of resources and liabilities. For instance, the average deposit with our bank correspondents amounted to $28,209; United States bonds, $56,362; loans and discounts, $99,556. The average deposits held during the year amounted to $208,290, of which $102,744 were interest bearing and $105,546 noninterest deposits. The second column shows these items in percentages to the resources and liabilities of the bank. Note that the amount loaned locally amounted to only 40 per cent of the total resources of the bank, which shows that we did not loan heavily locally to obtain the profit we did make. The third column shows the percentages to the total deposits of the bank, taking total deposits as 100 per cent. The fourth column shows the amount actually earned on each item. For instance, bank balances netted us $482.70; United States bonds, $1,907.37, etc. The lower part of this column shows the amount paid interest on our deposits. The last column shows the amount of these earnings in percentage, showing that our total resources earned us 5.367 per cent from interest alone, not figuring exchange, commissions, and other earnings. The lower part of this column shows the cost of our deposits in interest, showing that our total deposits cost us 1.106 per cent interest.

This bank keeps its books on the accrual or earned basis, the same method used by all the large banks, and not on receipts and disbursements. This makes possible very accurate computation of earnings so that the figures shown on the inclosed statements are quite accurate. It takes a little more time daily, but the extra effort is worth the results.

I also inclose a profit-and-loss statement for the year which explains itself quite fully. I believe it will compare very favorably with profit-and-loss statements of large banks.

In inclosing these various statements to you, I do so to prove that a small unit bank properly managed can be profitable and safe. You will note that at all times we have had large reserves. You will also note that our investments have been very conservative, being largely United States, State, and municipal bonds, with only $3,000 invested at this time in other bonds. No doubt we could have increased our profits by making a large number of local loans, smaller bank balances, other bonds than United States and State bonds.

Analysis of the loans and discounts for the past year shows that we started the year with total loans of $89,932.60, the lowest total loans during the year was $86,560.90; the highest was $110,922.61, and we closed the year with $90,575.86 in loans. On the closing day of the year we had an even 200 borrowers, making the average loan $452.87. The largest loan was less than $3,000. We have now a loan limit of $7,000, but never approach it. Three-fourths of our borrowers are farmers, being 151 in number. The others are business men, or other individuals living in our community. Of the total loans, $64,-808.49, or 71.7 per cent, is secured by chattel mortgages; $1,715, or 1.9 per cent, by first real-estate mortgages; $4,930.26 by local collateral; $825.25 by conditional sales contracts; $2,567.56 by guarantor or 2-name paper; $478.60 otherwise secured, and only $15,250.70 straight 1-name paper, being 16.8 per cent.

In making loans to farmers, we aim to loan only on the liquid security the farmer holds. A farmer, like a business man, must have a little capital of his own. If we have plenty of security, the loans pay themselves. On the other hand, we have never refused a loan to a customer of this bank or anyone in our community, who had ample and liquid security; and, in fact, I know that a group or chain bank would not have loaned a dollar more here than we have loaned. We aim to keep our loans in such conservative amount that in the event we had to call our loans, our borrowers could obtain a loan from the Agricultural Credit Corporation or competing bank and pay us up. Our records further show that during the year just closed we loaned $106,100.02 in cash loans over our counter, in 862 loans. During the same period customers paid back to this bank in cash loans amounting to $105,456.76. This turnover is not so large as a large commercial bank, but I believe it shows that we rendered a distinct service to the people of this community. During the year we lent money to 328 borrowers.

As noted before, we have invested our secondary reserves largely in Government obligations. We did, however, have as high as $17,000 invested in corporation bonds at one time during the year, but during the summer were dissatisfied with the bonds sold us by the investment houses, and sold out all excepting two bonds, the longest maturity of which is March 1, 1933. We knew very little about buying bonds when we first commenced to buy bonds about two years ago. We were told to select a sound investment house and rely on their judgment as that was the only safe way to pursue. Nobody took the trouble to inform us how to check up on the bonds we bought. We did, however, feel that we should know more about the bond business, and subscribed for one of the standard-rating services, showing the rating given each bond, the high and low prices for the year, when issued and at what price, earnings, and so forth. We also subscribed for some of the financial magazines and papers in order to know more about this new field. We found that some of the bonds that had been sold us by the investment houses were of such long term that any reverses would materially affect the market price. We also found we had bought bonds of holding companies holding nothing more than the common stocks of other companies. We also found that some of the bonds had only a limited market and the market depended only on the market by a few investment houses. We, therefore, sold out most of the bonds we held at a moderate, in fact, a comparatively small loss, excepting only the two short-term bonds now held. If we had taken the recommendation of these investment houses and bought everything they offered to sell, we would, I am afraid, have our entire surplus wiped out and possibly a serious impairment of our capital. In fact, we know of some banks who have serious losses in their bond accounts. Some of the investment houses have spent several dollars in telephone calls attempting to divest us of our United States holdings and invest our funds in their speculative bond offerings. We are going to buy other bonds again, but they will be of a higher class, better marketability, and shorter terms. I sometimes wonder if these investment affiliates of the large banks, defended by Pole and the chain bankers, have not to some extent contributed to the downfall of the small unit bankers by selling them frozen bonds, and bonds that are now selling for 50 cents on the dollar. If a small bank closes the small banker is the goat, and the big banker who helped to sell these long-term speculative bonds that possibly contributed to the closing of the small bank stands in the eyes of the public as a smart banker. If a large banker gets on his hands some large corporation, whose loans are frozen in the large bank, the investment affiliate arranges to float a debenture or long-term bond, which they sell to the small banker on their recommendation. The large banker certainly has this advantage and it behooves the small country banker to be informed nowadays, so he does not take some of the frozen loans in the large bank into his own bank in the form of a bond or debenture. It is no wonder that the larger bankers do not want to dispose of their investment affiliates. In fact, that was one of the big points argued by the group bankers two years ago—that through their large number of banks they would be independent of the New York bankers and float their own bonds.

Personally I am not opposed to all branch banking. I believe that limited branch banking within a large city is desirable. I believe that limited branch banking within the county would not be so bad, as it would probably be better than the cut-throat competition we had a few years ago in South Dakota. The only bad feature is that if branch banking is given a start that the areas will gradually increase. However, I do not believe we should have interstate branch banking or group banking spread over such a large territory as we have in the Northwest now. The worst feature is that trouble in one territory or in one bank may spread over the entire system. We now have in the Northwest one group chain that has a bank way out in Washington, a large bank in Omaha, the largest bank in Iowa, the largest bank in Duluth, the largest bank in South Dakota, the largest bank in North Dakota, and a number of banks in Montana, and the head bank is located in Minneapolis, and its ratio of capital to its deposits is much smaller than most of the large banks, and many of the small ones, too. It is such a vast organization with a number of large banks in the group, that any serious trouble in one of the large group banks might easily spread over the entire system. The deposits of its affiliates totals much larger than the head bank itself, and I do not think that this is a good thing. The other group in the Northwest, I believe, is better situated. I do not think that they are wholly in favor of group banking, but was forced into it by its competitor and they had to form a group of their own or let their competitor take their correspondents away from them. Furthermore, in this group they have two large banks to bear the burden. The deposits of the affiliates outside of the two head banks are in better proportion. In other words, they are in better position to take care of trouble in a part of their group, because the head banks are larger in proportion to the rest of the group.

There is another feature of group banking that appears bad to me, and that is pyramiding of deposits. For instance: A bank at Ree Hights, S. Dak., is listed in the Blue Book to use the bank at Miller as a correspondent. A former officer of the Miller bank is now an officer of the bank at Huron recently organized, and undoubtedly the Miller bank uses Huron as a correspondent; the Huron bank will naturally use the head bank in Minneapolis as a correspondent. All these banks are members of the same group. Now, if a farmer deposits $1,000 in the Ree Hights bank, the Ree Hights bank may deposit this in the Miller bank, and the Miller bank may deposit in the Huron bank, and finally the Huron bank will deposit this in the head bank. Now, the deposits in all these banks have increased each $1,000 from the same deposit. In a consolidated statement of all the members of the group, the original $1,000 will show up as a $4,000 deposit in the group total, and each bank will have increased its cash reserve $1,000, and the group total of cash will also show as $4,000 as the result of the one deposit. Although this may be an extreme case, it shows how deposits and cash reserves may be pyramided by interdeposits within the group. It would therefore be most interesting to see a consolidated statement of the group with all interdeposits, intercash, and interadvances eliminated. Surely it would greatly reduce the footings and total resources now so much advertised. In other words, the totals are not there when intertransactions are eliminated. It shows the possibilities of deception so that statements will not tell the true condition.

It is very encouraging, however, to note what the leading bankers of New York say about branch and group banking on a nation-wide scale. I notice many of them do not favor it. It is also encouraging to see what the leading financial magazines say about it. The Financial Chronicle of New York in their June 14th issue, page 4122, certainly did not indorse the group and branch banking, and ended up by saying "it is a false growth—one not in accord with the best banking and business interest." In the November 22d issue, after the failure of the Banco-Kentucky group, it stated, on page 3248, "The ease with which trouble in one of the banks in an affiliated group extended to all the other banks in the same chain or group is evidence that chain or group banking is no protection against disaster; rather the reverse. The reason is perfectly plain. Suspicion or doubt with reference to one of the members naturally quickly brings other members of the group or affiliation under similar doubt and suspicion. And when this is said the chief argument urged in support of collective banking disappears." The New York Journal of Commerce, on November 19 and November 20, 1930, in two editorials condemned group banking. The American Bankers' Association Journal in their last two issues commented editorially on the fact that it was not the form of banking, whether group, chain, or unit which was most important, but pointed out that each class has had failures.

I hope you will pardon me for taking up so much of your time by this long letter. We at the bank appreciate your efforts and for that reason wanted to let you know t hat we appreciate it. My sole purpose in writing you this letter is to present the side of the small unit banker and show that they can still exist. I often have wondered what would have happened if the groups out of Minneapolis had had all their members in 1919 to 1921. The story then might have been different. I would not object so much to the group banks if there was a way to untangle it, but once in, the one joining can not get out again.

The writer of this letter started in the banking business in South Dakota nearly 14 years ago as a bookkeeper. I have worked in both National and State banks, and have always been very much interested in banking affairs and read all information that I can obtain on banking subjects. My connection with this bank, however, has been only since it reorganized, as I was not connected with it before.

With kindest regard, I am, yours very truly,

ARNDT E. DAHL,
Vice President.

P. S.—The opinions herein expressed are the opinion of the writer only, and I do not wish to express the opinion of anyone else, although they may agree.

Analysis of profit and loss account of Citizens State Bank of Castlewood, S. Dak., from date of opening March 9, 1927, to December 31, 1930

YEARLY EARNINGS

	1927	1928	1929	1930	Total
Gross earnings	$10,296.09	$14,601.21	$16,479.70	$17,570.20	$58,947.20
Interest paid	1,930.96	3,168.93	2,889.21	2,753.91	10,743.01
General expenses	5,134.53	6,946.99	7,771.42	8,936.62	28,789.56
Depreciation			438.50	432.30	870.80
Total	7,065.49	10,115.92	11,099.13	12,122.83	40,403.37
Net profit	3,230.60	4,485.29	5,380.57	5,447.37	18,543.83
Earned per share	12.92	17.94	21.52	21.79	74.17

DISPOSITION OF NET EARNINGS

Net earnings since Mar. 9, 1927	$18,543.83
Dividends paid: Jan. 10, 1928, 5 per cent; Jan. 7, 1929, 7 per cent; Jan. 14, 1930, 7 per cent [1]	4,750.00
Transfer to reserve with State treasurer	1,098.00
Transfer to surplus fund	7,500.00
Doubtful assets charged off	231.80
Undivided profits on hand Dec. 31, 1930	[1] 4,964.03
Total	18,543.83

[1] An 8 per cent dividend will be declared and paid on Jan. 13, 1931.

Analysis of profit and loss account of Citizens State Bank of Castlewood, S. Dak., from date of opening March 9, 1927, to December 31, 1930—Continued

GROWTH OF CAPITAL INVESTMENT

	Mar. 9, 1927	Dec. 31, 1927	Dec. 31, 1928	Dec. 31, 1929	Dec. 31, 1930
Capital	$25,000.00	$25,000.00	$25,000.00	$25,000.00	$25,000.00
Surplus fund	2,500.00	3,000.00	5,000.00	7,500.00	10,000.00
Undivided profits	None.	2,460.78	3,072.39	3,864.39	4,964.03
Reserve with State treasurer	None.	None.	269.82	1,028.60	1,176.65
Total	27,500.00	30,460.78	33,342.21	37,392.99	41,140.68

NOTE.—The above reserve with State treasurer is required under the new law of South Dakota. The fund held by the State treasurer belongs to the stockholders of this bank and for the protection of the depositors of this bank only.

Average resources and liabilities showing earnings and cost of Citizens State Bank, Castlewood, S. Dak., year ending December 31, 1930

RESOURCES

	Average during year	Percentage of total—		Earnings of each item	Amount of earnings in percentage
		Resources	Deposits		
Bank balances	$28,209.00	11.3	13.6	$482.70	1.711
United States bonds	56,362.00	22.6	27.1	1,907.37	3.384
State and municipal bonds	28,608.00	11.5	13.8	1,321.38	4.689
Industrial bonds	11,909.00	4.8	5.7	626.17	5.262
Commercial paper	5,508.00	2.2	2.7	297.60	5.403
Loans and discounts	99,556.00	40.0	47.8	8,730.53	8.774
Total earning assets	230,152.00	92.4	110.7	13,365.75	5.811
Overdrafts	335.00	.1	.2		
Currency and coin	4,695.00	1.9	2.2		
Banking house and fixtures	10,150.00	4.1	4.9		
Cash and transit items	426.00	.2	.2		
Interest on earnings not collected	3,221.00	1.3	1.5		
Nonearning assets	18,727.00	7.6	9.0		
Total resources	248,979.00	100.0	119.7	13,365.75	5.367
Miscellaneous earnings				4,204.45	
Total earnings				17,570.20	

LIABILITIES

	Average during year	Percentage of total—		Cost of each item	Amount of cost in percentage
		Liabilities	Deposits		
Certificates of deposits	$60,915.00	24.6	29.3	$2,034.63	3.341
Savings deposits	4,077.00	2.0	2.4	189.37	3.729
State deposits	10,000.00	4.0	4.8	202.59	2.025
County deposits	25,820.00	10.3	12.3	308.97	1.197
Superintendent of banks	932.00	.4	4.5	18.25	1.981
Interest deposits	102,744.00	41.2	49.3	2,753.91	2.681
Noninterest deposits	105,546.00	42.4	50.7		
Total deposits	208,290.00	83.6	100.0	2,753.91	1.322
Capital investment	37,494.26	14.9	17.9		
Reserves	3,742.00	1.5	1.8		
Total	248,979.00	100.0	119.7	2,753.91	1.106
Expenses and depreciation				9,368.92	
Net profits for year				5,447.37	
Total to balance profit account				17,570.20	

NOTE.—The books of this bank are kept on a strict accrual basis so that the above figures are quite accurate as to percentages. The large yield on commercial paper is due to the fact that the largest amount was carried the first part of the year and bought the previous year during the high rates.

Profit and loss statement, Citizens State Bank, Castlewood, S. D., for year ending December 31, 1930

[Accrual or earned basis]

	Amount	Percentage
Gross income from all sources:		
Interest earned—		
Loans and discounts	$8,730.53	49.7
Bank balances with correspondents	482.70	2.7
United States bonds	1,907.37	10.9
State and municipal bonds	1,321.38	7.5
Industrial or other bonds	626.17	3.6
Commercial paper	297.60	1.7
Total interest earned	13,365.75	76.1
Exchange and collection commissions	1,157.79	6.6
Commissions received—		
Farm-auction sales	203.00	1.2
Real estate loan commissions	177.50	1.0
Insurance commissions	1,780.78	10.0
Service charges	612.27	3.5
Bonds handled for customers	15.50	.1
Miscellaneous commissions	12.40	.1
Total commissions	2,799.45	15.9
Rents—		
Hall rent, I. O. O. F. lodge	127.21	.7
Safety deposit boxes	120.00	.7
Total rents	247.21	1.4
Gross income from all sources	17,570.20	100.0
Expenditures:		
Interest on deposits—		
Certificates of deposit	2,034.63	11.6
Savings accounts	189.47	1.1
State funds	202.59	1.2
County funds	308.97	1.8
Superintendent of banks	18.25	.1
Total interest on deposits	2,753.91	15.7
General expenses, including depreciation—		
Officers and employees' salaries	5,880.00	33.6
Taxes	286.98	1.6
Repairs and upkeep (extras this year)	422.04	2.4
Depreciation, building and fixtures	432.30	2.5
Other expenses	2,347.64	12.9
Total expenses	9,368.96	53.0
Net profit for year	5,447.37	31.3
	17,570.20	100.0

AMERICAN NATIONAL BANK,
Santa Monica, Calif., January 22, 1931.

Hon. HIRAM JOHNSON,
Senator from California, Washington, D. C.

DEAR SIR: We wish to call your attention to a matter now before the Congress of the United States—that is, proposed revisions of the national banking act and the legislation dealing with the operation of banks and the Federal reserve system.

The independent banker occupies a place in the community that can not successfully be replaced by the local manager of a branch or chain organization. No other business comes so close to the vital needs of every community; no one has better understanding of the people in a community or their particular problems than the local independent banker, who has his own funds invested in the bank and whose prosperity must be keyed to the community's prosperity. The one element in American life which has given this Nation its greatness has been the individual initiative and enterprise of our independent business man. The American tradition of equal opportunity for every boy to become what he chooses is fast perishing and will cease to exist unless the opportunity for the individual with intelligence, integrity, and perseverence to continue a business for himself with relatively small amounts of capital is protected.

The Federal reserve system, if it is to be of any benefit to the majority of these smaller independent banks, must be modified. As it operates at present the great majority of the smaller suburban and country banks do not have any opportunity to use the Federal reserve system. The compulsory membership in the Federal reserve system often proves an expense and drain without compensating benefits. A change in the rules of accepting paper for rediscount must be made if these banks are to be able to use the Federal reserve system in the manner in which we believe the founders of the Federal reserve system intended. Paper held by such banks which is safe and liquid sufficient to pass an examiner's approval should be made eligible for rediscount to the Federal reserve bank under some proper rules and regulations. Many small banks with plenty of paper, even better secured than much of that now accepted by the Federal reserve, have been forced to close during a run because of the refusal of the Federal reserve to advance a dollar against these assets.

The question of safety of a bank obviously does not depend on mere size—it is rather the relation of quick assets to deposit liabilities and the quality of loans held by the bank. The smaller unit bank given equal opportunity to utilize its resources, with proper supervision and management, should be, we believe, the safest type of financial institution and certainly should not be discriminated against by the Federal reserve in favor of large combinations of the country's finances.

We believe this question to be of utmost importance to the welfare and future of the country. Is business by the smaller independent concerns to be allowed to continue and prosper, or shall the children of the great majority have nothing to look forward to save a precarious vassalage to some giant industrial or financial creature of the law, with an ever-diminishing opportunity for any degree of independence in the inevitable extinction of that individual initiative and enterprise that produces a nation of leaders and great men?

Undoubtedly you are aware of these circumstances, but the nature of the issue is such that those whose interests lie with the ever-increasing power of the large and monopolistic concerns are in a position to present their view before the Congress and throughout the press, whereas those whose interests are on the other side of this controversy (and we believe them to be the great majority) can not have their views receive adequate publicity, nor will they so often be presented and insisted upon. Not only as business men but as citizens we feel so sincerely on this question that we would feel we had been guilty of gross negligence of duty as patriotic citizens if we did not express ourselves accordingly.

We trust you will find it in accordance with your duty to the Nation and to your constituents to take an active part and do what you can toward safeguarding the welfare of the independent bank.

Yours very truly,

RICHARD K. GANDY.

Senator Norbeck also submitted for the record the following letter:

MONTICELLO, ILL., *January 23, 1931.*

Senator P. NORBECK,
Washington, D. C.

DEAR SENATOR: I have been reading with interest in the New York Times the investigation of the Senate Committee on banking, and from reports thought you would be the proper Senator to write to in reference to the following matter:

I note that Comptroller Pole says that the owner of national-bank stock may now transfer their bank stock to a holding company (a corporation) and thereby evade the liability of assessment, which is provided by statute.

As I understand the proceeding, First National Bank stock is merely exchanged for stock in the holding concern and the latter is nonassessable and in event of failure the holding corporation would have no assets with which to pay the assessment. Their stock can be, and I presume usually is, paid for by the exchange of stock for property and to simply receive the national-bank stock and issue in exchange stock in the holding company. Under the United States statute, as I remember, the transferor of shares in national bank is only liable if the bank fails within 60 days after transfer.

It occurs to me that this could be amended so that if the transfer is to a corporation at the time or subsequently at any time the transferee proves to be unable to pay the assessment, the transferor could still be held.

Very respectfully yours,

E. J. HAWBAKER.

MAY 14, 1921.

Hon. CARTER GLASS,

Chairman Subcommittee of the Committee on Banking and Currency, Washington, D. C.

MY DEAR SENATOR GLASS: Many thanks for sending me copies of the hearings in re Senate Resolution No. 71, and I assure you that I have read the same, finishing Part IV, with a great deal of interest and pleasure.

Senator Norbeck seems to have deplored the fact that data submitted with reference to branch banking in California covers only 10 or a dozen years, instead of a 50-year period. I would suggest that several New York City banks, such as Bank of Manhattan Trust, National City Bank, Chatham & Phenix National Bank, Irving Trust Co., Corn Exchange Bank & Trust Co., and the Manufacturers Trust Co., who have been operating branches for a number of years, could furnish data covering a period of from 20 to 30 years. I think the Corn Exchange have been operating branches for something like 30 years, and the National City and the Manufacturers Trust as now constituted embrace chains taken in through consolidations and those chains run back over a period of 20 years or more.

I may say that I have had a number of years' experience in the banking business, prior to the organization of the Federal reserve system, but have not been actively identified since, but have never lost interest in the subject, and have endeavored to keep posted on the development of the banking business by reading and other general observation. I thought I would write you on two or three points that interested me particularly and at the same time offer one or two suggestions, which may in themselves have no particular merit from your viewpoint, but, I hope, will start a train of thought that might develop something worth while in connection with the points covered.

Referring to affiliates of banks, I think the terms should be defined and might include (1) a trust company, (2) a savings bank, (3) a safe deposit company, (4) a real estate holding company, (5) a securities company, and (6) a holding or operating company. Nos. 1, 2, 3, and 4 should be organized under State laws, and Nos. 5 and 6, under national laws, being incorporated in the District of Columbia.

Provision could be made, I think, for incorporating under the laws of District of Columbia for operations carried on for Nos. 5 and 6, mentioned above, because such operations are nation-wide and often overlap State lines when not nation-wide.

All affiliates should be examined by the Comptroller of the Treasury at the same time of the auditing of the parent bank, except where the affiliates are under State supervision, and then, arrangements could be made with the State Department so that the State would examine the other companies at the same time.

Referring to banks of demand deposit, should, so far as practical, be prohibited from accepting what we consider as strictly savings and thrift accounts, except where the banks are operating in small communities and is necessary for the convenience of the public to handle all classes in the one institution. We have, however, a recent development here in New York, where the National City Bank has been extending to people entitled to same, what is known as small personal loans, somewhat similar to the Morris plan for personal loans. This is known, I understand, as 3-name paper, and the borrower repays the same by opening a thrift account or savings account, depositing therein weekly an amount sufficient to liquidate the loan in 10 or 12 months. I think this is a very desirable class of business and affords help to many people and saves them from going to the loan brokers, who in the past have charged very much beyond the legal rate. There is no doubt but what in times of stress savings department depositors are the ones who get excited and demand their money, thus drawing on the available resources of a bank, very often when conditions do not justify them, and for this reason I think that banks doing a demand deposit business should keep out of the savings and thrift field as much as possible.

Statements of condition of affiliates should be published as of the same date of the publishing of parent-bank statement. I do not think such statements should disclose the holdings in the portfolios, as the same has no special interest, in my opinion, to the public, and in many cases would reveal information to the banks or the affiliates' competitors.

With reference to voting of stock in Federal reserve bank as is proposed in the Glass bill, reference thereto being made in Part IV, page 614, referring to paragraph 3 of the Glass bill, I think it is entirely too drastic. All banks controlled by holding companies, by whatever name called, where the holding company has not incorporated under the laws of the District of Columbia, as suggested above, should not have in any Federal reserve district the right to vote for more than, say, one-sixth, instead of one-third of the Federal bank directors. In such cases the Government should elect the other one-sixth, thus giving the Government more control than as at present. Holding companies putting their money into bank stocks should not be disfranchised merely because they are not individuals or natural persons, but it might be well to curb any right of such a controlled group to dominate in any Federal reserve district. The suggestion to incorporate holding companies under the laws of the District of Columbia is made with the idea of bringing all such companies under the supervision of both the Comptroller of the Treasury and the Federal Reserve Board.

Some extra inducement might be offered State banks to join the Federal reserve system by extending to those banks in the system a credit on their taxes similar to the earned-income credit allowed individuals under the present Federal income tax laws.

All national and other banks in the Federal reserve system should be prohibited from contributing in any manner to any guarantee for protection of depositors. These guarantee systems are, in my opinion, an open invitation to promoters to get into the banking game.

All banks large enough should be forced into the clearing-house association serving their territory. Had this been done with the Bank of United States here in New York City, that bank would have been forced to comply with the very excellent banking methods of high standing of our Clearing-House Association, and I believe the depositors of that bank would be better off to-day had that been done. This plan might be developed to the point where clearing-house associations are organized to operate in one or more counties throughout the Nation, where the service to be secured from such clearing-house associations is not available from the Federal reserve banks.

Referring to Superintendent Broderick's plan to oust bank officers who fail to carry out superintendent's recommendations, I think entirely too drastic. To place such absolute authority in the hands of one man is not warranted, and in the hands of one less competent than the present superintendent one can readily visualize the amount of damage that could be done by a superintendent who was a political appointee rather than a practical man, and who had an axe to grind or political debts to pay. In lieu thereof I would suggest that the Comptroller of the Treasury, in making suggestions and recommendations that are ignored, as in the Louisville case, referred to in the record, then the Comptroller of the Treasury should have the power, with the approval of the Secretary of the Treasury, to issue warrant of distraint against the property of the chief executive officers and directors of such bank, the warrant of distraint to be served as any other such document and recorded in the county where both the bank and individuals reside and do business, all property so covered to be held under such warrant until the comptroller's recommendations are complied with. Such a warrant would affect the title to any property so covered. In addition thereto, the comptroller, with the approval of the Secretary of the Treasury, could have the power to appoint one or more acting vice presidents (not necessarily bank examiners) in such bank, at the expense of the bank and with authority to reduce the salaries of the executive officers sufficiently to cover compensation of such acting vice president. These two "clubs" should not be given any publicity in the press, for that might start a run on the bank, which we are trying to avoid. Any officer or director who may not think the action of the comptroller is reasonable could apply to the courts to have the same modified or revoked. This would put the burden on such officers and directors of establishing to the satisfaction of the court that these acts of the comptroller are not warranted. All such court actions to be public, the same as any other court proceednig.

If the two clubs referred to in the preceding paragraph are wielded by the comptroller, I do not think he would have to close any banks, for he will thus be enabled to force the officers and directors to improve conditions. He can thus take charge of the situation before it gets out of hand, and the depositors and stockholders could thus be saved from losses bound to arise when a bank is closed. In the event the comptroller is authorized to act thus, he can clear the records of the warrant of distraint by securing a court order of cancellation without publicity. Any publicity with respect to these two clubs should be very severely dealt with unless such publicity is authorized by the comptroller. This in no wise restricts the freedom of the press. This plan is devised to protect the depositors, the stockholders in the bank, whose interest should be paramount.

With reference to bank loans to brokers on securities, would suggest that a normal loan base be determined as follows: Take the average price over the last 10 years between the high and the low market prices, then the average of the high during the same period—the normal loan base should be some figure between these two averages, which might be fixed for securities against which banks might loan up to 50 per cent thereon. As the market price goes up or down from this normal loan base, the loan margin should be moved accordingly by some percentage rate that would keep any loan in proper relation to the normal loan base, i. e., if the normal loan base be taken at $100, then a bank could loan up to $50; if the price of the security held as collateral went up to $120, then the loan should not be over $52, or, say, 10 per cent of the increase above the normal loan base. Some plan along this line could, I believe, be worked out to handle this class of business and endeavor to keep the brokerage loan business in the banks, so as to prevent, as far as possible, another run-away bull market. This is a desirable class of business and should not be taken away from the banks. Every effort should be made to keep credit facilities in the control of the banks and Federal reserve system.

Loans to brokers for the distribution of new securities underwritten by them should be exempt from the provisions suggested in the preceding paragraph, which are made with an idea of controlling market trading.

Capital going into brokers' loans direct, and not through the banks, should be taxed the same as banks are taxed and penalized with a profit tax of 50 per cent in addition. If something of this kind is not done, then we are going to have "bootlegging" in handling market trading.

I think the Federal income tax law might be changed with respect to the capital gains and loss provisions, so that the tax on capital gains would be materially reduced to, say, about 3 per cent, and no deductions allowed for losses, unless the property has been held for a period of, say, 3 or 4 years. I feel reasonably sure that under the present law, taxpayers have been able to either materially reduce or dodge the payment of taxes, by deducting losses, as now provided for under the captain gain tax provision.

Referring to Part IV of the proceedings, page 603, last paragraph, where reference is made to the poor borrowers of country banks, would say that it seems to me that the borrowers of these country banks might be grouped in, say, several counties, if not a Federal reserve district, so that the banks could be permitted to carry group insurance at their own expense to protect themselves against the losses bound to arise through the deaths of these small borrowers.

Of course, I understand that what I am saying applies, so far as you and I are interested, to the national banking system, but I think some effort should be made to get the various States throughout the country to cooperate with Congress in devising a uniform banking system, so as to eliminate, as far as possible, the differences between the National and the State systems of banking, and where one has an outstanding feature it should be incorporated in the other.

I think we should realize the importance of not having too much government in business, but more business in government, and I think the laws should endeavor to be constructive rather than restrictive, allowing the largest freedom of action, for the vast majority of our bankers are both honest and capable. Legislation will not keep the banking system wholly free from incompetent individuals, and so-called bad boys. I think our best course of procedure is intelligent and well directed supervision and swift and sure punishment to those who are dishonest and we should always aim to endavor to protect the depositor and the stockholder by finding a way of punishing delinquent and incompetent officers and directors before serious damage is done, and I have endeavored to convey to you my thoughts along these lines, and hope that I am not intruding by writing you a letter of this length.

Respectfully yours,

FREDK. C. TRIMBLE.

THE CONSTITUTIONAL POWER OF CONGRESS TO ENFORCE A SINGLE SYSTEM OF COMMERCIAL BANKING

I. GENERAL PRINCIPLES

Congress derives no power over banking from the specific language of the Constitution. A discussion therefore of this question involves not an interpretation or construction of words and phrases in the Constitution but rather a broad consideration of the nature of the Federal Government and the power of Congress to realize the ends for which that Government was established.

There are certain fundamental constitutional principles which have become so thoroughly established that they require no further discussion:

(1) The Government of the United States is a government of enumerated powers. It is limited in scope to those powers delegated to it by the Constitution in contrast to the State governments which possess all powers of government which have not been conferred by the Constitution upon the General Government.

(2) Although limited as to the number and character of its powers the Government of the United States is, within its sphere of action with respect to any given power, supreme over all State and local governments.

(3) Congress possesses the incidental power to enact legislation necessary and proper to give effect to the powers specifically conferred by the Constitution upon the Federal Government.

(4) While Congress may by inaction suffer the States to exercise jurisdiction with reference to subjects delegated under the Constitution to the Federal Government, Congress may whenever it sees fit enter those fields completely with an authority that is exclusive and paramount.

(5) In making effective its constitutional powers the choice of means and instrumentalities is a matter of congressional discretion. Congress may if it sees fit utilize agencies created by the State governments; it may create its own agencies and at the same time permit State agencies to continue to exist pari passu; or it may dominate the entire field with instrumentalities of its own creation to the exclusion and the prohibition of any similar State agencies or instrumentalities.

It has been thoroughly established by repeated opinions of the Supreme Court of the United States from the earliest times that Congress may under its incidental powers create an instrumentality of finance in the form of banking corporations; that Congress is the sole judge of the nature and extent of the charter powers which such banking corporations may exercise; and that no State government without the express or tacit consent of Congress may limit the powers or impede the usefulness of such corporations. (McCulloch *v.* Maryland, 4 Wheat. 425; Osborn *v.* Bank of United States, 9 Wheat. 738; Farmers and Merchants National Bank *v.* Dearing, 91 U. S. 29; Davis *v.* Elmira Savings Bank, 161 U. S. 275; Easton *v.* Iowa, 188 U. S. 229. 1903; First National Bank of Bay City *v.* Fellows, 244 U. S. 426. 1917.)

The first Bank of the United States, the second Bank of the United States, the national banking system, and the Federal reserve system were established under this constitutional authority.

No particular constitutional provision can be detached and labelled as the specific constitutional power under which Congress established the system of national banks and later the Federal reserve system. These instrumentalities are not exclusively related by any manner of means to the fiscal operations of the Federal Treasury, although there appears to be no doubt that Congress could create a banking instrumentality solely by reason of its power and responsibility to provide for the management of the public finances of the Nation.

In discussing the basis of the power of Congress to establish the Bank of the United States by the act of 1816, the Supreme Court held that the General

Government might require such a fiscal instrumentality as an incident to its power to raise and support armies, to provide and maintain a navy, to regulate commerce between the States and with foreign countries, to collect taxes and customs duties, to borrow money and to make disbursements and transfers of funds. (McCulloch *v.* Maryland, 4 Wheat. 325; Osborn *v.* Bank of United States, 9 Wheat. 738.) The same constitutional sanction lay behind the creation of the national banking system and the Federal reserve system.

II. RELATIONSHIP OF THE COMMERCE CLAUSE TO FEDERAL FISCAL INSTRUMENTALITIES

The power of Congress to regulate commerce between the States was no doubt one of the principal constitutional powers brought into play in the enactment of the national bank act through which fiscal instrumentality there was set up a system of operating banks under Federal charter and supervision. The establishment of a system of currency which was uniform, national, and sound through the means of notes issued by these banks had for one of its primary objects the relief of interstate commerce from the mass of heterogeneous and inferior local bank-note currencies issued under State authority.

The following extract from the report of the first Comptroller of the Currency in 1863 reflects in part some of these conditions:

"The amount of losses which the people have sustained by insolvent State banks, and by the high rate of exchange—the result of a depreciated currency—can hardly be estimated. That some of the new States have prospered, notwithstanding the vicious and ruinous banking systems with which they have been scourged, is evidence of the greatness of their resources and the energy of their people. The idea has at last become quite general among the people that the whole system of State banking, as far as circulation is regarded, is unfitted for a commercial country like ours. The United States is a Nation as well as a union of States. Its vast railroad system extends from Maine to Kansas, and will soon be extended to the Pacific Ocean. Its immense trade is not circumscribed by State lines, nor subject to State laws. Its internal commerce is national, and so should be its currency. At present some 1,500 State banks furnish the people with a bank-note circulation. This circulation is not confined to the States by which it is authorized, but is carired by trade or is forced by the banks all over the Union. People receive it and pay it out, scarcely knowing from whence it comes or in what manner it is secured. Banks have been organized in some States with a view to lending their circulation to the people of others. Probably not one quarter of the circulation of the New England banks is needed or used in New England—the balance being practically loaned to other States. The national currency system is intended to change this state of things, not by a war upon the State banks, but by providing a means by which the circulation which is intended for national use shall be based upon national securities through associations organized under a national law. The United States notes, the issue of which was rendered necessary by the exigencies of the Government, and which it is presumed will be withdrawn whenever this exigency ceases, have taught the people the superiority of a national circulation over that to which they have been accustomed. In many sections the produce of the country can not be purchased with bank notes, and people find it difficult traveling from State to State without legal tenders. Everywhere the opinion is prevailing that the circulation of local banks has about had its day, and must yield to the demands of the people for a circulation of which the Government is the guarantor."

Although the power of Congress to establish a uniform system of currency exists independently of its power to regulate commerce, nevertheless, in the establishment of the new national currency through the national bank act these two powers were combined in a joint purpose.

Independently, however, of the question of a uniform national currency, the power of Congress to regulate commerce was directly involved in the creation of the national banks as instrumentalities to facilitate commerce between the States and with foreign countries. It was the purpose of Congress that the national banks supersede the existing State institutions engaged in commercial banking. It provided the means in the Act whereby the transition could be made voluntarily and without any disturbance of operations. In 1866, two years after the final revision of the national bank act, the national banks had in fact displaced the State commercial banking corporations. Thus there came into effect a uniform system of commercial banking operating in every part of the national domain under the general supervision of the Comptroller of the Currency. There was provided for those engaged in the purchase and sale of goods and commodities moving in interstate and foreign commerce a single type of banking facilities under the same regulations throughout the entire country.

This result was, however, not accomplished until after Congress had exercised its power of penalty and prohibition against State institutions which impeded at its inception the progress of the new banking system.

It may be said that the Federal reserve system is even more clearly related to the commerce clause of the Constitution than any of the preceding Federal fiscal instrumentalities. While it serves as an aid to the Federal Government in many capacities in the exercise of the specific powers conferred upon that Government by the Constitution, the Federal reserve system was designed and has become in fact the cornerstone of our business structure. It is most intimately related to the processes and facilities of interstate and foreign commerce. The system of currency made possible through it has contributed to the circulating medium the final element of value, namely, that of elasticity. This feature of elasticity arises out of the direct relationship between the volume of currency at any given time and the current demands of commerce for it. Apart from the question of currency the Federal reserve system, through its system of reserves and its operations in the field of commercial credit, provides a fundamental security for commercial banking and for commerce itself in all parts of the country.

While an analysis of all of the constitutional powers of Congress to establish the Federal reserve system is not necessary to support the legal sanction for that instrumentality, since Congress could proceed under any one of those powers if it deemed it appropriate, it would seem fair to say that if any one clause of the Constitution was relied upon to a greater extent than any other in the establishment of the Federal reserve system it was that empowering Congress to regulate commerce between the States and with foreign countries.

III. THE POWER OF CONGRESS TO PROCEED UNDER THE COMMERCE CLAUSE ALONE

Digressing for a moment, however, upon the theory that the commerce clause must be relied upon in any attempt by Congress to create a single standard of commercial banking, let us examine into the nature of commercial banking.

Modern commerce is carried on largely upon the basis of credit. Goods are bought, sold, and transported not through the delivery of cash or specie by the buyer to the seller but payment is made by means of certain paper facilities evidencing the transaction and the obligation, such as drafts, checks, acceptances, and promissory notes. Through these means funds situated at the place of the buyer are made avalable at the place of the seller. That is to say, there is a transfer of funds or a transfer of credit.

Banking institutions are essential to the operation of this commercial procedure. It is through the medium of a bank that these transfers are made. The field of commercial banking is fraught with many complications and technicalities of interrelation between banks and banks, between banks and customers, and between buyers, sellers, shippers, and carriers, but reduced to its simplest terms commercial banking is the instrumentality through which funds are transferred from buyer to seller in the purchase, sale and transportation of goods and commodities.

Commerce in the United States is almost entirely interstate and foreign and all commercial banks, whether State or National, are now engaged in furnishing facilities for the movement of interstate commerce. The Comptroller of the Currency has in fact several times pointed out that commercial banking is now predominantly in the hands of State chartered banks and trust companies. It is significant that there are six trust companies, five in New York and one in Chiacgo, with aggregate loans and discounts of approximately $3,400,000,000. The third largest commercial bank in the country is operating under a State charter. In all of the great commercial centers in the United States a large share, if not a preponderant share, of interstate and foreign commerce is transacted through State-chartered institutions.

Congress could, in order to control this situation, proceed in two directions under the commerce clause, one positive and the other negative:

(1) It could treat commercial banking as a facility of interstate and foreign commerce and regulate it, or

(2) It could deny the facilities of interstate and foreign commerce to state banks and trust companies.

The constitutional power of Congress over interstate and foreign commerce is extremely broad. It extends to the articles which move in such commerce and over the facilities furnished in aid of such commerce. The citation of a few general principles laid down from time to time by the Supreme Court of the United States will serve to illustrate the extent of this power.

(1) Commerce among the States is not a technical legal conception but a practical one drawn from the course of business. (Swift & Co. *v.* U. S., 196 U. S. 375.)

(2) "Commerce" as used in the United States Constitution, Article I, paragraph 8, clause 3, includes the fact of intercourse and of traffic and the subject matter of intercourse and traffic. The fact of intercourse and traffic embraces all the means, instruments, and places by and in which intercourse and traffic are carried on, and comprehends the act of carrying them on at these places by and with these means. The subject matter of intercourse or traffic may be either things, goods, chattels, merchandise, or persons. (McCall *v.* California, 136 U. S. 104.)

(3) Commerce is a term of the largest import. It comprehends intercourse for the purpose of trade in any and all of its terms, including the transportation, purchase, sale, and interchange of commodities between the citizens of our country and the citizens or subjects of other countries and between the citizens of different States. (Welton *v.* Missouri, 91 U. S. 275; Hopkins *v.* United States, 171 U. S. 578.)

(4) Interstate commerce is not confined to transportation but comprehends all commercial intercourse between different States and all component parts of such intercourse, including the buying and selling of commodities for shipment from one State to another. (Federal Trade Commission *v.* Pacific States Paper Trade Association, 273 U. S. 52.)

Under its authority thus to regulate Congress could require all corporations which supply banking facilities for interstate or foreign commercial transactions to operate under a uniform national standard under the national charter.

Congresss, in its regulation of commerce between the States, may penalize and prohibit the movement of articles in interstate commerce. Such a prohibition may be made within the discretion of Congress such as in the Webb-Kenyon Act as to alcoholic beverages, the white slave traffic act, the pure foood and drugs act, the cattle inspection act, and the like. Similar prohibitions could be imposed upon drafts, checks, acceptances, commercial paper, and securities passing in interstate commerce to or from State banks.

In concluding this phase of the discussion of the question reference should be made to the doctrine of congressional inaction. A review of some of the leading cases is given below:

(1) The power of Congress to regulate commerce is not exclusive where not exercised and does not prohibit the States from legislating on subjects relating to commerce provided their statutes do not conflict with those already enacted by Congress. (Thurlow *v.* Mass., 5 How. 504.)

(2) Congress by refraining from action in matters affecting interstate commerce permits common or civil law or State statutes to that extent to control. (Hall *v.* De Cuir, 95 U. S. 485.)

(3) The State, in the absence of express action by Congress, may regulate many matters which indirectly affect interstate commerce. (Missouri P. R. Co. *v.* Larrabee Flour Mills Co., 211 U. S. 612.)

(4) Any power which a State may have over interstate commerce because of congressional inaction ceases to exist from the moment that Congress exerts its paramount authority over the subject. (Chicago, R. I. & P. R. Co. *v.* Hardwick Farmers Elevator Co., 226 U. S. 426.)

In reliance, therefore, solely upon its power to regulate commerce, it would seeem clear that Congress may completely dominate the field of commercial banking.

IV THE POWER OF CONGRESS IN GENERAL TO REGULATE ALL COMMERCIAL BANKING

The power of Congress over banking, however, rests upon broader and more comprehensive grounds. It embraces the question of the power of Congress to preserve the fiscal instrumentalities set up by it from the encroachment of State institutions operating competitively in the same field. This phase of the question we shall now proceed to examine.

(A) *The practical conditions.*—The occasion for this discussion arises out of the fact that there have been brought to the attention of Congress reports upon the banking systems which have a serious bearing upon the effectiveness of the national banks and the Federal reserve system.

In his annual report to Congress for 1924 the Comptroller of the Currency directed attention to the fact that in the 40-year period from 1884 to 1924 the percentage of commercial banking resources controlled by national banks had declined from 75 to 47 per cent. That is to say, the aggregate of commercial banking resources in the hands of the State banks had increased by the same proportions and controlled in 1924 more than one-half of the volume of commercial banking facilities, namely, 53 per cent. He cited figures to show the decided trend of national banks toward the relinquishment of the national charters in favor of State charters. He called the attention of Congress to the danger of the ultimate loss of its control over commercial banking through this movement toward State charters. (Report of the Comptroller of the Currency, pp. 12 to 16.)

In his report for 1925 the Comptroller of the Currency again directs the attention of Congress to this situation. He cited cases of important withdrawals from the national system. He said:

"The number of losses of national banks to the various State systems within the past two years is formidable enough to arouse the serious attention of the Government of the United States. Many of these banks had been in the national system for more than 50 years * * *.

"These facts present a serious situation for the consideration of the Congress * * *. The national banking system is a time-honored Government instrumentality. The charter powers of the individual national banks are derived solely from Congress. Twice in the history of the United States, namely, immediately after the Civil War and immediately preceding the World War, the Federal Government was able to enforce a banking policy at a time of great financial stress through its authority to use the national banking system as an instrument for the public benefit. The individual national bank is always ultimately able to take care of itself in meeting the competitive conditions due to more favorable State laws by giving up its national charter and going into the State system. But the gradual loss of national banks and the consequent decrease in relative resources of the national banking system is of primary concern to the National Government, not only because the national banks form the logical and permanent basis of the Federal reserve system but also because only through the national banking system can there be maintained throughout the United States a standardized system of banking subject to the visitorial powers of the Federal Government and subservient at all times to the will of Congress." (Report of the Comptroller of the Currency, 1925, pp. 3 and 4.)

Turning to the report of the Comptroller of the Currency for 1926 we find him laying before Congress additional figures showing important new withdrawals from the national banking system.

"Each withdrawal constitutes the loss of a unit in the basic membership of the Federal reserve system. These widespread desertions from the national system are clearly indicative of the difficulty which national banks find in operating under their present charter powers. The fact that a greater or less number of State banks for one reason or another take out national charters in no way compensates for the loss of national banks. The national banking system should be adequate to meet all of the requirements for modern banking, and no national bank ought to be put in the position of being forced to yield its charter in order to carry on legitimate and necessary banking operations.

"My predecessor in his statement before the House Committee on Banking and Currency, April 9, 1924, showed that in the five decades preceding 1924, the aggregate resources of the national banks had dropped from a predominating control over commercial banking resources to only about 48 per cent thereof. This rate of decline has been accelerated during the past two years, the national banks to-day holding only about 46 per cent of the total commercial banking resources in the United States. This is true notwithstanding the fact that there has been year by year an actual increase in the aggregate resources of the national banks, the figure standing at the present time around $25,000,000,000.

"The steady decline in the relative strength of the national banking system is accounted for by the more rapid growth of commercial banking under State charter, the total resources of the State commercial banks being at the present time about $29,000,000,000. This rapid increase of State banking resources is due primarily to the operation of State laws more favorable to modern banking than is the national bank act. It arises in part from accretions from the national system but more largely from the normal banking operations. * * *

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"The above statements of fact show that the Federal Government is gradually losing its positive and immediate control over the instrumentalities of commercial credit and over the membership in the Federal reserve system. The greater volume of commercial banking has already passed under the policy control of the State legislatures." (Report of the Comptroller of the Currency, pp. 2 and 3, 1926.)

In none of the above-mentioned reports did the Comptroller of the Currency recommend setting up a national standard of banking under a national system of banking which would embrace exclusively the field of commercial banking. On the contrary, the remedy proposed was an approach as far as possible to parity between the National and State systems of banks by permitting national banks to engage in the various types of banking permitted under State charters. In other words, it was recommended that there be brought into the national charter those features of the State charters which were causing boards of directors and stockholders of national banks to relinquish national charters in favor of those of the State. The so-called McFadden Act (act of February 25, 1927) was the outcome of these recommendations.

It appears from the comptroller's reports of 1927 and 1928 that the McFadden Act for a time led to a relative increase of resources of the national banks over that of the State banks. But not to any considerable extent. This increase was caused almost solely by the conversion of several large State branch banking systems into national banks. We find the Comptroller of the Currency, in his annual report for 1929, again directing the attention of Congress to the exodus of national banks from the national charter. In this respect he abandons the theory of parity of powers between State and National banks and advocates legislation for the national banks without reference to powers under State charters. He said:

"Under the existing trend, with the operating advantage in favor of the State banks, the development is in the direction of 48 separate and distinct systems of commercial banking each under the supervision, control, and direction of a separate State government with a correspondent disappearance of the national banks from the fiield * * *.

"The announced legislative policy of the so-called McFadden bank act of February 25, 1927, was parity between the National and State systems. The purpose of the bill was to make the charter powers of national banks approximately equal in operating advantage to those of the State banks. Nearly three years of operation under that act has demonstrated that it has failed of its purpose in this respect.

"The theory of parity between the two systems of banks is, in my opinion, economically unsound. Commerce is interstate and is recognized by the Constitution of the United States as being fundamentally a national question. One of the primary purposes of the national bank act of 1863 was to establish a sound and uniform system of commercial banking throughout the country in order that commercial transactions growing out of the production, the manufacture, and the transportation of goods and commodities from one section of the country to the other might not be hampered by local banking legislation but should have access to a system of banks operating under Federal authority and supervision under a single set of rules and regulations and statutory enactments in order that the free flow of commerce should not be embarrassed by a multiplicity of restrictions having their origin in local political conditions." (Report of the Comptroller of the Currency, 1929, pp. 5–9.)

A year later, in his report for 1930, the Comptroller of the Currency in advocating new legislation for national banks said:

"State legislatures have conferred upon State chartered institutions, particularly upon trust companies, banking powers which national banks did not at the time enjoy. As a consequence, the national-banking system has, within recent years, declined in size, importance, and influence and has become thereby relatively less effective as an instrumentality of the Federal Government. Through the diversion of commercial banking from the National to the various State banking systems Congress has lost control over the major portion of the commercial banking resources in the United States.

"Upon the enactment of the McFadden bill the conversion into national banks of several larger State branch banking institutions and the consolidation of several State banks with national banks under the national charter gave rise to the hope that the national-banking system would reclaim the most important banks which had left it to operate under State charters. However, this hope was short lived, for there soon followed through State legislative or State judicial action new advantages for State banks, particularly with respect to the operation of the trust business and desertions from the national charter in favor of those offered by the States began to increase. That the disparity between the two systems of banks is pronounced is evidenced by the fact that whereas in 1886 the national banks held 75 per cent of the total commercial banking resources of the country, the latest compiled figures indicate that this proportion has now shrunk to less than 40 per cent." (Report of the Comptroller of the Currency, 1930, pp. 4, 5.)

The investigation instituted in both Houses of the Seventh-first Congress through the respective Committees on Banking and Currency, and particularly through the Senate committee, have brought out much additional information with respect to the effect of the existence of the State systems of commercial banks upon the national-banking system and the Federal reserve system. The question has definitely been raised of the desirability of the establishment of a single system of commercial banking under the national charter in order that Congress may set up adequate standards of banking which can not be avoided through an exit into a State system of competing banks. In this connection it becomes necessary to consider the constitutional power of Congress to effect such a purpose.

(B) *The power of penalty and prohibition.*—The situation now presented to Congress with respect to the fiscal instrumentalities set up by it is strikingly similar to that which followed the establishment of the national banking system. Hugh McCulloch, the first Comptroller of the Currency, in his second annual report to Congress, November 25, 1864, called the attention of Congress to the fact that although the national currency and the national banking system had been inaugurated, relatively a small number of State banks had taken advantage of the opportunity to convert into national banks, but that the bulk of State banks continued to use their own circulating notes under State authority. At this time out of 1,500 State banks only 168 voluntarily became national banks. The Comptroller of the Currency, regarding as detrimental to the public interest the failure of the national system to supplant through voluntary action that of the State systems of banks because it made the progress of the new banking system difficult, if not impossible, recommended to Congress the enactment of legislation which would impose a discriminating tax upon State bank currency for the purpose of driving it out of existence and thereby forcing all banks of circulation to operate under the national charter.

Following this recommendation Congress enacted the following provision which put a tax upon State bank currency:

"Every national banking association, State bank, or State banking association, shall pay a tax of ten per centum of the amount of notes of any person, State bank, or State banking association used for circulation, and paid out by them after the first day of August, 1866, and such tax shall be assessed and paid in such manner as shall be prescribed by the Commissioner of Internal Revenue. (July 13, 1866, 14 Stat. L. 146.)

The constitutionality of this act was brought squarely before the Supreme Court of the United States and upheld in the case of Veasie *v.* Fenno (8 Wall. 533). Chief Justice Chase, in delivering the opinion, said in part.

"The power to tax may be exercised oppresively upon persons, but the responsibility of the legislature is not to the courts but to the people by whom its members are elected. So if a particular tax bears heavily on a corporation, or a class of corporations, it can not for that reason only be pronounced contrary to the Constitution.

"But there is another answer which vindicates equally the wisdom and power of Congress.

"It can not be doubted that under the Constitution the power to provide a circulation of coin is given to Congress. Then it is settled by the uniform practice of the Government and by repeated decisions that Congress may constitutionally authorize the emission of bills of credit. * * * There can be no question of the power of the Government to emit them; to make them responsible in payment of debts to itself; to fit them for use to those who see fit to use them in all the transactions of commerce; to provide for their redemption; to make them a currency, uniform in value and description, and convenient and useful for circulation. These powers, until recently, were only partially and occasionally exercised. Lately, however, they have been called into full activity, and Congress has undertaken to supply a currency for the entire countrty. * * * Having thus in the exercise of undisputed constitutional powers, undertaken to provide a currency for the whole countrty, it can not be questioned that Congress may, constitutionally, secure the benefit of it to the people by appropriate legislation. To this end, Congress has denied the quality of legal tender to foreign coins, and has provided by law against the importation of counterfeit and base coin on the community. To the same end, Congress may restrain, by suitable enactments, the circulation as money of any notes not issued under its own authority. Without this power, indeed, its attempts to secure a sound and uniform currency for the country must be futile."

It should be observed that the tax imposed by Congress upon the State bank circulation was not for the purpose of raising revenue for the support of the Federal Government but was clearly in the nature of a prohibition to prevent the encroachment of State chartered institutions upon a Federal instrumentality. The purpose of the tax was to destroy State systems of currency and thereby in effect to put out of commission the State commercial banks. The report of the Comptroller of the Currency to the next session of Congress, in 1866, stated that the national system of banks had indeed supplanted the State banks and that all of the State banks of circulation had availed themselves of the privilege under the national bank act of converting into national banks, thus indicating the effectiveness of the tax.

This case serves to illustrate an important constitutional principle which has a direct bearing upon the present discussion. The constitutional powers of Congress are not divided into separate compartments each independent of the other. The Federal Government is a political organism and may rely upon a number of its constitutional powers in the performance of a single act. Its vitality depends upon its ability to use any and all of its powers to accomplish the ends necessary and proper to its existence. Consequently, Congress may proceed under one specific constitutional power by way of penalty and prohibition to make more effective another constitutional power. The two most convenient forms of penalty which have heretofore been employed by Congress have been imposed through its power to tax and through its power over articles moving in interstate commerce.

(C) *Responsibility of Congress for its own fiscal agencies.*—As a background to the power and the responsibility of Congress for the creation and the maintenance of the national banks and the Federal reserve system citations from a few of the leading cases before the Supreme Court of the United States may be of interest.

In Easton *v.* Iowa (188 U. S. 229, 1903) the court, in reversing the Supreme Court of Iowa, directly adopted and applied the constitutional principles enunciated in McCulloch *v.* Maryland (4 Wheat. 425) and in Osborn *v.* Bank of United States (9 Wheat. 738). It said that the national bank act "has in view the erection of a system extending throughout the country, and independent, so far as powers conferred are concerned, of State legislation which if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States."

The court further said, "On the immediate subject of control over national banks it was said in Farmers and Merchants National Bank *v.* Dearing (91 U. S. 29) 'the States can exercise no control over them (national banks), nor in anywise affect their operations, except in so far as Congress may see proper to permit. * * * The States have no power by taxation or otherwise to * * * burden or in any manner control, the operation of constitutional laws enacted by Congress to carry into execution the powers vested in the general Government.'"

The court in this case also cited with approval the principles laid down in the case of Davis *v.* Elmira Savings Bank (161 U. S. 375) in which the court had said: "'National banks are instrumentalities of the Federal Government, created for a public purpose, and as such necessarily subject to the paramount authority of the United States. It follows that an attempt by a State to define their duties or control the conduct of their affairs is absolutely void wherever such attempted exercise of authority expressly conflicts with the laws of the United States and either frustrates the purpose of the national legislation or impairs the efficiency of these agencies of the Federal Government to discharge the duties for the performance of which they were enacted. These principles are axiomatic, and are sustained by repeated adjudications of this court'."

The court further said: "Our conclusions, upon principle and authority, are that Congress having power to create a system of national banks, is the judge as to the extent of the powers which should be conferred upon such banks, and has the sole power to regulate and control the exercise of their operations."

Are not these principles directly applicable to a situation in which the State governments may have set up agencies or instrumentalities rival to and in competition with those set up by the Federal Government with the effect that the Federal instrumentalities be reduced to a state of impairment in the accomplishment of their purposes?

In First National Bank of Bay City *v.* Fellows (244 U. S. 426, 1917) Chief Justice White, in delivering the opinion of the court, confirmed all of the previous leading cases from the McCulloch case in 1819 down to 1917 upholding the constitutional power of Congress to create and maintain fiscal instrumentalities in the form of national banks, exclusive of State control or interference. This case involved the power of Congress to permit national banks to exercise trust powers. The court said:

"That even though a business be of such a character that it is not inherently considered susceptible of being included by Congress in the powers conferred on national banks, that rule would cease to apply, if, by State law, State banking corporations, trust companies, or others which, by reason of their business, are rivals or quasi rivals of national banks, are permitted to carry on such business. This must be, since the State may not by legislation create a condition as to a particular business which would bring about actual or potential competition with the business of national banks, and at the same time deny the power of Congress to meet such created condition by legislation appropriate to avoid the injury which otherwise would be suffered by the national agency."

In the more recent past Congress has pursued the policy of permitting the State legislatures to take the initiative in banking legislation and from time to time have attempted to enlarge the powers of the national banks in order to meet the State competition.

The desirability of the establishment of a single national standard of banking has led to two principal recommendations, one, to grant to the national banks charter powers of greater scope than can be attained by State banks in the expectation that those engaged in banking under State charters will seek the national charter; and the other, the complete and exclusive entry of the Federal fiscal agencies into the field of commercial banking through the removal of State commercial banking from the field.

The first of the above remedies has been recommended principally by the Comptroller of the Currency and the immediate weapon he would use is the extension of branch banking by national banks in disregard of State boundary lines.

The second remedy, that of the enforcement of a single standard of banking through congressional action, has several times been presented in the form of a question at the current investigation by Senator Glass and has specifically been advocated by Mr. Owen D. Young. It is on this question that doubt has been expressed as to the constitutional power of Congress to proceed.

V. CONCLUSION

In view of the foregoing considerations I am of the opinion that Congress clearly is possessed of the constitutional power, supported by legislative and judicial procedents firmly established, to proceed by direct action to remove the State banks from the field of commercial banking. This power is inherent in the power to establish and maintain the national-banking system and the Federal reserve system. The question of law does not present an obstacle. What remedy to adopt is a practical question of congressional policy.

If congress sees fit it may lawfully use one or more of the following methods of producing a single standard of commercial banking under Federal control:

1. It may place a prohibitive tax upon (*a*) checks drawn in one State upon a State bank in another State. That is to say, State bank checks moving in interstate commerce; (*b*) other means of the transfer of funds through State banks from one State to another.

2. The denial of the facilities of interstate and foreign commerce to State banks and trust companies, such as (*a*) telephone, (*b*) telegraph, (*c*) railroads, (*d*) aeroplanes, (*e*) steamships.

3. The denial of the use of the mails in connection with transactions in interstate commerce.

The fact that the above procedure would be drastic is of no consequence since its purpose would be to transfer a system of banking which has come into harmful competition with the banking instrumentalities created by Congress. Such a policy by Congress would be nothing more in principle than a repetition of the tax act of 1866 and for the same purpose.

CHARLES W. COLLINS.

MEMORANDUM ON COUNTRY BANKING

(Furnished to committee by Robert Warren, New York City)

The country bank is peculiarly an American institution. It has no counterpart and no equivalent in any other country. With its faults and its virtues, is was the country bank that financed the growth of the United States over the past century, and to-day "country banks" probably hold half the deposits of the American people.

Yet, important as the country bank is in American economic life, country banking as a distinct type of banking has received little attention from American economists. Indeed, they have generally failed to recognize that there are fundamental differences between country banking and city banking almost as wide as those which divide city-deposit banking from investment banking. It is only recently that statistical data have been available which would permit quantitative statistical analysis of country banking as a distinct field, and even to-day the data are not entirely adequate. It is limited to the "country banks" of the Federal reserve system which, although they hold about one-third of the total deposits of the member banks, are a minority of the country banks in the United States and do not probably hold half the deposits of the country banks of the United States.

The figures in the accompanying analysis have been taken from the call report of December 31, 1930, and refer only to member banks of the Federal reserve system. It is believed that they are representative of country banking in general; although, since the country member banks of the system have in general weathered the financial storms of the past year more successfully than nonmember country banks, it is probable that the statistics available present a rather better picture than the complete actualities. For the purpose of examination they are, however, satisfactory.

CHARACTERISTICS OF COUNTRY BANKING

Any consideration of country banking must start from the premise that it is a distinct type of banking, that its problems are not identical with those of city banking, and that identical criteria of behavior can not apply. The fundamental characteristic of the country bank is the concentration of its field, as contrasted with the diversification which the city bank enjoys. A country bank is primarily dependent upon the welfare of the particular agricultural specialty of its community, and upon a limited number of commercial and manufacturing enterprises, whose welfare in turn is closely associated with the local type of agriculture. Now, of all human enterprise, agriculture is subjected to three common and inevitable hazards:

1. A slow turnover, generally only once a year.
2. Wide and frequent price fluctuations.
3. Dependence for its volume of output upon a force beyond human control or foresight; i. e., the weather.

These facts enter the problem of the country bank to an extent unknown in city banking.

Second, the function of the country bank is essentially different from that of the city bank. In theory at least, the function of city banking is the financing of goods in process or in transit; the function of country banking is, to a certain extent, to provide, through credit, the working capital of the entrepreneurs of communities which are, generally speaking, deficient in capital.

That is, the country bank supplies a different kind of credit to a different kind of customer, from that which the city bank supplies to its borrowers. This fact in no way implies that one type of banking is "purer" or more "orthodox" than the other; it merely asserts that the two types are fundamentally different in character.

From these fundamental characteristics of country banking one unavoidable consequence derives. It is the duty and the responsibility of the country bank to serve the economic activities of its community, although the economic activities of its community are subject to inescapable hazards. The implication is that the local loans of a country bank never do, never will, and never can possess the "liquidity" which can and should characterize the loans of a city bank. This is stating bluntly the basic problem of country banking. No matter what the prudence of the banker nor the diligence and ability of his borrowers, they can not avoid the hazards of the economic sphere in which they have cast their lot—the fluctuations of prices and the vagaries of the weather operating upon an industry which has only one turnover per annum. The country bank can not shirk the responsibility of lending the greater part of its resources locally, but it must (or should) do so in full realization that in spite of human diligence or forethought circumstances beyond local control or prevision may make it impossible for those loans, or at least a considerable part of them, to be paid in full at the specified maturity. The word "impossible" is here used to mean not so much absolute inability as inability except at such sacrifices as will prove grievous to the community. Putting it frankly, any country bank in any year may find its local loans in a condition varying from "slow" to "badly frozen." When this occurs (as, for example, in 1930) it is not prima facie evidence of bad banking. On the contrary, in certain sections of the United States in 1930 no country banks which conscientiously and loyally was endeavoring to serve it community could avoid finding the liquidity of its local loans gravely impaired. While 1930 was an exceptional year in several ways, in that the affected areas were unusually widespread, this situation to a greater or less degree is by no means infrequent. It is the ever-present hazard of country banking.

CUSTOMERS' LOANS AND OTHER ASSETS

Starting, therefore, from the premise that in any given year any country bank in America may find the liquidity of its local loans impaired, and that in exceptionally years country banks as a group may find themselves generally in this condition, entirely as the result of circumstances which they could neither foresee nor prevent, it is obvious that the country bank must set up defense mechanisms adequate to protect itself and its depositors. That is, since its local loans must (or should) from its character comprise the major part of its earning assets, and since these local loans are subject to certain inevitable hazards, it is clear that the country bank should apportion the remainder of its funds among assets of a certain quality of liquidity and security. In this respect its determinants are radically different from those of a city bank. Whereas the city bank may depend more heavily upon the liquidity of its customers' loans and may regard its investments as primarily the placement of its time deposits, thus assimilating that part of its function to the operation of a savings bank, a country bank must candidly recognize that at any time its local loans may become quite unliquid and that its investments, far from being assimilable to those of a savings bank, are its first line of defense in maintaining liquidity and even solvency.

ANALYSIS OF ASSETS

The available statistics indicate that country banks as a class have not clearly grasped this essential requirement. The following tables show the distribution of the assets of country banks (members of the reserve system) as reported in the December 31, 1930, call; and alongside the distribution reported by the member banks of New York City.

TABLE I.—*Distribution*[1] *of assets December 31, 1930*

[000,000 omitted]

	Country member banks	New York City member banks
Total loans and investments	$12,458	$8,579
Customers' loans	7,702	4,336
Open-market loans	176	1,525
United States securities	1,153	1,239
Other securities	3,367	1,196
Loans to banks	59	283

[1] Source: The Federal Reserve Bulletin, February, 1931, p. 111.

There is one very important figure lacking from this table. Its absence is negligible so far as the New York City banks are concerned, but it is badly needed to complete the picture for the country banks—this is the figure of the net balance due from city correspondents. On September 24, 1930, the call showed such a net balance of $569,000,000.[1] This figure can not be applied to the table given because it includes correspondent relations outside the reserve system and hence would not be strictly comparable to the other items in the tabulation. This figure, whatever it is, is one of the key figures required for any analysis of country banking in the United States, and it is herewith suggested that its inclusion in future calls would be highly desirable.

Taking the statistics as they are, they disclose the following distribution of customers' loans.

TABLE II.—*Distribution of customers' loans December 31, 1930*

[000,000 omitted]

	Country member banks	New York City member banks
Collateral loans [1]	$2,146	$2,137
Loans on real estate	1,451	147
Other loans [2]	4,106	2,051
Total customer loans	7,702	4,336

[1] Includes loans to brokers outside New York City.
[2] Loans to customers exclusive of banks, otherwise secured and unsecured. Sometimes classed as "other loans chiefly commercial." F. R. Bulletin, February, 1931, p. 111.

Reducing these items to percentages of their respective totals, the following table is desired:

TABLE III.—*Proportion to total loans and investments*

	Country member banks	New York City member banks
	Per cent	*Per cent*
Customers' loans	61.5	50
Open-market loans [1]	1.5	18
United States securities	9.0	14
Other securities	27.0	14
Loans to banks	.5	4

[1] Acceptances, commercial paper, and "Street loans."

The first figure is interesting—a larger proportion of the resources of the country banks is found under customers' loans, a fact by no means surprising in view of circumstances.[2] Certainly the figure can not be regarded as disproportionate—and, as a proportion close to this was reported at the end of 1928 and of 1929, we may presume that it is a sort of "normal" figure. Whether it holds for the nonmember country banks is unknown. We may suppose, however, that country banks on the average place about 60 per cent, or between 60 and 70 per cent of their funds into loans with local customers.

[1] Federal Reserve Bulletin, November, 1930, p. 756. This figure is approximate only. It is the difference between the "net due to other banks in the United States" by country member banks, and the "net due from other banks in the United States." It necessarily includes items "due to" and "due from" nonmember banks, and hence is imperfectly comparable.
[2] Strickly speaking the "street" loans of the New York City banks are a type of customer loan.

The following table shows the distribution of the customer loans:

TABLE IV.—*Proportion to total customer loans*

	Country member banks	New York City member banks
	Per cent	*Per cent*
Collateral loans	28	50
Real-estate loans	19	3
Other loans	53	47

It has already been noted that country banks put a larger proportion of their resources into local customer loans than city banks, and this table indicates that these loans are distributed very differently from the customer loans of New York City banks. It is not the purpose of this memorandum to criticize this distribution; its object is to emphasize that the local loans of country banks are inherently of a type that becomes more or less unliquid in case the community suffers from either general or local adversity.

The following table is a regrouping of Table III in order of availability:

TABLE V.—*Grouping of assets in order of availability*

	Country member banks	New York City member banks
	Per cent	*Per cent*
Immediately available	11.5	32
Negotiable	27	14
Total	38.5	46
Customers loans (commercial and collateral)	61.5	50

The "immediately available" item is composed of United States securities and "open-market loans"; these can be realized instantly and with assurance of recovery of the entire principal. The "negotiable item" includes the "other securities." It will be noted that, after their customers' loans the New York City banks put about 45 per cent into the "market" and the country banks about 40 per cent—again there is nothing to criticize in the distribution. But whereas the New York banks put 32 per cent into "first rate" placements and only half as much into "second rate" securities, these proportions are reversed in the country banks. And this, in spite of the fact that the customer loans of country banks are inherently subject to hazards not common to the customers' loans of city banks.

THE "OTHER SECURITIES" OF COUNTRY BANKS

Country banks put approximately 27 per cent of their funds into investments other than United States securities, while New York City banks place only 14 per cent in such securities. This wide disparity of practice provokes attention and is open to criticism.

A "good" investment is one which answers the needs of the investor; "goodness" is not an intrinsic quality of the investment itself. A given bond may be admirably suited to the needs of one investor and utterly unsuited to the needs of another. The object of this memorandum is to show that from their character country banks are obliged to place very heavy dependence upon their other than local loans to maintain ilquidity, in case of the ever threatened local adversity, and the unescapable corollary of this thesis is that only a certain kind of security can meet the requirements of a country bank. This is a security whose instant marketability, without serious loss of principal can be absolutely depended upon in case of general or local adversity. Yet the statistics show that country banks are prone to place their dependence upon a type of security which, however "good" in itself, is not unqualifiedly suited to their specific requirements.

We may suppose that these "other investments" have certain high merits, i. e., that all are negotiable in some organized market, that few or none are threatened with default, etc. But these merits do not suffice for the needs clearly indicated, unless they possess one other, namely, such recognized quality and general desirability as will free them from wide fluctuations in price. Bonds with limited markets, or narrow markets, or uncertain quality, or subject to wide fluctuations, while they may be admirably suited to the portfolios of certain persons or institutions (for example, investment trusts or, in due proportions, even city banks) are absolutely unfitted for the needs of country banks. Yet it is a matter of common knowledge that such securities form a large proportion of the "other securities" held by country banks.

It is perfectly true that country banks are never or rarely forced to suspend specifically because of the depreciation of their bond portfolios. That is not the point. The impairment of the liquidity of their local loans (forced by circumstances they can neither foresee nor prevent) drives them into dependence upon their nonlocal assets, of which the greater part is composed of securities other than "open market" loans or United States Government securities. If at the same time that the liquidity of the local loans is impaired, the secondary bond market is simultaneously depressed, country banks as a group find themselves in difficulties—difficulties ranging from absolute insolvency to technical insolvency, or mere impairment of capital assets. It was precisely this combination of adverse circumstances which occurred in 1930—impaired liquidity of local loans synchronized with a weak market for secondary bonds. Against the former contingency the country bank has no protection—it is inherent in the very character of country banking; country banking is liable to such maladies as the individual is liable to illness, in spite of all human precautions. But against the second and, in 1930, concomitant contingency, the country bank possesses a defense. It could keep a larger proportion of its nonlocal assets in absolutely first-class placements, i. e., "open market" loans or gilt-edge securities, and a smaller proportion in "other securities," which, whatever their other merits lack the great essential—instant availability without serious loss of principal. Returning again to the analogy of the individual, no person can insure himself against illness, but he can insure himself against some of the consequences of illness by keeping a portion of his capital at hand in his bank, rather than having all of it either immobilized in his business or subject to the vagaries of the security market.

There is a further consideration. A country bank, having a paper loss on its bonds, and finding its deposits shrinking, is confronted with the alternative of taking a loss by liquidating its bonds or bringing pressure upon its customers to contract their loans. The temptation is to take the latter course, even though the former might be preferable from the standpoint of general welfare. There were distinct traces of the operation of such a force in the statistics of 1930.

The object of this memorandum has been to invite attention to the statistical evidence that country banks place too great reliance upon their holding of second-grade securities. That is, the proportion of second-grade securities to other assets is large, both by comparison with the practice of New York City banks, or by rational deductions from the inherent characteristics of country banking. The conclusion appears unescapable that it would be highly desirable for country banks as a class to place a greater proportion of their assets in "open-market" loans, United States Government securities, and other bonds of the highest grade; and a smaller proportion in second-grade securities, which, however meritorious, lack the essential quality of instant availability, in an organized market, at a price which assures no serious loss of principal. Indeed, it appears to be no straining of the statistical evidence to offer the conclusion that a large proportion of the difficulties of country banking, leading, as they so frequently do, to insolvency, could be removed by a systematic and thorough recasting of the investment practice of country banks as a group.

SUGGESTIONS

Such a recasting coul be achieved by prescribing lists of investments for country banks, as certain States do for savings banks. There are both advantages and disadvantages to the proposal; but to the writer it has one absolute disadvantage. It would, in his opinion, place too great a restraint upon the initiative and discretion of the individual banker. Although this memorandum is critical of the investment policy of country banks as a class, the writer is too well aware of, and has too high a regard for, the enterprise, prudence, and financial acumen of country bankers not to wish them the greatest latitude for the exercise of their abilities that is consistent with safety to their depositors and to the integrity of the banking situation.

Nevertheless, having criticized the investment practices of country banking, the writer feels under obligation to suggest a method by which these practices could be improved. It is therefore suggested that, rather than prescribe a fixed distribution of nonlocal assets or prohibit investment in securities outside a prescribed list, the improvement be sought indirectly.

1. It is therefore suggested that it be required that all banks make public their statements, as of the call dates, and that in such statements the value of their investments, in the aggregate, be entered at a figure not higher than the market value of these investments as of the same date. In this way, an impairment of the "secondary reserve" would be brought forcibly to the attention of the bank's directors, and the temptation to invest in secondary reserve in bonds of uncertain marketability and subject to extreme fluctuations, would be automatically restrained without the necessity of arbitrary interference. This method of reporting is already habitual with some banks of the highest character; and it is believed that great benefits would accrue if the practice were made universal. While it is not to be expected that the investment portfolio of all banks will at all times show a net profit over cost, there seems to be little justification for the publication of statements in which an item of "surplus and undivided profits" makes no allowances, or an inadequate allowance, for a possibly serious depreciation an item which may comprise nearly 30 per cent of the earning assets of the bank.

2. It is also suggested that a standard form of bank statement be devised by the Comptroller of the Currency, or by the Federal Reserve Board, so devised as to indicate more clearly the absolute and the relative liquidity of the institution and that it be recommended that all banks in their published statement follow such a form. At present, although most banks publish periodical statements, it is scarcely an exaggeration to say that no two banks present identical statements, or a form which makes possible comparison with other banks; and that these diverse statements have only one common quality—for the most part they are presented in such a way as to fail to disclose the liquidity or even the solvency of the bank. It is believed that the elementary rights of the depositor entitle him to a statement which will give him a fair impression as to the state of the institution to which he intrusts his money. This opacity of statement is not peculiar to country banks; it is common to city banks. The object of such a revised and standardized form of presentation would be to indicate the relative liquidity and true worth of the assets, neither of which are clearly shown in the present common types of statement.

CONCLUSION

The events of the past year have emphasized the facts demonstrated over a long period of previous years: That American banking practice is subject to certain weaknesses which lead to deplorable numbers of bank failures which, even when individually small and scattered, are calamitous to the communities in which they occur. It is obvious that a rather elaborate system of bank examination and supervision, although helpful, is inadequate to give either bank depositors or bank stockholders the protection to which they are reasonably entitled. It is believed that if the present systems of examination and supervision were supplemented by more intelligent scrutiny by depositors and shareholders, made possible by such modifications of the periodical publication of bank statements as have been herein suggested, the quality of American banking could be materially improved. Better informed public opinion would reward the conservative and liquid bank by its patronage and bring pressure upon the imprudent and unliquid bank to improve its practice in order to regain competitive favor. In this way bank failures, if not obviated, could at least be made far less frequent.

R. Warren.

March 2, 1931.

THE ACTIVITIES OF THE FEDERAL RESERVE BANKS

(A study by Robert D. Kent)

Section I: Vice President Hazelwood, of the First National Bank of Chicago, on retiring from the presidency of the American Bankers Association at its recent convention, said:

"The Federal reserve system is for our use in emergencies to carry us over peak periods, to influence the general credit situation through its open market operations, and to be the custodian of the country's gold supply, upon which all credit is based. The Federal reserve system does not operate for the purpose of adding permanently to the funds which we dispense to our customers, nor to enable us to make an additional profit through rediscounting at a better rate, nor to make it possible to take care of customers who desire to purchase or hold securities after the loanable funds of our banks have been exhausted by commercial or agricultural loans."

Mr. Hazelwood correctly states the purposes of the Federal reserve system, but I can not, however, agree with him when he states that it does not operate for the purpose of adding permanently to the funds which we dispense to our customers nor to enable us to make an additional profit through rediscount at a better rate. It should not operate to do these things, but it does actually so operate.

In our necessity to have our currency made elastic I do not recall that anyone advocated that the system should issue currency at wholesale rates to banks for the latter to retail to their customers at higher rates. Old-fashioned and conservative bankers condemn such a policy, but bankers by the thousands seek to make the additional profit mentioned and condemned by Mr. Hazelwood. So far has this gone that when the credit strain of the past few months grew more acute the banks very largely found themselves with lines of accommodation so high with the Federal reserve banks and with such a limited supply of eligible paper on hand that they could not readily apply for further assistance and in consequence were compelled to decline to grant credit that under normal conditions would gladly have been extended.

It has been uniformly the policy of the Bank of England to maintain its rate somewhat above that of the street or open market. This policy results in the law of supply and demand working automatically through the banks of the nation, a surer index of business requirements than the judgment of the majority of a body of 8 or 10 men.

The mistaken policy of the Federal reserve system indicated above has been a large factor in bringing about the overextended use of credit through which we have been passing for the past two or three years and which has resulted in losses of hundreds of millions of dollars to our people and which, if the reaction is not stopped, will produce much more serious results

James B. Forgan, the eminent banker, said in an address:

"In the long run commerce suffers more from periods of overabundance of money than from those of scarcity. The origin of each recurring period of tight money can be traced to preceding periods of easy money. Whenever money becomes so overabundant that bankers, in order to keep it earning something, have to force it out at abnormally low rates of interest, the foundations are laid for a period of stringency in the not far distant future, for then speculation is encouraged, prices are inflated, and all sorts of securities are floated."

Doctor Anderson, the economist of the Chase National Bank, in a recent address said that "the world's business is not a moribund invalid that needs continuous galvanizing by an artificial stimulant. Cheap money is a stimulant. It is also an intoxicant if the dose is large enough; a very substantial temporary effect can be brought about. But headaches follow. It is not the sound way to do it." And he also says that "real estate, both urban and agricultural, has been encouraged to overborrow in periods of excess funds. States and municipalities increase their debts with great rapidity in periods of easy money. Foreign governments, States, and municipalities borrow far more than is necessary in such periods because it is so easy to do so."

Andrew Jay Frame, who retired from active banking service some 8 or 10 years ago after an experience of over 50 years, was 20 or more years ago listened to with close attention when he addressed bankers' conventions and legislative committees. In speaking of the experience of the Bank of England he said that "in 1847, 1857, and 1866 it broke the $90,000,000 limit of its expansive power of credit and panics were immediately stayed"; but mark the historic fact that the extra currency issued to relieve distress was without delay reduced to normal. A member of our monetary commission lately asked the governor of the Bank of England why this $90,000,000 limit was not enlarged, and his answer was, "We fear overexpansion of credit."

"The idea that untaxed currency without some force to drive it home when not needed will automatically expand and contract with our needs has no warrant in experience.

"I reassert that currency issues not practically covered by gold issued in the day of stress must be penalized by an adequate tax so that it will only come out to relieve distress, and will at once retire when stress is over, to the end that inflation and overexpansion of credit may be averted. The whole world has practically conceded it. This is the crux of the whole problem."

In advocating the establishment of a national reserve bank prior to the enactment of the Federal reserve act he said: "What is the true mission of a central reserve bank?

"First. To be our servant and not our master.

"Second. By holding large cash reserves that in normal periods the independent banking system may obtain rediscounts with which to move crops and in abnormal periods with extraordinary note-issuing powers that our banks may obtain aid to the end that cash suspensions by banks generally with their train of evils may be avoided."

In speaking of the central banks of foreign countries Mr. Frame says:

"The 20 great central reserve banks have restricted extraordinary currency issuing powers to the end, like a water reservoir, that aid be given banks in any section on the day of trouble."

Speaking of the bill which was proposed by the Aldrich commission, he said: "Its true mission is to aid us in troublous times," and "to hold our reserves, to allay distress in the day of pressure and none other. Banks that in normal times can not stand practically on their own resources are like pampered weaklings."

To those who desire to broaden their knowledge of monetary and banking matters it is recommended that Mr. Frame's utterances be given close attention.

Except for the inability of the banks of reserve cities to have any method of creating new credit to help annually to move the crops and to meet any unusual demands the old system of reserve banks gave admirable service.

Mr. Warburg, years ago, in advicating a more elastic currency, in speaking of the annual pressure, said it was so great as to threaten the safety of the European machinery when we were compelled to use it to its utmost capacity in order to provide for our needs.

From this it will be seen that the expansion power was desired not for constant use but for crop moving and other unusual demands.

In providing a remedy for the vital defect in our old system, the operation of the Federal reserve system has gone too far. The provision for expansion has proved effective, but due regard was not given to the desirability of restricting the expansion process to meet crop-moving necessities and other unusual demands nor was proper provision made to retire the credit instruments when the purpose for which they were created had been served. The low rate of which the reserve banks supplied money at any and, indeed, all times to the banks of the country has proved the means of serious inflation.

Samuel P. Arnot, president of the Chicago Board of Trade, in an address given recently before the Nebraska Bankers' Association, said, "An easy money policy adopted by the Federal Reserve Board in 1927 to aid European countries in recovering from postwar troubles was the foundation of the tremendous bull market movement which reached its apex last summer." He cited statistics in an endeavor to show that when the board became alarmed at the increasing intensity of speculation months later, its policies "vacillated to the distress of the markets."

Right or wrong, the part played by the Federal Reserve Board in the great drama just finished on the financial stage undoubtedly will come in for most intensive discussion during the next year.

Some 30 or more years ago one writer, in speaking of the policy of the Bank of England in a time of severe and protracted money stringency, said that it loaned freely and was not over particular about the collateral. Our policy was the opposite. We loaned freely when no emergency existed, and when the special need arose we were unable to meet it.

About every 15 or 20 years our people in all classes enter upon an era of undue speculation. We have had a fever of that sort upon us for the past three or four years, and the policy of the Federal reserve system has been to stimulate the fever by adding the oil of cheap credit to the fire of the fever. To extend the thought along this line, let us consider what would be thought of the policy of a large city, which in normal times had a sufficient supply of water, and built a reserve reservoir for possible emergencies, yet made daily use of the contents, so that when the anticipated emergency arose the water was found to be at a very low level and not sufficient to meet the demands of a continued drought or conflagration. There is but one answer.

Have not our Federal reserve banks been acting on this principle? For the past two or three years they have been inducing the member banks by low rates to use the reserve facilities for the profitable resale of credit at higher rates; an incentive of almost irresistible power. So far had this gone that when since September of last year there existed a natural and great need for accommodation on the part of the general public, the member banks found themselves so far indebted to the Federal reserve banks and their supply of eligible paper so low that they were nearly all of them reluctant to apply for further accommodation. Thus, when the emergency did come, the water or credit supply in the special reservoir was at a low level and the public could not be accommodated as was intended when the reserve system was established.

If we had been better students of finance, we would have had regard for several experiences which will now be specified:

First. That of the Bank of England and the central banks of Europe in keeping their rate for money above the current or street rate and coming to the assistance of the banks when unusual demands were to be met.

Second. That of the clearing houses of the country which by the occasional issue of clearing-house certificates in times of severe financial stress always charged the accommodated banks full rates. These certificates admirably served their purpose and were then returned and canceled.

Third. The action under the operations of the Aldrich-Vreeland Act which did, indeed, issue emergency currency at a low rate, but this rate was raised monthly until it was higher than the outside rate. The $380,000,000 special currency enabled us to withstand the financial shock of 1914, the most severe in our history, and was in five or six months fully retired. The plan now complained of is more and more being condemned by thoughtful bankers and economists.

Years ago Bagehot, in his classic work Lombard Street, said: "The Bank of England, until 1844, had the unlimited right to issue notes against their portfolio and such authority was in more than one instance used with extreme unwisdom, so that devastating panics followed hard upon the heels of the reckless speculation which the too-great facilities for borrowing had engendered." We in the past year have found out another instance in which history repeats itself.

Attention should be called to the statement of Mr. McGarrah when he was about to sail for Europe to assume the presidency of the World Bank, that application had been made to the Federal Reserve Board by the reserve banks of New York, Philadelphia, and Boston for some time prior to the September break, for permission to increase the rate for rediscounts but that the requests had been refused.

The banks of the cities named were nearer the firing line and were better judges of the proper policy to adopt than were the members of the Federal Reserve Board. The refusal mentioned cost the people of the country untold millions of dollars.

As part of the Federal reserve system we have a Federal advisory council which is composed of 12 prominent and experienced bankers. As far as can be learned, it does not appear that the point made by Mr. McGarrah has had consideration by the council, although part of its duties as defined by the reserve act "is to make recommendations in regard to discount rates."

It would be instructive if those who defend the practice complained of would give the reasons for the adoption and point out its supposed benefits and inform us what financial authority advocated the policy now criticized.

While it is felt that for the benefit of the business interests of the country the policy of the reserve system should be changed it is not advocated that it be abruptly done, but only after careful study of the matter by a body composed of competent authorities and a plan agreed upon as to how and when to make the change.

If the argument which has been presented is considered sound and of sufficient importance the writer has a plan to propose which will develop the machinery by which the matter can be digested and the remedy worked out.

Section 2. Banking practice can be greatly improved if we adhere somewhat closely to a well-known part of legal procedure. One branch of law is known as common law. This is the outgrowth of the law merchant. This last was based on the common practice of merchants as they conducted their business from day to day.

We should recognize as sound banking practice the usual and ordinary methods of experienced bankers in meeting the proper needs of the people of the different localities. It is the people who furnish the capital and deposits of the banks, and the banks were organized for their convenience. Thus would we apply the principle underlying the common law. The Federal reserve system should mobilize the reserves of the banks of the country, loaning and rediscounting when necessary, but on lines of sound banking practice as daily carried on by properly managed banks.

With your permission I will amplify this thought. Our old system of reserve cities and central reserve cities, our older bankers and students will recall, served us well in all possible ways except one: No provision was made by which ultimate elasticity of currency was provided, as is now done by the Federal reserve banks. In other respects we had better service than now. Of paper held by the member banks, it is probable that only about 15 per cent consists of what is termed "eligible." The percentage will be somewhat greater in the banks of large cities, but elsewhere the proportion will hold good. This statement is based upon inquiries made of banking friends. I know of two small banks that estimated that they held about 5 per cent eligibles. It is probable that 50 or 60 per cent of the loans held by the so-called country banks would be acceptable to the old reserve-system banks. A considerable part of the receivables would consist of paper made absolutely good by makers and indorsers well known by the banks to which it was offered. Second, some of the paper would be secured by high-grade collateral of which the market value could readily be known and which could in case of necessity be quickly sold to make good the loan. A third classification would be notes of counties, cities, towns, villages, boroughs, and school districts, which are generally issued in anticipation of taxes. All of these classes of notes are ineligible at the Federal reserve banks, but were readily accepted by the reserve agents when offered by and with the indorsement of the corresponding bank of whose standing they were assured. The above classes of loans have always been regarded as proper assets of banks but are now taboo by the Federal reserve banks.

Again it should be remembered that the banks of the country are organized by the people of the various localities to serve the business of such localities. These furnish the capital and the deposits and when financially responsible should be able to borrow within proper limitations. These, however, should be determined by the officers and directors of the banks without narrow and arbitrary regulations made by a group of men in Washington who are certainly remote and who are inclined to be somewhat theoretical and academic.

Proper banking practice should be based upon daily and ordinary transactions in the banking business, conducted as bankers have learned to conduct them, to the best advantage of all concerned. But the laws, rules, and regulations as they now exist have been made to a considerable extent by those who are not fully familiar with the actual conditions. In particular, the small proportion of eligible paper held by the general run of commercial banks indicates one of two conditions—either that the banks are ignorantly and improperly conducted or that the Federal reserve banks are too restricted in the classification. A careful study along this line should be made and the fault corrected.

The old system of reserve banks gave immediate credit for out-of-town checks. This practice has been improperly changed by our present system. This feature of banking is treated by the writer somewhat in detail as a separate matter.

We will all agree that speculation often runs to excess and that every 15 or 20 years it becomes a sort of fever in which the butcher, the baker, and the candlestick maker and their relatives and friends neglect their ordinary vocations and try to make their living, and a good one at that, without giving an equivalent of service. Appreciation of this fact has resulted in a discrimination against stocks and bonds as a proper basis of credit. Let us see if we have not gone too far in this direction. The class of paper looked upon with favor is that running not over three months and given for the sale of merchandise. This is regarded as self-liquidating, as the goods will be sold and the resulting proceeds used to pay the notes. This would apply to the sale of a trainload of wheat, but what would that wheat be worth (if grown at all) if it was not for the railroad to move it to the eastern market? Building and operating a railroad means coal and iron mining, building and operating rolling mills, building and operating lumber mills, building docks, and tunnels under and bridges over rivers. All of these various matters are carried on by incorporated companies which must of necessity be financed by stocks and bonds. These securities, therefore, within certain prescribed limitations, should be honored as part of our economic and industrial life. If a man wants to buy some stock or bonds and can contribute a fair proportion of the cost, say, 33⅓ per cent, and a banking house of good standing will also obligate itself and the issuing company has a record of some prescribed standard, there certainly should be no discrimination against the loan on the part of those whose business it is to lend money. If paper of the class referred to is not regarded as desirable as that given for the sale of merchandise, let the interest in it be at a higher rate. This, I understand, is the position taken by the Bank of England.

There are about 25,000 commercial banks in the country, only about one-third of which are members of the Federal system. Numerous banks have relinquished their membership. Because of the failure of the Federal reserve banks properly to meet the ordinary business needs of the country, the tendency is to change to, or remain under, State supervision. Under these circumstances, should not something be done to bring the practice of the reserve banks into harmony with the requirements of business as it is properly conducted by the vast majority of the banks of the country?

Mr. Owen D. Young has recently recommended that all of the commercial banks of the country be placed under national authority. The writer wishes unqualifiedly to indorse this proposal.

Section 3: The Federal reserve banks were instituted for the purpose of assisting and backing up the banks of the country in their ordinary operations, carried on for the benefit of the general business interests of the country. One of these activities consisted in giving immediate credit for out-of-town checks issued by makers of supposed good standing and indorsed and deposited by the depositors of the bank of whose financial strength and standing the bank was well informed.

In collecting all of such checks there are two principal items of expense: the loss of time involved and the express charges on possibly 10 per cent of the amount which might have to be shipped in currency to balance the outgoing and incoming currency at any particular point. These charges are inherent and must be provided for. The Federal reserve banks have seen fit to assume the express charge mentioned, but if under obligations to assume the one item it would seem logically to be under obligations to assume the other.

One authority states the objection to giving immediate credit is that such a policy would "involve inflationary consequences." This I will admit if instead of "consequences" the word was "possibilities." It should be remembered that the principal reason for the creation of the Federal reserve banks was that the assets in the vaults of the commercial banks of the country which were "frozen" in the shape of unavailable receivables might be thawed out and enter into the general flow of currency, if special demand arose.

When the banks of the country were prevented by the ruling of the Reserve banks from making daily use of their out-of-town checks as they had been accustomed to do, their assets to that extent were "frozen" and taken from general circulation. By the immediate credit for the out-of-town check the member banks would need to borrow just so much less from the reserve banks, therefore, the action now advocated would only to a limited extent involve "inflationary consequences."

It is held not sound practice to give immediate credit on out-of-town checks, the reason being that to do so would result in inflation. To a limited extent this may be true, but a far greater amount of inflation is produced and encouraged by wholesaling credit. Federal reserve banks lending at a low rate of interest so that banks borrow and reloan at a higher rate, pocketing the profits. Dealing in credit on this basis is somewhat like straining at a gnat and swallowing a camel.

If a carload of merchandise, wheat, corn, pork, potatoes, or cotton were sold on three months credit the resulting instruments, bills payable, would be welcomed by the reserve banks, but if an instrument of credit called a check, payable on presentation, is offered for credit the member banks are refused the accommodation, although both instruments in point of strength and purpose for which issued are identical.

Mr. Paul M. Warburg in his recent work suggests that the reserve banks should give immediate credit for transit items, charging, however, for the loss of time involved.

In their work, Banking and Business, H. Parker Willis, professor of banking of Columbia University, former secretary of the Federal Reserve Board, and George W. Edwards, professor of banking, New York University, say: "Country items are credited to the account of the depositors at once although their collection and ultimate payment may not take place for some time, owing to the fact that the instruments are drawn on banks situated outside of the immediate locality."

CHECKS LIFEBLOOD OF TRADE

In an article on the subject, published in 1919, the writer said, "The out-of-town check seems to be looked upon as an excrescence on sound banking, as something that can scarcely be got rid of, which is to be considered to a certain extent discreditable."

As a matter of fact, checks, both local and foreign, are the lifeblood of our business existence. They are entitled to high standing and deserve to be honored as making for greater progress and facility in business. One might almost say that their circulation should no more be impeded in the arteries of trade than should the circulation of the blood be impeded in the human system.

Nearly 100 years ago, Daniel Webster said, "All bills of exchange, all notes running upon time, as well as the paper circulation of the banks, belong to the system of commercial credit. They are parts of one great whole. We should protect this system with increasing watchfulness, taking care, on the one hand, to give it full and fair play, and on the other, to guard it against dangerous excess."

In this I think all authorities on the subject will agree. If Webster was right and his term "bill of exchange" includes the modern check it seems to me that the logical and inevitable conclusion is that the Federal reserve system, if it attempts to handle the out-of-town check of the country on a large scale, should discount or buy the checks and so facilitate the business of the country.

THE FEDERAL RESERVE SYSTEM

REPORT OF THE BANKING AND CURRENCY COMMITTEE (1929) OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

[Filed with the subcommittee of the Committee on Banking and Currency of the United States as an exhibit to testimony]

To the Board of Directors of the Chamber of Commerce of the United States:

By action of your board the banking and currency committee of the chamber was authorized to study, among other questions relating to banks and banking, the necessity for changes in the Federal reserve act, and for changes in the policies and practices of the Federal reserve system, as well as the problem of securing a better integration of the credit structure of the United States.

Your committee has confined its studies to the Federal reserve system. It found this subject to be of such scope and importance as to engross all of its attention. It is recommended that the problem of better integration of our credit structure, including the interrelationships of the national bank act with the Federal reserve act, be made the subject of later chamber study.

Your committee became convinced in the course of its work that its report, to be most useful, should deal with those features of policy and of operation of the system that are permanent. It does not undertake to develop ephemeral phases of situations passed or passing. Proposals for changes in policy or practice, and current conditions, have been considered fundamentally in the light of their long-time effects upon the system and upon the economic well-being of the country.

The report and certain auxiliary statements are the result of committee and staff studies conducted for more than a year. In the course of our scrutiny of the system we have considered, so far as we are informed, every criticism of it and every current proposal for change in its policies or practices that might have a bearing upon its normal functioning. These include statements in the public prints, congressional hearings, proceedings of learned societies, and resolutions and reports of bankers' associations and of other organized groups dealing effectively with phases of our economic life.

A number of unpublished proposals for change in the system's policies and methods were brought to our attention. Some of these, emanating from thoughtful men with considerable knowledge of the situation, were not put forward with a view to their immediate applicability. Such suggestions will require continued study. Their authors agree that no far-sweeping changes should be made when there are serious doubts as to their suitability to a system that, as a growing organism, must be adapted carefully to our country's needs as those needs actually develop.

A number of factual studies were prepared, as well as reviews of studies made under other auspices. They have served as working documents and have not been included in our report. Much of their content has been collected in a series of eight supplementary statements which accompany this report. The titles of these auxiliaries[3] indicate their scope:

I. The Rediscount Operations of the Reserve Banks.
II. The Open Market Operations of the Reserve Banks.
III. Guides to Reserve Credit Policies.
IV. The Structure and Control of the Reserve System.
V. Reserve Requirements for Reserve and Member Banks.
VI. Federal Reserve Notes and Other Currency.
VII. Membership of the Reserve System.
VIII. The Reserve Banks and the Use of Bank Credit by the Security Market.

Not all of the proposals studied by the committee are discussed in the report. Many ideas relating to the structure of the system, the number of reserve banks, rearrangement of district lines, and the existing district organization in general, were considered. Numerous suggestions for changes of almost every conceivable sort have been given attention. A good many of them dealt with details which were in harmony with or opposed to some general principle agreed upon by the committee, and so were not given specific mention. The report is devoted in the main to problems of fundamental interest and importance.

The committee was assisted in the preparation of this report by a supplementary group of business men, bankers, economists, representatives of agriculture and labor, and Federal reserve officials, who met in advisory conference to consider an earlier draft. Their contribution is gratefully acknowledged.

We believe that we have been able to reduce the field of controversies to a comparatively small area, and we are gratified to have reached agreement upon the content of our report.

BANKING AND CURRENCY COMMITTEE.
HARRY A. WHEELER, *Chairman.*

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[3] These auxiliary statements, prepared at the order of the committee, are primarily of the nature of staff studies.

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NOTE.—Mr. Chellis A. Austin, the late president of the Equitable Trust Co. of New York City, Mr. Charles A. Hinsch, the late president of the Fifth-Third Union Trust Co. of Cincinnati, Ohio, and Mr. Theodore F. Merseles, the late president of Johns-Manville Corporation, New York City, were also members of the committee and signed the report. Their contributions to this report are gratefully acknowledged.

I. Introductory

The record of the Federal reserve system has so far met with public approval as to induce legislation extending the charters of the Federal reserve banks for an indeterminate period. This favorable public sentiment should discourage constant legislative action with respect to the system's basic and fundamental features.

The Federal reserve system is not a borrowed scheme of central banking, but a distinctive American institution wrought out of our own financial experience and especially adapted to the business and banking requirements of the United States.

We express confidence in the usefulness of the system. Inaugurated at the beginning of the World War it was called upon within a short period to deal with situations of the utmost gravity. It met admirably the trying tests of those times, earning a record of distinguished service.

In the postwar period of tremendous credit expansion it was prevented by the fiscal policies of our Government, reflected in the dominating influences of the Treasury, from imposing early effective checks upon inflationary uses of credit. Nevertheless, in the ensuing price decline of 1920 and 1921 the system demonstrated its ability to avert the development of a threatening financial panic.

Throughout the searching times of war and of world economic reconstruction the system has been a bulwark of strength for the United States and a helpful influence in the financial stabilization programs of other countries.

The system's short history can be divided into three parts. As stated, in its early formative years—the first four—it operated under the influence of actual hostilities, and in postwar years—the second four—it labored in the unsettled economic situation that was the aftermath of the Great War. It is only in recent years—the past seven—that under more normal conditions its operations permit of accurate approximation of its utility in times of peace.

We believe the system possesses these definite values:

It provides a system of mobilized bank reserves, reinforcing the credit structure of the country and increasing the ability of banks to care for credit needs.

It supplies a sound, elastic system of currency.

It serves to avert the danger of money panics.

It safeguards gold movements; it protects the gold reserve of the country and regulates its employment as a base for credit extension.

It increases the supply and general availability of credit for agricultural and commercial purposes and checks extreme and frequent fluctuation in the cost of such credit.

It improves the facilities for maintaining our banking resources in a liquid condition.

It establishes an almost universal system of par payment of checks, increasing the usefulness of the check as our principal medium of exchange, and practically eliminating a former heavy toll on business.

It improves our credit facilities for the orderly marketing of farm crops.

It aids in the financing of our foreign and domestic trade by developing a discount market for acceptances and by stimulating the world use of dollar exchange.

It is helpfully related to the maintenance of the gold standard abroad, thereby reducing trade risks from unstabilized currencies and rapidly fluctuating exchanges.

It supplies the financial institutions of the country with the means of cooperating more effectively to meet future exigencies of our national interests at home and abroad.

Prior to 1914, this country had had no recent experience in the field of central banking. It was not then certain whether the new system would succeed in attracting from more gainful private callings able men who would devote themselves wholeheartedly to the special problems of reserve banking.

The history of the reserve system records many instances of personal sacrifice by men of influence and capacity who have become members of its governing bodies. The continuation of this devotion and energetic enthusiasm is quite as important for the future welfare of the system as any alteration in its structure or methods of operation.

Timely modifications in the Federal reserve act and in the administrative policies of the system, however, will continue to be necessary. With the changing requirements of our domestic business and the increasing influence of our country in international trade and finance, new responsibilities will thrust themselves upon the Federal Reserve Board, the regional banks, and member banks.

The system must be subjected to periodic review by those who have an understanding of its values and a sympathetic appreciation of the complexity of the problems with which it deals. If friendly and constructive critics do not devote attention to perfecting the credit structure, it will be difficult to meet radical proposals of a harmful nature or well-meant but mistaken efforts to divert the system from its proper course.

The prime essential is the development by the American business public of a sober and sympathetic spirit of criticism of the policies of the system. It is in furtherance of this purpose that we submit our reports.

II. Reserves and Note Issues of Federal Reserve Banks

(The auxiliary statement upon Reserve Requirements for Reserve and Member Banks, No. V, and the one upon Federal Reserve Notes and Other Currency, No. VI, develop this subject in somewhat greater detail.)

The Federal reserve system is not a central bank, yet its fundamental operations are in the field of central and not of ordinary banking. It is designed to supplement the credit distribution activities of ordinary banks that deal directly with the public and depend upon profits. It is charged with a primary responsibility to which, if necessary, every other consideration should be subordinated, viz, the maintenance of the currency and credit structure firmly upon an adequate foundation of gold. In general, as a reserve or supplementary credit institution, it must seek to exert a steadying influence upon the money market and upon the course of industry.

Such an agency must be endowed with ample powers of credit and currency expansion and contraction. The possession of such powers imposes a measure of responsibility which can be discharged successfully only by an experienced and politically independent management. The extent to which such powers of a central banking agency must be hedged about by legal limitations, in contrast with those self-imposed by its management, is the first problem of legislative action.

The statutory restrictions that are imposed upon the lending powers of the system have to do principally with the reserves required of the reserve banks themselves, with the reserves required of member banks, and with the issue of Federal reserve notes.

The reserve which each of our regional reserve banks is required to keep behind its liabilities limits the total amount of reserve credit which it can supply upon the basis of a given amount of gold or other reserve money; the reserve which each member bank must carry with the regional reserve bank furnishes substantially all of the cash resources of the reserve banks; and, finally, note issue provisions determine the extent to which currency demands may be satisfied without the issuance of the kinds of money which would reduce reserves.

Even those who advocate further restrictions upon the lending power of the Federal reserve banks are not concerned over the first of these statutory limitations—the reserves that the 12 regional banks must maintain against Federal reserve notes and against deposits. In recent years these reserve resources for the most part have been well in excess of the legal minima of 40 per cent against Federal reserve notes and 35 per cent against deposits. Throughout this period it would have taken a rather drastic increase in the required reserve percentage to have imposed any serious check upon the lending powers of the reserve banks.

CASH IN VAULT AS LEGAL RESERVE

There are proposals, however, for changes in the legislative provisions applicable to the reserves that must be maintained by member banks and for alterations in the character of the reserves behind note issues. These have as their purpose the restriction of the credit powers of the reserve banks. One such recent legislative proposal provided that a member bank might keep 40 per cent of its legal reserve in cash in its own vault instead of the present requirement that the entire legal reserve be maintained with its regional Federal reserve bank. The proposal also would prohibit the issuance of Federal reserve notes against gold or against acceptances purchased in the open market. It would rescind, moreover, the provision that gold serving as collateral for Federal reserve notes may also be counted by a reserve bank as a part of its required reserve. Another suggestion of an even more drastic character is that Federal reserve notes should be issued only against the collateral of paper obtained by discount.

In general, these and somewhat similar suggestions seem to assume that it is possible to gauge in advance the exact amount of lending power that reserve banks may require at any time. They overlook the fact that the need for reserve credit is subject to wide and unforeseeable variations. The reserve banks must be provided with wide powers and large resources, and it is not a matter of great consequence if at times these are even materially in excess of requirements. There is no evidence in recent experience that the policies of the reserve banks, or their effects, would have been essentially different if a smaller volume of resources had been at their disposal.

The extent to which the Federal reserve banks' lending powers would be lessened, by permitting member banks to keep 40 per cent of their reserves in their own vaults, would depend upon the amounts member banks actually would withdraw from the reserve banks. Nearly a billion dollars could be withdrawn. Any such decrease of the lending powers of the reserve banks would be undesirable. It is doubtful, however, whether in practice any large amount would be withdrawn, and, therefore, whether the lending power of the banks would be materially affected. Regardless of the effect upon the lending powers of the reserve banks, this proposal does not recommend itself as a matter of principle. Even if there were no material withdrawal from the reserve banks, there nevertheless would be an expansion of the lending power of the member banks resulting from the permission to count a considerable portion of their cash in vault as reserve. The desirability of such an increase in their lending power is questioned later in Section III, which deals with the reserve requirements placed upon member banks.

ISSUANCE OF RESERVE NOTES AGAINST REDISCOUNTED PAPER ONLY

The proposal that Federal reserve notes should be issued only against the collateral of paper obtained by rediscounting is made in an effort to devise a means whereby note issues would expand and contract automatically with the needs of trade as evidenced by changes in holdings of discountable paper. This proposal rests upon a misconception which has persisted from the date of the enactment of the Federal reserve act. What bankers will do with the proceeds of a rediscount customarily has no relation to the collateral they offer reserve banks. Member banks borrow because of reserve deficiencies which result from their operations of every character and because of the demand depositors make upon their balances. Applications for additional credit by member banks may arise because of operations which are not necessarily advantageous to the community. The supply of eligible paper is always sufficient to permit an enormous increase in the volume of credit if it is employed as a basis of rediscount at the reserve banks. The Federal Reserve Board can affect the supply, moreover, by the exercise of its power to define the character of paper eligible for rediscount, within the meaning of the act.

On October 4, 1929, according to the latest estimate made by the Federal Reserve Board, member banks held $4,598,000,000 of eligible paper. Since on that date the Federal reserve banks' holdings of rediscounted bills amounted to around a billion dollars, member banks, by the use of all eligible paper which they possessed, could have increased their rediscounts about four and a half times. It is true that the volume of eligible paper automatically increases in periods of business activity and rising prices. So, too, does its employment by member banks as a basis of accommodation at reserve banks. Because it is precisely at such times that restrictions upon the use of reserve credit may be necessary to prevent the development of unsound conditions, the eligibility principle can not be depended upon either to impose a satisfactory limitation upon the aggregate supply of reserve credit or to insure wise use of the credit released.

ISSUANCE OF RESERVE NOTES AGAINST ACCEPTANCES BOUGHT

As a further means of restricting the powers of the reserve banks there has been advocacy also of the proposal to eliminate as a basis of Federal reserve note issues those bankers' acceptances that are purchased by reserve banks. Bankers' acceptances, when acquired by the reserve banks either through rediscount or through purchase in the open market, are now legal collateral for such note issues. The effect of the change would be to restrict the paper collateral of Federal reserve note issues to that obtained by meeting the discount applications of member banks. This change is supported by some on the theory that the real need for currency is better represented by member bank demands than by reserve bank decisions to purchase or not to purchase such acceptances.

Aside from the impossibility of employing eligibility tests to control properly the activities of the reserve banks, this proposal is objectionable because individual reserve banks on certain occasions may find themselves inadequately supplied with rediscounted paper to secure their note issues. Reserve banks located in the agricultural sections of the West and South are not in a position to secure more rediscounting in their own districts by sales of bills and securities. Since these sales must be made in the larger money centers, any increase in the volume of rediscounts that might result from sales would be in those centers and not in their own districts. Thus the proposal would restrict the note-issuing powers of some interior reserve banks undesirably with respect to those enjoyed by reserve banks operating in the money centers. The bankers' bills, moreover, obtained by purchase are just as commercial in character as rediscounted paper.

ISSUANCE OF RESERVE NOTES AGAINST GOLD

Another restriction that some favor would prohibit the issue of Federal reserve notes in exchange for gold. The public's currency demands are to-day served efficiently and to an important extent by issuance of Federal reserve notes. As the proposal to restrict these notes to the amount of rediscounted paper would reduce the volume of this form of money, it would be necessary to make good the deficiency by the issuance of money of another form. The effect would be to supplant about a billion of Federal reserve notes with a billion of gold certificates. This would reduce the reserve ratio materially, and thus decrease the lending powers of the reserve banks.

We do not believe that it is possible to insure the wise use of reserve credit either through restricting by legislation the resources of the reserve banks or through concentrating attention upon special regulations of Federal reserve note issues. The precise adaptation of the volume of reserve credit to the needs of business is the problem of administration rather than of law. No automatically operating statute can be substituted in this particular for prudent judgment and discretion. The reserve administration is acquiring by experience an art and technique that will produce more definite and continuous progress than prescription by the legislative body. The reserve administration should be encouraged to build upon its experience, retaining those policies and practices which prove successful, discarding those which are fruitless, and thus continuously developing improvement.

This committee concludes that—

1. It is not a matter of great consequence if the credit powers and resources of the reserve banks are at times even materially in excess of immediate requirements.
2. As the future needs for reserve credit and currency can not be definitely foretold, it is desirable that reserve banks possess ample powers of credit and currency expansion to insure the largest measure of serviceability, especially in any periods of strain.
3. The precise adaptation of the volume of reserve credit in all its forms, including note issues, to the requirements of trade is a problem of administrative rather than of legislative control.
4. No changes should be made in the provisions of the Federal reserve act relating to the issue of Federal reserve notes or to the reserve requirements, pertaining to reserve banks or to member banks, solely for the purpose of restricting the lending powers of the reserve banks.

III. Reserves of Member Banks

(An auxiliary statement upon Reserve Requirements for the Reserve and Member Banks, No. V, develops this subject in somewhat greater detail.)

An important legal restriction upon the lending powers of member banks of the Federal reserve system is the statutory requirement of prescribed reserves. Changes in the legal reserve requirements would affect either the total volume of credit the member banks can extend or the relative credit granting powers of the different classes of such banks. The desirability of encouraging an expansion in the aggregate volume of member bank credit by means of a general reduction in reserve requirements depends upon the need of business for more abundant supplies of credit. No general reduction on this account seems necessary. But rearrangement of reserve schedules as they apply to different classes of member banks could iron out some existing discrepancies and permit of more scientific definition of the kinds of deposits upon which their reserves are based.

This committee does not believe that general reductions in reserve requirements, whether initiated by direct or indirect means, should be considered. The resulting increase in lending powers of member banks would not coincide, save by accident, with any need of business for more credit. Once the country has become adjusted to certain reserve requirements it is undesirable to subject them to serious and sudden alteration. The extent to which such reduction would benefit the average bank may also be questioned. The increased lending power thereby acquired by any one bank would be offset to some extent at least by the intensified competition of other banks whose lending powers similarly would be increased. It should be remembered, too, that reserve percentages are now much less than they were prior to the enactment of the Federal reserve act. In 1913, national banks in central reserve cities and reserve cities were required to maintain a reserve of 25 per cent against total deposits, grouping demand and time deposits, and "country" national banks, 15 per cent. Now, as member banks, the requirement for these three classes of banks, are respectively, 13 per cent, 10 per cent, and 7 per cent against demand deposits, and 3 per cent against time deposits.

The committee has given consideration to a number of proposals which have been advanced, designed to remove the inequalities which now exist between the different classes of banks as regards reserve requirements. Some of these proposals merit approval. Suggestions for change are not put forward with any idea that all the present inequalities of member bank reserves will be removed thereby. While recommending a few changes in the direction of equalizing the burden as between different classes of banks, the committee is convinced that a legislative revision of this section of the Federal reserve act, based upon recommendations from within the system itself, will be found to be desirable. In their review of needed changes, the officials of the system should take into account such changes as those advanced by the Association of Reserve City Bankers and others who have studied this problem.

Because this committee does not believe general reductions in reserve requirements should be made, it does not favor the proposal that vault money should be counted as a part of the legal reserves of member banks. On December 31, 1928, the vault cash of member banks exceeded half a billion dollars, and the counting of any considerable portion of this amount as reserve would be likely to lead to a large and sudden increase in the volume of member bank credit.

Nevertheless, the present method of treating vault money does not make sufficient allowance to a certain class of banks, mainly rural banks, for the larger vault cash reserves they are obliged to carry. Banks that are remote from Federal reserve banks or branches can not employ in obtaining currency the "wheelbarrow" method of the more accessible banks.

It thus happens that on December 31, 1928, member banks in the reserve and central reserve cities held as cash in vault an amount equal to less than 2 per cent of their demand deposit liabilities, whereas on the same date all country bank members held cash in vault to an amount equal to 5 per cent of their demand deposit liabilities.

The practice of not counting cash in vault as reserve, dating from the amendment of June 21, 1917, has been realized upon by city banks to a much greater extent than by those outside of reserve and central reserve cities.

To lessen this handicap upon the banks, desginated in the Federal reserve system as "country" banks, this committee recommends that member banks be permitted to deduct cash in vault from demand deposits in computing their required reserves. This deduction would only reduce the aggregate required reserves by about $50,000,000. It would afford some relief to country banks, and yet would not lead to any such violent expansion in the lending powers of member banks as would be induced by counting cash in vault as legal reserve.

There is another respect in which country banks are handicapped in the computation of reserve requirements. At the present time in determining their net deposit liabilities requiring reserve member banks must include the net amounts that are due to other banks. When banks have amounts due from other banks they may subtract these amounts from those they owe to other banks. In cases, however, where the "due from" items exceed the "due to" items there is no way under present law by which banks can be given credit for the excess. The class of banks which are most handicapped, namely, those which in balance with other banks are usually creditors, is again composed mainly of country banks.

"DUE FROM" DEDUCTED FROM DEMAND DEPOSITS

In determining net deposits requiring reserve this committee believes a bank with a net amount due from other banks should be permitted to set off this amount against its demand deposit liabilities. It is therefore urged that, in the computation of net demand deposit liabilities, banks should be permitted to deduct from gross demand deposits the net amount due on demand from other banks.

On the other hand, there is a liability incurred by some country banks which, in the judgment of the committee, might well be subjected to an increase in reserve requirements. Some country banks, although this is not the usual situation, acquire large balances from other banks just as do the larger city institutions. The possession of such deposits is one of the principal reasons why city banks have been subjected to somewhat higher reserve requirements than those imposed upon country banks. The situation will be roughly equalized if that portion of the liabilities of country banks that consists of net balances "due to other banks" is subjected to a 10 per cent reserve requirement rather than to the 7 per cent requirement now enforced against it and other demand deposit liabilities.

1. The committee concludes that, based on the recommendations of administrative officials of the reserve system, there should be a legislative revision of those provisions of the Federal reserve act relating to member bank reserves.

2. The committee favors revision of reserve requirements to:

a. Permit member banks to deduct cash in vault from demand deposits.

b. Permit member banks having net balances due from other banks to deduct items "due on demand from other banks" from gross demand deposits.

c. Require country member banks to maintain a 10 per cent reserve against net deposits due to other banks.

3. The committee is not in favor of general reductions in reserves required of member banks:

a. Secured by permitting member banks to count cash in vault as legal reserve.

b. Intended solely for the purpose of lowering the lending powers of reserve banks.

c. Intended solely for the purpose of increasing the lending powers of member banks.

IV. MEMBERSHIP

(An auxiliary statement upon Membership of the Reserve System, No. VII, develops this subject in somewhat greater detail.)

There are about 26,000 banks in the United States. Approximately one-third of them belong to the Federal reserve system, embracing all the national banks—nearly 7,500—as compulsory members and almost 1,200 State banks as voluntary members.

Of the 17,000 or more nonmember State banks, it is estimated that about 10,000 comply with the technical requirement for membership that they possess present or prospective capital of not less than $25,000, or somewhat larger capital if located in cities or towns with populations of more than 3,000. In order, however, to become members they must also meet the test of examination and approval by the Federal Reserve Board, which would bar some.

It is evident that in number the outside institutions that might apply for membership in the system exceed the present membership. Many of these do not become members because the reserve requirements of State law are frequently less burdensome than would be the reserve requirements attendant upon membership in the Federal reserve system. It is generally agreed that it would be necessary to make considerable modifications in present law and in methods of reserve-bank operation in order to attract quickly into the system any large number of nonmember banks. The essential question is the intensity of any need for a larger membership in the system.

VOLUNTARY MEMBERSHIP

From the point of view of the resources of the reserve banks no additional membership is now urgently required. Member banks possessed on June 30, 1929, according to the latest available official figures, over 60 per cent of the capital and surplus of all banks of the country and a like percentage of deposits and of total resources. The approximately 1,200 State-bank members control about two-fifths of all State-bank resources. The resources of the reserve banks are more than sufficient to meet any demands upon them. Membership is sufficiently distributed to enable reserve banks to furnish the needed volume of reserve credit in every section of the country.

It is not necessary for all banks to belong to the system in order that credit released by the reserve banks shall flow to their localities. By indirect processes, such as by borrowing from correspondent banks and by receiving on deposit funds emanating from other communities, nonmember banks participate in credit extended to member banks. Despite various frictions and obstructions, an excess of credit in one part of the country tends to flow toward localities where there exists any intense demand.

The Federal reserve banks have done much among their members toward improving bank standards. Many nonmember banks undoubtedly would gain through more direct contact with the reserve banks. Additions to membership are desirable in so far as they would enable particular banks to serve their communities more effectively and to the extent that they would lessen failure hazards. While statistics of bank failures over the past few years, particularly those relating to smaller banks, do not indicate that membership in the system is a guaranty against failure, nevertheless the reserve system possesses great potentialities for enhancing member-bank strength and solvency. When, and if, these are realized to the full and the legend "Member of the Federal reserve system" becomes all over the country an unfailing and recognized badge of merit with real meaning, an increase in membership will follow.

Universal membership might bring gains in the better integration of the credit structure of the country. But there is error in thinking that because the system has merit it must be directly shared by all. The addition of small, comparatively weak banks would injure rather than help the system. Many institutions, however, could be inducted into membership with mutual benefit to them and the system.

The membership problem is more serious when thought is directed to the retention of the present number of members. Any scattered withdrawal might seriously interfere with the ability of the reserve banks to serve various communities, and if those withdrawals should reach large proportions they would tend to restrict the resources of the reserve banks to an undesirable extent. The proposal which is sometimes made to place membership in the system upon a voluntary basis for national banks does not seem advisable to this committee. Under such an arrangement it is to be feared that the management of the reserve banks might be subjected to undue pressure in the determination of policies by threat of numerous withdrawals.

It is unlikely that for any long period of time membership in the reserve system will be stationary. Either the reserve system will be adjudged to be so necessary and salutary that its influence will increase or its prestige must gradually weaken. A continuous, even, though slow, drift away from membership would develop anxieties on the part of the reserve administration and tend to bring about a general lowering of standards. From this point of view it is highly important that membership in the system should prove satisfactory to members and serve to strengthen and render them more safe. The passage of the McFadden-Pepper Act, making continuance in the national banking and Federal reserve system more attractive to banks, was a move in the right direction. In furtherance of the purpose which that statute was designed to serve, there should be a serious effort to clear up in a satisfactory fashion the uncertainty which has arisen in many States and is reflected in the recent decision of the Supreme Court of the United States in a Massachusetts case concerning the continuance by a national bank of the fiduciary relationship enjoyed by a State bank which merges or consolidates with the national bank.

The most hopeful means, however, of preventing a serious number of withdrawals would seem to be through developing a solvency record for member institutions that will be conspicuously superior to that of nonmember banks.

But even though principal reliance must be reposed in the gradual heightening of the solvency of member banks, no sound means should be overlooked of making membership more acceptable to the banks of the country. Changes in the law and concessions in administrative procedure should be made wherever they would attract a larger membership and would involve no sacrifice of strength of either the reserve or member banks. From this point of view attention is directed to proposals to:

a. Effect certain changes in the reserve requirements of member banks.

b. Pay interest on reserve balances.

c. Enable member banks to participate to a larger extent in the earnings of reserve banks.

CHANGES IN RESERVE REQUIREMENTS

In the preceding section of this report certain changes in reserve requirements are recommended for the purpose of removing some of the handicaps under which some member banks labor in computing reserves.

INTEREST ON RESERVE BALANCES

The second proposal—namely, that interest be paid on reserve balances—would be in accord with a practice of long standing before the system was established. Nonmember banks to-day are permitted in most States to carry some reserves on interest with other banks, while member banks must place all of their required reserves with the reserve banks, which pay no interest.

No method has been proposed, however, by which interest could be safely offered by reserve banks upon a member's balance. On January 2, 1929, member banks' reserve accounts were nearly two and a half billions of dollars. Two per cent interest on this sum would amount to almost $50,000,000. In 1927, after meeting dividend and surplus requirements, the net earnings paid to the Government as a franchise tax amounted to only $249,591 and for 1928 to only $2,584,659. Thus it is seen that the interest which could have been paid upon reserve balances is almost negligible. In 1928, for instance, only one-tenth of 1 per cent could have been so paid. In rejecting the interest-payment proposal this committee calls attention to the fact that by the reserve act reserve percentages have been reduced by amounts calculated to be sufficient to offset the loss of interest which was earned on reserve balances when carried with other banks.

SHARING SURPLUS EARNINGS

But even though the reserve banks can not safely be subjected to the obligatory charge of paying interest on balances, they might well be required to meet the lesser obligations of sharing surplus earnings, in years when there are such, with member banks. This committee believes that the reasons for limiting dividends on stock holdings in reserve banks to 6 per cent are no longer applicable.

With the experience which has been gained in reserve operation, reserve banks will not be expected to deviate from sound procedure in order merely to enlarge earnings. The principle should be recognized, however, that such earnings as do result from reserve bank operations should benefit the stockholding member banks which contribute to the reserve bank capital and make the earnings possible. The system was set up to improve the ability of its members to serve the public. From them its resources were drawn. It would be well if some practicable means could be devised for distributing the net profits of reserve banks in larger part to member banks instead of paying them, after present dividend and surplus requirements, entirely to the Government as a franchise tax. The committee supports this in principle and does not believe that the adoption of some such method of distribution would result in too great an emphasis upon earnings.

It should be remembered that future reserve operations may require large development of the reserve banks' open market dealings. Member banks which may meet, even to a slight extent, competition on this account from reserve banks have a right to share in the profits derived in part from these operations.

Even though the monetary return be small, the principle is thought to be important.

Consideration has been given to the " free services " which are performed by Federal reserve banks for their members. It is our opinion that the authorities of the system might do well to review carefully this situation, especially as it concerns the collection of " noncash " items. It is recognized that there are two possible viewpoints in connection with this question. Even though such a service as the free collection of " noncash " items by the Federal reserve banks cuts into the earnings of some member banks, it may perhaps be justified from the angle of service to commerce and industry, and to other member banks differently situated. Generally, the committee believes that care must be exercised in the development of any free services lest they encroach unduly upon the proper field of activity of member banks to the eventual detriment of the system.

This committee further believes that annual meetings of stockholders, which have been held in some districts, may well be adopted throughout the system as a means of developing mutual understanding of reserve and member-bank problems.

One inadvertence in the McFadden-Pepper Act, prejudicial to member State banks, should be corrected. The language of that act denies to member State banks the privilege of establishing branches in foreign countries and in dependencies or insular possessions of the United States. Foreign branches of national banks are expressly exempted from the branch-banking restrictions of the act. There should be no discrimination against State member banks in this respect. The Federal Reserve Board has recommended that the reserve act be amended to cover this discrepancy. This recommendation should be made effective.

The committee calls attention to one factor which has operated to keep some State banks out of the system. Reserve requirements of State law have been liberalized without the same justification which led to the lessening of the reserve burden upon members. The suggestion is made that the reserve percentages of State law in some of the States might well be raised, as respects nonmember banks. On the other hand, there are States in which reserve requirements are an obstacle to membership, because a State bank upon becoming a member must still comply with the reserve requirements of the State and also with those of the reserve system. It is desirable in all States that legislation respecting reserves should include the acceptance of reserve requirements for member banks as complying with State standards.

As stated, the principal hope of increasing the membership of the reserve banks must be reposed in an endeavor to establish a superior solvency and management record for member institutions. If the percentage of member bank failures in the last five years had been conspicuously smaller than those of nonmember banks, similar in size and geographical location, the greater confidence of depositors would operate to bring into the system virtually every desirable nonmember bank.

In efforts to increase membership the reserve banks could well afford to establish the policy of periodical visitation upon desirable nonmember banks by officers and staff detailed for this purpose. Similar visits to member banks would serve to tie them closer, and develop a better cooperation and understanding.

This committee concludes that:

1. Without lowering membership standards, a larger membership in the reserve system should be sought in order to enable the reserve banks to serve various communities more effectively, to safeguard the reserve system against loss of influence on account of future withdrawals, and to encourage improvements in banking standards.

2. Reserve banks should not pay interest on member banks' reserve balances.

3. The system should now be permitted to distribute its profits in larger part to member banks instead of paying them, after present dividend and surplus requirements, entirely to the Government as a franchise tax.

4. Free services rendered by Federal reserve banks such as the collection of " noncash items " and safekeeping of securities should be developed with care lest the reserve banks encroach unduly upon the province and functions of member banks.

5. The reserve banks should exert every effort to establish a superior solvency and management record for member banks.

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V. LENDING OPERATIONS

(An auxiliary statement upon the Rediscount Operations of the Reserve Banks, No. I, and another upon the Open Market Operations of the Reserve Banks, No. II, develop the subject of lending operations in somewhat greater detail.)

Reserve credit may come into use either as a result of the initiative of member banks or as a result of reserve bank discretion.

When the initiative proceeds from member banks, or other financial institutions, the operation will take the form of a rediscount or of a sale of acceptances or in some cases of a sale of Government securities to the reserve banks. When reserve banks are prompted by their own discretion to increase the volume of reserve credit, there is on occasions but a single means of practical effect, viz, the purchase of Government securities in the open market.

In any consideration of the inability of the reserve banks to depend upon rediscount rate changes to secure the proper adjustment of the volume of reserve credit, it will be serviceable to classify the occasions which lead member banks to apply for rediscount accommodations. Aside from periods of general financial strain, member banks resort to reserve banks to meet occasional deficiencies in reserve; to take care of seasonal peak requirements of somewhat longer duration; ti relieve sporadic local difficulties such as crop failures; and finally, in some cases, to secure enlarged resources for more or less prolonged employment.

It is commendable that both member banks and the management of the reserve banks regard permanent borrowing as contrary to sound banking principles, and this is one of the reasons why it is not imperative that rediscount rates of reserve banks should be regularly above current lending rates. The persistency and extent of the indisposition of member banks to borrow continuously is one of the unexpected developments of the system's operations. On account of this disinclination, open market operations conducted by reserve banks become necessary if they are to discharge responsibility for providing the country with the amount of reserve credit that may be deemed desirable. They can not meet this responsibility merely by the adjustment of rediscount rates. Nor would open-market operations confined to acceptances, thus excluding Government securities, be sufficient.

This is not to imply that reserve banks' rates on rediscounts, as well as on acceptances, do not exercise some influence upon the general volume of credit. When rediscount rates are low, member banks which have borrowed to restore temporary reserve deficiencies will not be under so heavy pressure to pay off their reserve indebtedness quickly. In similar fashion low rates on acceptances would encourage their sale to the reserve banks. But if rates on acceptances should be well under other rates the reserve banks would come to hold such a large volume of these bills that holdings by member banks and other investment agencies would become unimportant. Acceptance rates well under rediscount rates would lead member banks holding acceptances and desirous of obtaining reserve accommodation to sell acceptances to the reserve banks instead of to rediscount. Acceptance rates persistently or far below call-money rates would lead member banks to invest surplus funds in the call-money market instead of in bills.

Inasmuch as one reason for introducing the bank acceptance into the country was to provide banks with an asset based upon commercial transactions, which would become an object of general demand, and thereby facilitate the effective mobilization of surplus bank funds, wider use by member banks of the bankers' acceptance as an item of investment should be encouraged.

Relatively high rates on acceptances would tend to discourage their original creation. If the reserve banks should be unwilling to purchase these bills except on costly terms, a situation might be created in which borrowers would find it more advantageous to rely exclusively upon direct loans as a means of meeting their requirements. With these limitations upon acceptance and rediscount rate changes, the reserve banks on occasions have been obliged to depend very largely upon dealings in Government securities in order to alter in the desired manner the outstanding volume of reserve credit.

Thus far in the system's history there has been an ample supply of Government securities available at all times for purchase in the event that the reserve banks wanted to enter the market as buyers. Within the next 5 to 10 years it may be necessary to face the situation which will develop when the outstanding issues are greatly lessened in amount by retirement and have come to be more closely held by investors. The dependence to be placed upon open-market operations in regulating the total amount of reserve credit may then become less certain. Whether or not that development will bring with it its own adjustment or whether some other forms of securities will have to be admitted as eligible for purchase by the reserve banks is a matter of conjecture.

A material reduction in the volume of Government securities would have its effect upon rediscounting practice as well as upon open-market operations. A common and convenient method for securing Federal reserve funds is for a member bank to submit its own note collateraled by Government securities. As such securities become less abundant or less available, it will be necessary for member banks when borrowing to offer paper eligible for rediscount or for purchase. This possibility has led to a renewal of the suggestion that the definition of eligibility should be so broadened as to make rediscountable with the reserve banks' paper collateraled by stock exchange securities of high grade. This proposal was made during the debate in Congress on the bill creating the Federal reserve system. So definite was the feeling against it that the act contained a prohibition against the discounting of notes, drafts, or bills "covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States." The renewal of the suggestion is considered by this committee as untimely and unnecessary, certainly while the present volume of eligible paper and of Government securities is available.

It should be recalled that the Federal Reserve Board possesses considerable power within the limitations of the act to admit to the rediscount privilege desirable kinds of paper. When and if the requirements of industry and commerce make necessary an added volume of eligible paper or it is deemed desirable in the interest of the smooth working of the system, eligibility regulations can probably be sufficiently broadened without an amendment to the Federal reserve act.

RELATIVE EFFECTIVENESS OF REDISCOUNTS AND OPEN-MARKET OPERATIONS

It is sometimes contended that reserve credit extended by means of rediscount operations meets the requirements of the country much more effectively than reserve credit released by the reserve banks' open-market purchases. This contention is based upon the fact that rediscounts are made to banks situated in every part of the country, whereas the bulk of the open-market operations, both those made at the initiative of member banks as well as those conducted at the discretion of the reserve banks, must be confined to the central money markets of the country, and mainly to New York City. But owing to the fluidity of credit, an increase in its volume at any one point tends to furnish additional funds to those parts of the country where there are additional demands. The determination of which particular types of earning assets, whether rediscounts, acceptances, or Government securities, most effectively may be increased or decreased is a matter of detail. The fundamental question is whether it is desirable that more or less reserve credit be employed.

COMPETITION WITH MEMBER BANKS

Open-market dealings in Government securities are frequently subjected to the special objection that they bring the reserve banks into competition with member banks and on occasions tend to ease money rates to such an extent as to impair the profits of member banks. But these open-market operations of the reserve banks would not and do not exert normally more than a limited influence upon the course of the money market. Lending rates, and in turn the profits realized by banks, are primarily determined by far more fundamental considerations, such as the volume of current savings seeking investment and the demand coming from the business community for credit in all its forms. A downward tendency of rates can be accelerated through these open-market operations, but persistently low rates during a period of active business can only be explained as an outcome of a continuing abundance of capital seeking investment relative to available opportunities for its employment. Certainly this was true when reserve bank operations were confined within narrow limits as in some recent years.

In the determination of open-market policies the reserve banks should not allow considerations of their own earnings or those of member banks to exert a controlling influence. The possible unfavorable effect of these operations upon the earnings of commercial banks is clearly a factor, but not of major importance. Whenever the policies of the reserve banks, as well as more fundamental influences, are tending to bring about a general lowering of the cost of credit to the business community, it should be recognized that both member and nonmember banks are warranted in adjusting themselves to the situation by the adoption of a more elastic policy with regard to the rates of interest they pay to depositors.

The committee concludes that:

1. Rediscount rate changes alone can not at all times be relied upon to provide the country with the desired volume of reserve credit.

2. Open-market operations are necessary and should be continued.

3. The recognized requirements of a bill market preclude the predominance of the system indefinitely in this market, as would be the case if open-market operations were confined to acceptances. The volume of acceptances, readily available for purchase, moreover, would be so small in some periods as to hamper the system's operations.

4. Dealings in Government securities, therefore, are required to supplement the rediscount and acceptance activities of the reserve banks in order that the total volume of reserve credit may be adjusted properly to the country's needs.

5. It is not imperative that the rediscount rates of reserve banks should be continuously above the current lending rates for ordinary commercial transactions.

6. The inclusion of bonds, other than those of the United States Government, as security for notes rediscounted by the reserve banks, is considered as untimely and unnecessary, certainly while the present volume of eligible paper and of United States Government securities is available.

VI. Reserve Credit Policy

(An auxiliary statement upon Guides to Reserve Credit Policy, No. III, and the one upon the Structure and Control of the Reserve System, No. IV, develop this subject in somewhat greater detail.)

In devising rules for the regulation of the credit activities of the reserve banks, limitations upon the power and influence which they can exercise are a factor of major importance. The reserve banks have no direct contacts with individual borrowers and aside from the discretionary power to insist that rediscounts will not be granted unless the member bank is in sound condition—a power which this committee believes should be exercised with even greater frequency than in the past—the reserve banks are in large measure powerless to determine the uses that member banks make of credit acquired from reserve banks. Neither do the reserve banks exercise nearly as much discretion as is customarily believed in determining which member banks are to obtain the use of reserve credit. It is true that applications to rediscount or offers to sell acceptances to the reserve banks may be accepted or rejected. Unless, however, the bank requesting rediscounts is borrowing too extensively or continuously most of its applications will be accepted as a matter of routine, and under their acceptance policy the reserve banks for many years took all prime bills offered and still give the market some support.

Even the denial of an application can not prevent funds which emanate from the reserve banks from tending to flow to communities where the demand is greatest. By means of the purchase and sale of Government securities the reserve banks can exercise some discretion regarding the total volume of their credit emissions. But the distribution of these funds throughout the country is determined by the operation of economic laws and financial customs and herein the power of the reserve banks is decidedly restricted. The reserve banks' influence is in high degree confined to determining the volume of reserve credit which is to be released, and there are some situations in which even their volume powers are subject to decided limitations. One such situation would be that in which funds released by purchases of Government securities would be employed to pay off rediscount indebtedness. Even when the reserve banks are in the most favorable position as regards regulation of the volume of reserve credit, it must still be remembered that reserve credit released is merely supplementary to the supply directly within the control of the member banks, and customarily gets into use through the initiative of private financial institutions.

It is further essential to recognize that, even if the reserve banks possessed greater powers than they actually do over the activities of member banks, they could not be held responsible for improper uses of credit. Nor can all of our economic ills be cured by the credit policies of individual member banks. The demand for bank credit springs from the initiative of customers and owing to highly competitive banking conditions the banker can not exercise complete control over every such demand. While the reserve banks may do much to encourage the proper use of reserve credit by member institutions, their powers are largely of a quantitative character. In employing reserve credit to supplement that of member banks the reserve banks are highly restricted by the general state of business and prevailing financial practices. It should not be expected that the reserve banks can exercise such close supervision over the member banks as to prevent unwise extension of credit by them. With the member banks rests the primary obligation of conservative banking, and it would not behoove them, if they contribute to credit overextension, to object to the officials of the system pointing to the need for curtailment. There should be no unreasonable expectation that the most ideally administered banking system can overcome all misdirections of business enterprise.

The reserve banks were created to supplement and in a measure to regulate the credit operations of their members to the end that business and commerce might be more effectively served. It is, of course, true that as supplementary institutions the reserve banks may make mistakes in their analyses of legitimate credit needs. But legislative restrictions can not be depended upon to any great extent to reduce or prevent such errors. Dependence must be reposed in the discretion of prudent management, proceeding upon the basis of admittedly sound principles.

The reserve banks should not be operated to derive maximum earnings. The full and regular employment of their lending powers would not leave sufficient reserve to cope with the very emergency situations with which they were designed to deal. Such a practice would not contribute the desired steadying influence upon the business situation. Fortunately, the idea that reserve banks should be operated to produce large and regular earnings is coming to be pretty generally discredited. There is now widespread acceptance of the idea that the reserve banks are service institutions; that they were not created for profit making. In the early days of the system it appeared likely that some or all of the reserve banks might have to operate at a loss over a period of years. This possibility was viewed with equanimity by the founders. It developed, however, that the banks derived large earnings as an incident to the necessary expansion of their activities during the war years and those immediately suceeding. Substantial surplus accounts were built up and the system thus fortified for any period of little or no earnings. There is even less reason now than formerly for any policy of earnings for earnings' sake. There should be no disposition to test the ability of reserve bank management by the volume of earnings.

Fixing the rate of rediscount is a policy function which attracts considerable public attention. Changes in the rediscount rates of the regional banks are watched carefully. There are, of course, many factors entering into decisions by the officials of the system with reference to changes in the Federal reserve rediscount rate. The guides which are followed are numerous and those which are major determinants at one time may play little or no part at another.

UNIFORM REDISCOUNT RATE

One question of general application which has emerged with respect to the rediscount rate is whether or not it should be uniform throughout the country. Because the Federal Reserve Board's jurisdiction is nation-wide, any tendency to establish similar rediscount schedules in the different districts operates to increase the board's rate influence. If the principle is accepted that the cost to member banks of securing reserve credit should be the same in one district as in another, each district directorate is put in a position wherein local needs may have to be subordinated to presumed national requirements. It is true, of course, that the needs of the country as a single unit could be appraised by the cooperative counsel of different district officers, but only the Federal Reserve Board is endowed by statute with authority to speak for the whole system.

In recent years there may have been comparatively little need of setting up different rate schedules in the various districts. As is stated in another part of the report, member banks, since 1920, have been generally desirous of avoiding continuous indebtedness to the reserve banks. In this situation it has not often appeared necessary to employ rate increases as a means of imposing serious restraints upon the volume of rediscounts.

It is not certain, however, that the disinclination to rediscount will always be as widespread as it has been, and occasions probably will arise in some districts which will develop a special need of utilizing rate increases to restrict the demand for reserve accommodation. In such a situation each district bank should be reasonably free to act with respect to its own requirements, and it should not be obliged to delay its rate increase until the need of rate increases is generally experienced. The continuation of low rates in a period of active rediscount demand might thrust upon the district directorates the responsibility of making an embarrassingly large number of direct refusals.

No defense for a uniform rate schedule can be had by appealing to European precedent. The area of the United States is substantially similar to that of Europe, and there are many independently administered central banks in Europe. If the map of the United States is superimposed upon Europe, with San Francisco upon London, New York falls in Asia. Credit requirements may necessitate as clearly differences in rediscount rate schedules between New York and Minneapolis as between London and Rome.

Uniformly to subordinate local needs to supposed national considerations in the absence of clear emergency is inconsistent with the theory of the regional system. This committee disapproves of a policy favoring a single rate of rediscount as a principle of reserve system operation.

INITIATION OF RATE CHANGE

A second question which has been the subject of considerable discussion is whether or not the power of initiating a rate change should properly be exercised by the Federal Reserve Board or by a regional bank board. The Federal reserve act specifies that the rates of rediscount shall be fixed "with a view of accommodating commerce and business." It gives to each Federal reserve bank power to establish rates of rediscount, but makes them "subject to review and determination of the Federal Reserve Board." Believing as we do that conditions in this country do not warrant a policy favoring a uniform rediscount rate, and strongly supporting the fullest measure of local autonomy among the regional banks, we are of the opinion that the initiation of rate changes normally should be left to the district directorates, power remaining with the Federal Reserve Board to veto changes. Only in the interest of national coordination and in emergency situations should the board initiate rate changes. It is to be recognized also that the persistent refusal of the board to permit a change in rate can be as violative of district autonomy as the actual forcing of a rate change.

It must be admitted that each regional bank is swayed in its judgments by the problems of its district and can not be expected to hold so impartial an attitude as would the Federal Reserve Board representing the needs of the whole country. District banks, therefore, if given unrestricted freedom in the matter of rediscount rates might precipitate discrepancies and inequalities of a disturbing nature. If the Federal Reserve Board exercises its power to act in presumed national emergencies, the country has a right to assume that such action will be taken only after conference with regional bank directorates and after full consideration of the resulting influence of its act upon the commerce and industry of the districts especially affected. The committee does not believe the proper solution of this difficulty lies in legislative enactment.

THE RESERVE RATIO AS A CREDIT GUIDE

It is sometimes suggested that the reserve ratio should be the predominant factor in the determination of the rediscount rate. Owing particularly to the huge influx of gold since 1920, the reserve ratio of the reserve banks has been high, seldom sinking below 70 per cent. It can not now be employed as a serviceable guide in determining the desirable volume of reserve credit. Even if the reserve ratio were much lower than it is now, its changes would not supply a satisfactory guide to policy. Changes in the ratio may not agree either in direction or in intensity with the country's need for more or less credit. The volume of gold imports, and consequently the reserve ratio, is influenced by the policies of the reserve banks. By increasing or decreasing open market purchases money rates may be eased or hardened to some extent. Gold imports are retarded by low money rates in the financial centers and are encouraged by high rates. Since the reserve activities determine to some extent changes in the gold holdings of the reserve banks, the height of the reserve ratio does not supply a clear guide to credit policy.

STABILIZED PRICES AS A CREDIT CONTROL

There is also advocacy of dependence upon index numbers of commodity prices as a valuable guide to reserve-credit policy. This proposal received considerable attention during the pendency of the so-called Strong bill in Congress. There may arise situations in which it would be generally agreed that the movement of prices might constitute the most important single factor. A pronounced rise of prices continuing for some time after labor was fully employed, and when industrial output, therefore, was not being materially increased, would indicate that bank credit was being too liberally employed and that the volume of reserve credit should be reduced. On the other hand, a pronounced decline in prices accompanied by rising rates in the money market would serve to indicate credit pressure and the need of supplying more reserve credit. But the significance of moderate changes in prices, either in an upward or downward direction, is difficult to diagnose. When the cause of these milder fluctuations is not clear and uniform in its influence, it is not certain whether and to what extent credit should be employed as a counteracting agent. Moderate price changes are but one, and not always the most important, of the various factors of which account should be taken in the determination of the lending policies of the reserve banks.

Among the other factors are diverse fluctuations in the prices of various groups or even of single commodities, the degree of activity in trade, the accumulation of inventories, tendencies in the financing of industry, including the financing of durable consumer goods, activity and conditions in the real estate and building markets, the situation in individual commodity markets, the course of long-time interest rates, and finally the industrial and financial position in important foreign countries.

A variety of considerations, which will have different degrees of weight at different times, must necessarily influence the general credit policies of the reserve banks. In a period of business depression or inactivity it may be felt that some stimulus to business can be given by that ease in the money market which may be expected to follow an increase in open market purchases and lowered rates of rediscount. Such seems to have been one of the motives impelling the reserve banks to action at times. On other occasions it would appear that the reserve banks have given thought to the desirability of providing themselves with a sufficient volume of securities to be able to exert a restraining influence upon the credit situation if that should become desirable. Such purchases may be made at times when it is believed that a moderate increase in the volume of reserve bank credit will have no pronounced influence upon the money market.

Again, the foreign situation may bulk large. During the last few years, when foreign countries have been stabilizing currencies and restoring the gold standard, it has been desirable in the general interest that no unnecessary pressure upon important foreign money markets should be exerted from this side. The accentuation of ease in the money market, if that involved no serious risk of undesirable domestic developments, was clearly advantageous, since it would aid in the restoration of normal monetary conditions in other countries.

Indeed, to avoid undesirable domestic developments, there may be positive necessity to contribute to economic recovery abroad. Without stabilization of important foreign currencies there inevitably would be a narrower market for our exports. This would be especially serious in periods of increasing domestic production, when foreign outlets for goods are of the highest importance in preventing that congestion in our domestic markets which would tend to lower prices and reduce profits.

At times widespread speculative tendencies of the public, as reflected in the course of the real estate, commodity, or security markets, may make such demands upon the credit resources of the country as to impair their liquidity or dislocate the supply available for undertakings involving a normal business risk or unduly increase its cost.

Important price movements in these markets may arise from many causes other than increase or decrease in the volume of money or credit. Questionable price movements, however, that are largely resultant from an insufficient or overabundant money or credit supply are clearly of concern to the system, since it possesses some power to influence the quantity and the cost of that supply.

When price movements in any of these fields are largely the result of masses of bank customers indulging their speculative tendencies, the system may not wisely avoid seeking or urging such adjustments in the credit supply or in the directions of the use of credit as will assist in restoring the proper balance between the volume of credit used for speculative purposes and that used in accommodation of business and industry.

VOLUME OF SPECULATION AS A GUIDE

The extent to which security market developments should influence reserve policies is one of the most difficult problems of reserve administration. Events and conditions in the security markets are per se of little concern to the reserve banks. But possible repercussions of security market developments upon other industry must be taken into account by the reserve banks because of their interest in basic conditions. They must weigh indications of developments which may later affect industry, commerce, and agriculture. Furthermore, security market uses of credit, if permitted to develop unchecked, may tend either to deprive industry, commerce, and agriculture of credit or to increase money rates.

Because of the rapid turnover of funds on the Street, a considerable expansion of stock market operations may take place without depriving other business of credit to any large extent. But the volume of security speculation may increase on occasion out of proportion either to the normal growth of the country or to the credit volume justified by sound business expansion.

The prices of securities may continue to rise in the face of the most sharp advances in money rates, and those who purchase stocks with the purpose of turning them quickly in an advancing market may be little deterred by higher credit costs. The advance in money rates, applying as it does to well collateraled loans, has a powerful influence not only in pulling funds from domestic sources but also from abroad. The international flow of gold may be affected to such an extent as to minimize the power of any restrictive measures which the reserve banks initiate. To the extent, furthermore, that street loans are for the account of other than banking corporations, a situation may develop in which a superstructure of speculation comes to be built upon funds which may be drawn suddenly and with little warning.

Inasmuch as appeal would necessarily be made to the member banks of the system, and even to the reserve banks, to replace funds thus withdrawn in order to avert a general collapse of confidence, the reserve banks do have an interest in the events which lead up to such a condition. Indeed, stock market declines of considerable proportions occurring for almost any reason may threaten to produce such repercussions upon industry and commerce as to require that banking support be given to efforts to secure a more orderly security market. Member banks and reserve banks would be well advised to anticipate the strain which may later be thrust upon their resources and endeavor by all their powers to prevent the emergence of important money-market dislocations.

Once well under way a condition of excessive speculation may be difficult to correct. In recent years of widespread public indulgence in security speculation, many analysts have regarded the situation primarily as a belated manifestation of too abundant a supply of bank credit in earlier months and years. In these earlier periods of time the superabundance of credit may not have reported itself immediately either in rising prices or in increasing trade activity. But the surplus supply of credit had sooner or later to find an outlet and when it did begin to emerge in security operations a situation developed in which immediate correction was difficult, if not impossible.

Another factor complicating the problem has been the impossibility of determining just how much credit security financing alone deserves. Security operations may not signify an enlargement in the total credit transactions of the country so much as merely a substitution of capital issues for bank credit directly obtained. The net result of experience derived in late years of reverse system operation seems to point sharply to two principles of policy. In the first place, care should be taken to prevent the creation of an excessive supply of credit in general, out of which speculative excesses are likely to develop. In the second place, vigorous rather than mild measures of restraint are required to bring the situation under control when speculation assumes unhealthy dimensions as tested by the unwillingness to heed the significance of rising money rates.

Throughout the last five years the factors reviewed above, as well as other considerations, doubtless have played a part in the determination of the open market activities and the rediscount policies of the reserve banks. Similarly, in the future a variety of influences must determine the course which reserve banks will follow in the formulation of their general credit policies.

In conclusion it may be repeated that there is no one guide to which primary significance must be invariably attached. The elements which create a financial situation are constantly being combined in different proportions and it is not possible to state in advance which offer the key to the understanding of the problem. The determintion of desirable policy in confused and complicated situations obviously necessitates the exercise of the most far-sighted management. The experience of recent years has been especially pointed in illustrating the mixed elements which must be considered in determining credit policy, and the importance which a single one of them can assume upon occasion.

Your committee concludes that:

1. In respect of the autonomous character of the district banks, the Federal Reserve Board should not exercise its powers of initiation of rediscount rates except after conference with regional bank directorates and after full consideration of the resulting influence of its act upon the commerce and industry of the districts.

2. In the employment of the resources of the reserve banks no single guiding principle is available and no specific object, such as price stability, should be imposed by legislation as a definite duty upon the reserve board and the reserve banks.

3. It is desirable that Federal reserve authorities take into account the course of speculation so far as it may involve at any one time immediate or prospective strain upon the credit operations of the reserve or member banks.

4. A policy favoring a uniform rate of rediscount as a principle of reserve system operation should be disapproved.

VII. Management

(In an auxiliary statement upon The Structure and Control of the Reserve System, No. IV, certain aspects of the management problem are treated more fully.)

In this report the committee has endeavored to stress as a factor of utmost importance the necessity for capable management throughout the system. Upon capacity for good management and its increasing efficiency, as distinguished from legislative devices, must now rest the well-being of the system and its ability to serve to the limit the high purposes for which it was created in the interest of all the people.

No banking system is self-operating, no matter how perfect its structure, nor how smooth its working parts. This is especially true of central or supplementary banking systems, and peculiarly so of the Federal reserve system.

The provisions of the Federal reserve act relating to the management of the reserve banks and of the system as a whole are among its most important features. Certain unusual management problems are encountered in the reserve system. The special needs of 12, largely autonomous districts must be met, while at the same time the policies and activities of district organizations must be blended into a national policy conceived in the interest of long-sustained business stability. In the direction of meeting this twofold requirement the

Federal reserve act provides for a balanced system of administration, wherein the activities and policies of the district banks are integrated with those of the Federal Reserve Board. The function of coordinating the activities in a national way must rest with the Federal Reserve Board.

It is obvious that the board can not concern itself in any high degree with the minutiæ of operation. The board could not acquire such knowledge of local conditions as is required in passing upon the large number of rediscount applications which may be made by nearly 9,000 member banks. It can take action within the district only on important matters of an interdistrict or national character.

No matter how judiciously the board functions, however, efficient administration of the reserve system depends to an important extent upon the activities of the district directorates and their officers. Their functions as regards the determination of rediscount rates and open market operations are of the greatest importance, and the large degree of autonomy wisely permitted them must be zealously guarded in the interest of proper servicing of district situations. It is encouraging that the district directors, representative of industry and commerce as well as of banking, are developing special knowledge and experience in these and other system matters. In this direction lies the proper offset to the natural tendency toward centralization noticeable at times in the conduct of the system. As directors of the district organizations are mainly within the selection of the member banks, a large measure of responsibility for the soundness of the system's operations rests upon the member banks. If these members, as occasionally happens, fail to select competent men as directors, the efficiency of the district bank may be impaired, since the directors determine the policies of the bank. District boards should consist uniformly of men of such recognized ability that membership will be considered one of the highest business honors.

THE RESPONSIBILITY OF THE DISTRICT DIRECTORS AND OFFICERS

The responsible duties of the chairman of the board and the governor of a regional bank make it essential that those offices be filled by men of the widest experience in the field of financial administration. The chairman of the board is an appointee of the Federal Reserve Board at Washington, and with it rests the responsibility for selection of men adequately equipped to perform the duties of the office. The governor of a Federal reserve bank is appointed by its board of directors, thus emphasizing in operation the autonomous character of the bank, which should be insured by the fact that six of the nine directors of each bank are elected by the member banks of the district and form a two-thirds majority of the board.

A STRONG FEDERAL RESERVE BOARD IS NEEDED

The emphasis upon the necessity of an efficient district administration does not mean that an able Federal Reserve Board is not required. Although the board's executive powers are exercised chiefly in emergency situations, its very detachment from daily district administration and its domestic and foreign sources of information furnish a background which should prove of great value in judging financial trends and in exercising its persuasive, interpretative, and harmonizing influences which are always imperative in the continuous task of adapting the total volume of reserve credit to the requirements of the country as a whole. This committee does not accept the opinion that even with the most competent district management the system can be properly administered without the service of a strong and able board.

The board is not and can not be the arbitrary dictator over credit and business conditions which it is sometimes pictured to be. The Federal reserve act, however, does confer upon it discretionary powers of no mean degree. Federal reserve notes are issued at the discretion of the Federal Reserve Board. It may grant in whole or in part, or reject entirely, applications from the regional reserve banks for notes. It has the authority to review and determine rediscount rates which are established by regional reserve banks. It has the power of determining or defining the character of paper eligible for discount, within the meaning of the act. It makes regulations governing open market transactions and other system operations. It can order Federal reserve banks to establish accounts in foreign countries, to appoint correspondents or establish agencies, as well as to open accounts here for foreign banks.

The board is empowered to examine the accounts, books, and affairs of each Federal reserve bank and of each member bank, and to require such statements and reports as it may deem necessary. It may permit or require one Federal reserve bank to rediscount the discounted paper of another Federal reserve bank. It may suspend reserve requirements specified in the act. It can classify cities as reserve or central reserve cities. It can suspend or remove any officer or director of any Federal reserve bank. It can require the writing off of doubtful or worthless assets upon the books of Federal reserve banks. It can suspend the operations of a Federal reserve bank, take possession thereof, or liquidate or reorganize it. It can authorize national banks to act in fiduciary capacity. It is authorized to "exercise general supervision over" the reserve banks.

A number of ideas have been considered by the committee relative to methods of selection of the members of the Federal Reserve Board. Suggestions have been offered that nominations be made by the Federal advisory council or by district directors or other agencies. Proposals which received favor with some members of the committee involved the appointment by the President of a few members of the board and the election of the others by district directorates. One such plan proposed an increase in the number of board members to 9, 3 to be appointed by the President and the remaining 6 to be chosen one each by the joint vote of the directors of Federal reserve banks in two contiguous districts. The consensus of opinion is that no immediate necessity demands a change from the present system of presidential appointment without any formal machinery of nominations.

It is recognized that the selection of highly competent men presents a number of difficulties:

a. Because the duties are supervisory, coordinating, and analytical rather than of direct executive character.

b. Because the salary, which all too often in the public mind becomes the measuring rod of importance of service, is so sadly out of line with the compensation paid officers of the regional banks.

c. Because the relative rank and dignity of members of the board in official life is clouded and uncertain by the dependence upon the Treasury for its housing and the possible interpretation of the wording of the law that the board is merely a bureau of the Treasury Department.

It is the belief of this committee that if its recommendations can be made effective it will become evident that no public service is of greater importance to the whole country than the board's close contact with and understanding of all the currents of domestic and international credit and finance; that this function supported by the powers now reposed in the board by the Federal reserve act will attract the services of a group of men willing to devote their experience and ripe judgment to all of those intricate and important relations which exist in this field.

To encourage able men to accept the sacrifice which board membership involves, every effort should be made to develop the dignity and independence of the board and to improve its working conditions. To increase the strength of the board we believe that the prestige of the position of its governor should be enhanced. We are convinced that the board can not possibly be expected to meet the anticipations of the framers of the reserve act, while it continues to include the Secretary of the Treasury as its chairman, overshadowing the governor. Indeed, your committee is convinced of the inadvisability of including the Secretary of the Treasury as a member of the board.[4]

On general principles, the exclusion of Treasury representation on the reserve board would seem to be desirable because the Treasury is a frequent borrower and is consequently prone to attach major importance in the determination of credit policies to the maintenance of easy conditions in the money market that will facilitate the placing of loans at minimum rates. This consideration, as is well known, was given undue weight for a year and more after the armistice, and, apparently, thought with less serious consequences, on some subsequent occasions.

This proposal—to free the reserve board from Treasury influence—it should be clearly understood, is not urged on the ground that that influence has com-

[4] Mr. Clause and Mr. Hecht do not agree with this view.

monly been exerted in support of unwise policies. By no means! Treasury influence at times undoubtedly has been a factor in securing effective action without unreasonable delay. Even so, it is evident that representation of the Treasury on the board has not been conducive to realization of that personal responsibility, independence of action, and freedom from administration influence which the country has the right to expect.

It is hardly going too far to say that since the establishment of the reserve system the Treasury Department to a considerable extent has overshadowed the board and has tended, consciously or unconsciously, to reduce the board to the status of a departmental bureau. As members of the Cabinet, holding an historic office of great responsibility, it is to be presumed that Secretaries of the Treasury will be in the future, as they have been in the past, men of wide experience and strong character, enjoying widespread public confidence. It is precisely for this reason that, if a strong board as a whole is to be secured, the Secretary of the Treasury should not be one of its members.

More particularly, the chairmanship of the Secretary must obviously render the post of governor of the board less attractive to a man of executive capacity and energetic temperament. In the judgment of your committee, the dominant personality on the board should be the governor, and he, not the Secretary of the Treasury, should be its chairman. The elimination of the Secretary of the Treasury from membership, or at least from the chairmanship, will surely assist in making the position of governor of the board more distinguished and influential. Enhancement of the importance of this office is necessary if men of the highest capacity are to be secured and if board membership in general is to be more attractive. This proposal is not to be understood to involve any reflection upon the present Secretary of the Treasury. On the contrary, his ability and the undoubted high character of his public service stamp his administration as one of the ablest the country has ever enjoyed. It is because of his very incumbency that such a proposal can be made without the restraints that would be necessary were a lesser man in office.

There should, however, be some rather close interrelationship between the Federal Reserve Board and the Treasury Department, and it is inevitable that in the very nature of things there would be. To be independent is not to be less cooperative. There could exist, and undoubtedly would, a close contact and splendid cooperation between the department and the board, without the official connection we suggest being dissolved. There are important banks of issue abroad which have no representatives of the Government upon their governing boards.

The committee has reviewed current proposals that instead of the Secretary of the Treasury being a member of the board the Under Secretary should be, but believes that this is not a practical suggestion. The committee is convinced of the undesirability of the Secretary's membership on the board. While we do not insist that there is an immediate and pressing need for legislation relieving the Secretary of the Treasury from his duties as a member of the board, we do believe that an early change in the chairmanship of the board is desirable.

This committee is further of the opinion that there should be a thoroughgoing survey of the office of the Comptroller of the Currency and its relationships to the Treasury Department and to the Federal Reserve Board to see if it would not be feasible to make such a transfer as would bring the duties and activities of that office under the purview of the Federal Reserve Board rather than continue them under the Treasury. While recognizing the force of some of the practical difficulties, the committee nevertheless feels that more is to be said for the divorce of the office of the Comptroller of the Currency from the Treasury Department than against that proposition.

As a further means of developing the independent status of the board, that body should be adequately housed in a special building of its own. This building should provide adequate facilities for the board's analytical and research work, now being done at a distance from the Treasury Building where the board is housed.

Board salaries are now palpably inadequate and incommensurate with those which necessarily must be paid to both the reserve agents and the governors of the district banks. Some of the latter receive three and four times as much as members of the Federal Reserve Board. Their compensation must approach at least the salaries paid in the field of general banking, from which Federal reserve management must be drawn. This committee recommends that salaries be increased from the present figure of $12,000 to a minimum of $30,000 per annum for the governor of the board and $25,000 for the other members. Objection to these salary increases should not be made on account of conditions existing in the general governmental service. It is to be noted that salaries as well as other expenses of the board are defrayed, as would be the cost of a separate building, from assessments upon the reserve banks and not upon the United States Treasury.

It is not enough that there be efficient district administration plus a strong Federal Reserve Board, unless the two work in unison. Just as the regional reserve banks should maintain constant and intimate contact with member banks, so also should the Federal Reserve Board have first-hand knowledge of situations within the regional banks and their branches. Frequent visits to the reserve banks would assist the members of the Washington board to familiarize themselves with the practical problems of regional administration. By such contacts they can also assist the officers of the district banks through discussion of the policies of the board and the reasons for their adoption.

This committee concludes that:

1. Successful management in administration of the Federal reserve system must always depend more upon the individual ability of its officers and governing boards to meet changing conditions than upon limitations of powers by legislation.

2. Efficient management of each district bank requires that:

a. Member banks select competent men for reserve bank directors.

b. District directors exert every effort to select able governors.

3. Provision should be made to increase the attractiveness of board membership and develop the influence and independence of the board by:

a. Enhancing the importance of the position of governor of the board by making him chairman.

b. Housing the board in a building of its own.

c. Increasing the salaries of the governor and members of the Federal Reserve Board to compare more favorably with the salaries paid the principal administrative officers of the reserve banks.

4. Thoroughgoing consideration should be given to the relations of the Treasury to the Federal Reserve Board, especially with respect to discontinuing the membership of the secretary on the board, as well as to the desirability of a change in the status of the office of the Comptroller of the Currency to bring that office more directly under the purview of the board.

VIII. Relationships With Member Banks

(In an auxiliary statement upon The Rediscount Operations of the Reserve Banks, No. I, and another auxiliary statement upon Membership of the Reserve System, No. VII, some of the matters referred to in this section are considered more fully.)

While the establishment of the reserve banks has enormously improved our banking system as a whole, it has accomplished little in the way of reducing the number of bank failures. There has been a discreditably large number of member as well as nonmember bank failures in the recent past. These failures are in part a result of the inflationary methods of war finance, for which the reserve banks were not responsible, and in part the outcome of the acute agricultural depression which seems to have been due fundamentally to its overdevelopment and maladjustment throughout the world. The large number of failures is also to be attributed to an excessive number of banks in the agricultural sections of the country—many of them of little financial strength and managed by unskilled officers. The ability of management to avoid failure is evidenced by the fact that conservatively operated banks, situated in rural communities of strong banking competition, succeeded in weathering the storm developed by the inflation.

As between member and nonmember banks, the only essential change affected by the establishment of the Federal reserve system was to increase the borrowing power of the member banks. Limitations on the types of assets available for rediscount at reserve banks have not served to confine borrowings within safe limits. They have simply served to transfer to the reserve banks a portion of the more liquid assets of the borrowing banks. Unless the added loans made by the member bank are as good as the paper discounted at the reserve bank, the position of the borrowing bank is obviously changed for the worse. Proper consideration of the interests of the depositors of member banks places upon the reserve banks responsibility for taking account of the general condition and character of the management of member banks, as well as the situation in the locality in which the bank is operating, when extending any appreciable accommodation by way of rediscount.

There are difficulties to be encountered in the execution of such a policy. The member bank ordinarily requests reserve credit in order to restore its reserve balance which has been depleted as a result of all its operations and the use its depositors are making of their balances. The reserve bank is the principal channel through which checks drawn on its members are presented for payment. These clearing operations deplete the members' reserves. To make up such deficiencies, the reserve bank is inclined, naturally, when a member presents good paper, to grant the accommodation requested. The reserve banks can not, without notice, establish new and rigid practices in the extension of credit to member banks. On the other hand, if it is made clear to all members that the character of their management and their general condition will be the primary factors in the extension of accommodation, member banks will conduct their affairs with reference to these requirements. By this means the reserve banks can come to exert a steady and powerful influence in the direction of the maintenance of sound banking practices on the part of member banks.

REDISCOUNTING PAPER OF A FAILING BANK

Most bank failures are the outcome of unsound banking policies followed for months and even years. There is ample time in most instances for corrective measures to be effectively applied and it is believed that the reserve banks are in position to exert a large influence in this direction as an incident of their rediscounting relations with borrowing banks.

Another difficulty of basing rediscount advances upon the condition of the applying bank has grown out of this country's limited experience in the field of central banking. Undoubtedly too much has been expected of the reserve banks with regard to servicing distressed banks in emergency situations. When an emergency is acute and general, it will no doubt be incumbent upon the reserve banks to offer their credit more liberally. But member banks in their relations with reserve banks should come to understand that the avoidance of a strained condition is much more important normally than the alleviation of strain after the situation has become acute. In so far as the reserve banks have been obliged to resort to restrictive measures in order to maintain and improve member bank solvency, their activities should command support from their members. If permitted thus to operate, the reserve banks can come to exert a steady and powerful influence in the direction of the maintenance of sound banking practices on the part of member banks.

It is gratifying to note that increasing attention is being given to this important aspect of reserve-bank operations by all of the reserve banks.

This committee concludes that the granting of rediscount accommodations by reserve banks should depend upon the general condition of member banks and the effect of granting the rediscount upon the safety of depositors as well as upon the character of the paper which the applying bank tenders.

IX. The Public Relations of the Reserve Banks

Throughout its report this committee has insisted that the efficiency of the reserve system must depend upon wise administration. On this account it has opposed the employment of legislative devices to restrict narrowly the powers of the reserve banks.

The grant of liberal powers to the reserve banks necessarily requires that there be complete recognition by them of their public responsibilities. Neither the public in general nor Congress will be content to rely solely upon the probability that the administration will always be composed of farsighted men. The activities of the reserve banks must be such as to insure confidence in the system's general policies. Such confidence can not be gained unless the proper type of criticism is stimulated.

To insure the desirable type of criticism it is essential that the public be provided with ample information relative to the activities of the reserve banks.

The amount of valuable credit information, statistical and otherwise, supplied by the Federal reserve system is far beyond that furnished by foreign central banks. For this accomplishment the reserve administration is to be commended. But in providing the country with official or semiofficial explanations of the basic purposes of major policies much yet remains to be done.

The scheme of 12 regional banks and the division of responsibility between the Federal Reserve Board and the district officials increase the difficulty of supplying the public with the desired interpretations of reserve policies. It is to be recognized that various officials may support the same measure from different points of view and that to secure agreement upon the factors to be emphasized may create discord within the system. The further fact that a certain measure might accomplish one useful purpose, but not precisely that originally avowed, must also serve to retard explanation.

But despite the difficulties attendant upon complete statements of intent, no secretive policy will succeed in securing approval for the reposal in the reserve administration of a large degree of discretionary power. An ill-informed public will demand precise statutory limitations. Without ample knowledge public criticism can not be intelligent and beneficial. The more abundant the information and the sharper drawn the issues, the less fertile becomes the field in which charges of ulterior motives can be sown. When ignorance abounds the arena belongs to the careless, the radical, and the irresponsible.

With general discussion of reserve problems lifted to a higher plane, ill-advised critics will find it more difficult to secure an audience of intelligent men. Neither should there be too great apprehension regarding the inevitability of frequent reversals of policy. Thoughtful men understand the imponderable character of most credit problems and they will not demand that the views of reserve officials as stated on various occasions agree precisely.

The explanations and interpretations advanced in the Federal Reserve Bulletin and in the annual reports of the Federal Reserve Board have been highly serviceable and beneficial. What appears to be required further is that on irregular occasions of important decisions men who occupy prominent administrative positions in the system should seek to clarify their motives. By this it is not meant that there should be a newspaper release on every action. But in some recognized way, such as by addresses of the officials of the Federal Reserve Board and of the district banks, sufficient information should be given about the determining factors in the situation, so that intelligent men may be able to engage in frank and friendly criticism. It would be evidently advantageous if as a regular feature of reserve-bank practice full and detailed publicity were given to the purposes and results of various policies after the situation with which they were concerned had developed to such a point as would make such a statement practicable.

This committee concludes that the grant of liberal legislative powers to the reserve board and to the reserve banks imposes upon them the responsibility of providing the public not only with an ample amount of factual and statistical credit information but also with the means of determining the purposes of major policies. Much is yet to be accomplished in the way of supplying the public with an adequate amount of interpretative material.

There is need also for greater exchange of information and clear opinion within the system itself. The regional reserve banks should be thoroughly familiar with the policies of the Federal Reserve Board and the reasons therefor. Only thus can they be in a position to chart their own course and to enlighten the member banks. Not otherwise may there be expected the fullest comprehension of problems and solutions, with wholehearted and intelligent cooperation. There may be some justification upon occasions for not taking the entire public into confidence; there is little for lack of frankness between the board and the reserve banks.

Although this committee undertook its detailed investigations with no prejudgment, it is gratified to note that the post important of its affirmative declarations require administrative rather than legislative solution. It recognizes the mechanical simplicity and structural soundness of the reserve banking system. Future alterations of its machinery will be, of course, required. But these should be initiated step by step out of proven experience. As we earlier stated, the prime essential is the development by the American business public of a sober and sympathetic spirit of criticism of the system's administrative policies. Toward this the administration of the Federal reserve system itself is in position to make the greatest contribution.

Nathan Adams, M. A. Arnold, J. W. Arrington, Chellis A. Austin,[5] Sewell L. Avery, Julius H. Barnes, A. J. Brosseau, Walter S. Bucklin, James E. Caldwell, Charles S. Calwell, E. L. Carpenter, W. L. Clause, Thornton Cooke, Frederick H. Ecker, J. H. Frost, Hunter L. Gary, W. F. Gephart, Everett G. Griggs, Rudolph S. Hecht, Charles A. Hinsch,[5] A. L. Humphrey, C. T. Jaffray, Fred I. Kent, William A. Law, Murray D. Lincoln, Charles E. Lobdell, John G. Lonsdale, James R. MacColl, Robert F. Maddox, W. S. McLucas, Theodore F. Merseles,[5] John M. Miller, jr., F. C. Rand, George A. Ranney, John J. Raskob, R. G. Rhett, H. M. Robinson, Levi L. Rue, J. T. Scott, Paul Shoup, Frank L. Stevens, Philip Stockton, Henry B. Wilcox, Daniel G. Wing, Theodore Wold, Matthew Woll, Moorhead Wright, Harry A. Wheeler, chairman, and John Jay O'Connor, secretary.

Acknowledgment

Special mention should be made of the assistance given the committee by Prof. O. M. W. Sprague, of Harvard, who conferred at frequent intervals on all questions under review; Prof. Harold L. Reed, of Cornell, who assisted the committee full time for more than a year, making valuable contributions to the committee report and undertaking the main work of drafting the auxiliary statements; and Prof. Ray V. Leffler, of Dartmouth, who prepared some special studies upon currency problems.

Mr. John Jay O'Connor, manager of the finance department of the Chamber of Commerce of the United States, as secretary of the committee, and Mr. C. B. Upham, of the department staff, gave helpful assistance upon every phase of the undertaking. Mr. W. W. Stewart, formerly director of research and statistics of the Federal Reserve Board, assisted in the formative period of the committee's work.

To them, to the members and staff of the Federal Reserve Board, and to directors and officers of the Federal reserve banks, and to many others who in conferences or in correspondence aided in the work, the committee acknowledges its indebtedness.

Appendix to the Committee Report

HISTORY OF THE STUDY

Following the annual meeting of the Chamber of Commerce of the United States in May, 1925, the board of directors authorized a comprehensive study of the Federal reserve system and its developments. During the year following the preliminaries of the project were investigated, the general set-up was planned, study of some of the individual problems was begun, and a canvass of available personnel was made.

In the spring of 1926 the president of the chamber invited a group of past presidents of the chamber and other business men who are familiar with chamber methods to consider the feasibility of organizing a Federal reserve study to be undertaken under the auspices of the chamber. On May 8, 1926, the following gentlemen conferred with the president of the chamber in Washington:

H. A. Wheeler, vice chairman of the board, the First National Bank of Chicago, Chicago, Ill.

Julius H. Barnes, president Barnes-Ames Co., New York, N. Y.

Fred I. Kent, director Bankers Trust Co., New York, N. Y.

John G. Lonsdale, president Mercantile-Commerce Bank & Trust Co., St. Louis, Mo.

James R. MacCall, president Lorraine Manufacturing Co., Pawtucket, R. I.

Lewis E. Pierson, chairman of the board, Irving Trust Co., New York, N. Y.

John J. Raskob, vice president E. I. Dupont de Nemours, Wilmington, Del.

R. G. Rhett, president Peoples First National Bank, Charleston, S. C.

Following this conference the board of directors of the chamber recommended a continuance of the investigation of important questions affecting the banking systems of the country, particularly proposals for changes in Federal reserve

[5] Deceased.

law and practice and a better integration of the credit structure of the country. The president was authorized further to appoint the necessary committees, arrange for the necessary conferences, and make the required budget adjustments.

During the progress of the committee study the charters of the Federal reserve banks were extended in February, 1927, for an indeterminate period. The first public discussion of charter renewal appeared in an article contributed by the Secretary of the Treasury, Andrew Mellon, to the May, 1925, issue of Nation's Business, a publication of the Chamber of Commerce of the United States. At the time the banking and currency bill was before Congress in 1913 the national chamber, through referendum vote of its membership, went on record as favoring the automatic continuance of the proposed banking system until superseded by later legislation. Instead, the bill as enacted into law provided for 20-year charters for the Federal reserve banks. In affirmation of its earlier position, the chamber adopted a resolution at its fourteenth annual meeting in 1926 reading as follows:

The Chamber of Commerce of the United States has a record of steadfast support of the Federal reserve system and from the beginning has favored indeterminate or automatically renewable charters for the Federal reserve banks.

American commerce and industry have taken the system's continuance for granted. To avoid any danger of unsettlement to business or disturbance of public confidence, the charters of the reserve banks should be extended without delay for an indefinite period until dissolution by act of Congress or until forfeiture of franchise for violation of law. Extension should not be made dependent on the adoption of other amendments, however meritorious.

The chamber campaigned vigorously for the legislation extending the charters of the reserve banks for an indeterminate period, and that provision was written into law on February 25, 1927, as a part of the so-called McFadden-Pepper Act.

The study was not inspired by any feeling that the Federal reserve system was deficient in serving American business or that fundamental changes in law or practice were needed. It was more that the system had become indispensable to business progress and that business therefore had a vital interest in being in position to indorse its perpetuation, at the same time indicating, if possible, ways in which even better cooperation between banking and business might be developed.

As the president of the chamber stated in his letter inviting the members of the executive committee of the study to serve:

"It is not the hope of the chamber that the inquiry will recommend modifications of the Federal reserve act, necessarily, or of the policies and practices of the Federal reserve banks. It is rather the desire that all current suggestions for such modifications, and all serious criticisms of the system emanating from responsible sources, be appraised by a competent group.

"You will readily appreciate the importance of the chamber and the business community being placed in a position to say, in regard to any pertinent criticism or suggestion concerning the system, that it has been the subject of special study of business men. It is apparent from the personnel we are inviting to participate in this inquiry that a nucleus is being sought of influential persons, well distributed over the country, to develop, as far as may be possible, a common viewpoint as regards the values of the system. Around this nucleus may later be summoned a national conference * * *. It is to be hoped that Congress shortly will provide for extension of the charters of the Federal reserve banks. The foundation will then be laid for general recognition of the Federal reserve system as a permanent institution. We desire to build firmly on such a foundation."

In addition to the executive committee under the direction of the general chairman of the entire project, Mr. Harry A. Wheeler, three other committees were organized. Under the chairmanship of Mr. Sewell L. Avery, committee No. 2 was appointed to study the organization and structure of the reserve system. Committee No. 3, under the chairmanship of Mr. John G. Lonsdale, had for its field of study reserves and note issues. Rediscounts and open-market operations were given attention by committee No. 4, under the chairmanship of Mr. Chellis A. Austin. The personnel of the committees will be found below.

After each committee had made its report it was felt by the executive committee that one consolidated report should be made and placed before an advisory conference, made up of bankers and other business men, journalists, representatives of agriculture and labor, economists, and Federal reserve officials, so that the committee might have the benefit of the thought of all groups and all sections focused upon the definite proposals made. Such a conference was held in June, 1928.

In the light of conference discussion and of subsequent events in the credit field, the committee report and the auxiliary statements were revised and presented to the board of directors of the chamber, which ordered them printed for distribution in conjunction with a referendum of the organization members of the chamber.

Personnel

EXECUTIVE COMMITTEE

Harry A. Wheeler, chairman, vice chairman of the board, First National Bank of Chicago, Chicago, Ill.

Chellis A. Austin, chairman Committee IV, president Equitable Trust Co., New York, N. Y. (deceased).

Sewell L. Avery, chairman Committee II, president United States Gypsum Co., Chicago, Ill.

Julius H. Barnes, president Barnes-Ames Co., New York, N. Y.

Fred I. Kent, director Bankers Trust Co., New York, N. Y.

Murray D. Lincoln, executive secretary Ohio Farm Bureau Federation, Columbus, Ohio.

Charles E. Lobdell, formerly fiscal agent Federal Land and Intermediate Credit Banks, Washington, D. C.

John G. Lonsdale, chairman Committee III, president Mercantile-Commerce Bank & Trust Co., St. Louis, Mo.

James R. MacColl, president Lorraine Manufacturing Co., Pawtucket, R. I.

John J. Raskob, vice president E. I. du Pont de Nemours, Wilmington, Del.

R. G. Rhett, president Peoples First National Bank, Charleston, S. C.

H. M. Robinson, chairman of the board, Security-First National Bank of Los Angeles, Los Angeles, Calif.

Matthew Woll, president International Photo-Engravers Union of North America, Chicago, Ill.

COMMITTEE II

Charter and structure

Sewell L. Avery, chairman, president United States Gypsum Co., Chicago, Ill.

Federal reserve district No. 1. Daniel G. Wing, chairman of the board, the First National Bank of Boston, Boston, Mass.

Federal reserve district No. 2. Frank L. Stevens, president Stevens & Thompson Paper Co., North Hoosick, N. Y.

Federal reserve district No. 3. Levi L. Rue, chairman of the board, Philadelphia National Bank, Philadelphia, Pa.

Federal reserve district No. 4. Charles A. Hinsch, formerly president Fifth-Third Union Trust Co., Cincinnati, Ohio (deceased).

Federal reserve district No. 5. John W. Arrington, president Union Bleachery, Greenville, S. C.

Federal reserve district No. 6. Robert F. Maddox, chairman of the executive committee, First National Bank, Atlanta, Ga.

Federal reserve district No. 7. George A. Ranney, vice president and treasurer. International Harvester Co., Chicago, Ill.

Federal reserve district No. 8. F. C. Rand, president International Shoe Co., St. Louis, Mo.

Federal reserve district No. 9. E. L. Carpenter, president Shevlin, Carpenter & Clarke Co., Minneapolis, Minn.

Federal reserve district No. 10. W. S. McLucas, chairman of the board, Commerce Trust Co., Kansas City, Mo.

Federal reserve district No. 11. J. T. Scott, president First National Bank, Houston, Tex.

Federal reserve district No. 12. Paul Shoup, president Southern Pacific Co., San Francisco, Calif.

COMMITTEE III

Reserves and note issues

John G. Lonsdale, chairman, president Mercantile-Commerce Bank & Trust Co., St. Louis, Mo.

Federal reserve district No. 1. Walter S. Bucklin, president National Shawmut Bank, Boston, Mass.

Federal reserve district No. 2. A. J. Brosseau, president Mack Trucks (Inc.), New York, N. Y.

Federal reserve district No. 3. William A. Law, president Penn Mutual Life Insurance Co., Philadelphia, Pa.

Federal reserve district No. 4. A. L. Humphrey, president Westinghouse Air Brake Co., Pittsburgh, Pa.

Federal reserve district No. 5. Henry B. Wilcox, vice chairman of the board, Merchants National Bank, Baltimore, Md.

Federal reserve district No. 6. James E. Caldwell, president Fourth and First National Bank, Nashville, Tenn.

Federal reserve district No. 8. Moorhead Wright, president Union Trust Co., Little Rock, Ark.

Federal reserve district No. 9. Theodore Wold, vice president Northwestern National Bank, Minneapolis, Minn.

Federal reserve district No. 10. Thornton Cooke, president Columbia National Bank, Kansas City, Mo.

Federal reserve district No. 11. J. H. Frost, president Frost National Bank, San Antonio, Tex.

Federal reserve district No. 12. M. A. Arnold, president First National Bank, Seattle, Wash.

COMMITTEE IV

Rediscounts and open-market operations

Chellis A. Austin, chairman, president Equitable-Seaboard Bank & Trust Co., New York, N. Y. (deceased).

Federal reserve district No. 1. Philip Stockton, president Old Colony Trust Co., Boston, Mass.

Federal reserve district No. 2. Frederick H. Ecker, president Metropolitan Life Insurance Co., New York, N. Y.

Federal reserve district No. 3. Charles S. Calwell, president Corn Exchange National Bank & Trust Co., Philadelphia, Pa.

Federal reserve district No. 4. William L. Clause, chairman of the board, Pittsburgh Plate Glass Co., Pittsburgh, Pa.

Federal reserve district No. 5. John M. Miller, jr., president First & Merchants National Bank, Richmond, Va.

Federal reserve district No. 6. Rudolph S. Hecht, president Hibernia Bank & Trust Co., New Orleans, La.

Federal reserve district No. 7. Theodore F. Merseles, president Johns-Manville Corporation, New York, N. Y. (deceased).

Federal reserve district No. 8. W. F. Gephart, vice president First National Bank in St. Louis, St. Louis, Mo.

Federal reserve district No. 9. C. T. Jaffray, president Minneapolis, St. Paul & Sault Ste. Marie Railway Co., Minneapolis, Minn.

Federal reserve district No. 10. Hunter L. Gary, Theodore Gary & Co., Kansas City, Mo.

Federal reserve district No. 11. Nathan Adams, president American Exchange National Bank, Dallas, Tex.

Federal reserve district No. 12. Everett G. Griggs, president St. Paul & Tacoma Lumber Co., Tacoma, Wash.

AGENDA

COMMITTEE II

Charter and structure

I. Rechartering:

1. Duration of charter.

2. Method of securing renewal of charter:

(*a*) Press for renewal of charter as separate congressional measure, or (*b*) Include renewal provision in congressional bill of more general nature relative to Federal reserve.

3. Time of renewal:

(*a*) Press for renewal at earliest possible opportunity, or (*b*) pursue an opportunist policy and urge renewal when political and other conditions seem most propitious.

II. Districts:

1. Number of districts.
2. Boundaries of existing districts.
3. Federal reserve cities.
4. Federal reserve branches:

(*a*) Number of.

(*b*) Location of.

III. Directors:

1. Qualifications of members of the three classes.
2. Method of selection.
3. Changes in the number of members of each class.

IV. Board:

1. Number of members.
2. Tenure of office.
3. Salaries.
4. Ex-officio membership thereon.
5. Qualifications of appointive members.
6. Method of selecting those who are not ex-officio members.
7. Should one or more members of the advisory council be members of the Federal Reserve Board?
8. Powers of. (To be considered under the various specific heads such as discount policies, open-market operations, etc.)

V. Advisory council:

1. Method of selection.
2. Tenure of office (now one year).
3. Should it be given more power (now has only advisory power on certain questions)?
4. Possibility of establishing closer relationship with board.

VI. Membership:

1. National banks.
2. State banks:

(*a*) Is it desirable to encourage wide membership with the view of securing a better integration of the entire national credit system; or (*b*) is it desirable to limit membership to the larger State banks, aiming at financial strength, rather than number of banks?

(*c*) Qualifications for admission of State banks.

(*d*) Is it desirable to provide for associate memberships with limited requirements for admission and limited privileges so as to increase Federal reserve resources and unify the credit system of the country?

VII. Foreign agencies and correspondents:

1. Should the foreign activities of the Federal reserve system be increased? If so, by—

(*a*) Establishment of agencies, or (*b*) by increased use of correspondents?

VIII. Bank examination:

1. Desirability of placing bank examination under supervision of Federal Reserve Board.
2. Desirability of superseding or supplementing State examination of State member banks by—

(*a*) National bank examiners supervised as at present by the Comptroller of the Currency, or (*b*) examiners under the supervision of the Federal Reserve Board.

IX. Operating functions:

1. Correspondent relationships with foreign central banks (carrying of deposits, earmarking, purchase and sale of gold, making of loans upon gold security).
2. Fiscal agency and depositary functions for Federal Government:

(*a*) Sale and delivery of Government securities.

(*b*) Redemption of Government securities.

(*c*) Exchange of Government securities.

(*d*) Transfers of Government securities.

(*e*) Security purchases for Government account.

(*f*) Maintenance of Government deposit accounts with designated depositaries.
(*g*) Custody of Government securities.
(*h*) Depositaries for Treasury—payment of Government checks, warrants, and coupons.
(*i*) Collections of checks and noncash items.
(*j*) Relations with depositary banks—telegraph transfer of funds; former subtreasury functions; replacing, exchange and redemption of currency and coin.
3. Research and publications:
(*a*) Board.
(*b*) Banks.

AGENDA

COMMITTEE III

Reserves and note issues

I. Reserves:
1. Federal reserve banks. Topics for consideration:
(*a*) Reserves against Federal reserve notes (now not less than 40 per cent in gold).
(*b*) Reserves against deposits (now 35 per cent in gold or lawful currency).
2. Member banks. Topics for consideration:
(*a*) Reserves against demand deposits: (1) Central reserve city banks (now 13 per cent); (2) reserve city banks (now 10 per cent); (3) country banks (now 7 per cent).
(*b*) Against time deposits: (1) All banks (now 3 per cent); (2) effect which this low reserve ratio has on savings institutions; (3) incentive to convert demand deposits into time deposits.
(*c*) Should some of the reserves be carried in the vaults of the member banks? If so, what portion? (Original act provided that one-third should be retained by member bank.)
(*d*) Should interest be paid on reserves?
(*e*) Method of computing reserves (e. g., should reserves be held against trust funds, Government deposits, and other special types of deposits?).
(*f*) Redesignation of central reserve city, reserve city and country banks.
(*g*) Should State banks be permitted to consider Federal reserve notes as reserves.
II. Currency:
1. Federal reserve notes. Topics for consideration:
(*a*) Should Federal reserve notes be issuable only against commercial paper as collateral?
(*b*) Should Federal reserve notes be issuable against gold and collateral of commercial paper, Government securities, private corporation securities, or other recognized collateral or some combination of these?
(*c*) Should there be a certain fixed amount of Federal reserve notes constantly outstanding but to be supplemented as occasion demands by notes based on gold or commercial paper?
(*d*) Should the class of collateral now used as basis for Federal note issues be widened or narrowed?
(*e*) Changes in regulations affecting note issues in excess of the 40 per cent rates.
2. Federal reserve bank notes:
(*a*) Continued as at present.
(*b*) Abolished.
(*c*) Modifications as to collateral:
3. National-bank notes:
(*a*) Continued as at present.
(*b*) Abolished.
(*c*) Modifications as to collateral.
4. Relation of Federal reserve currency to other currency such as national-bank notes, silver certificates, "greenbacks," etc. Consideration of such topics as—
(*a*) Volume of currency.
(*b*) Elasticity of currency.
(*c*) Velocity.
III. Operating functions:
1. Handling of member-bank reserves.

2. Supplying of currency and coin.
3. Collection and clearance of checks.
4. Collection of noncash items (drafts, notes, and coupons).
5. Wire transfers of funds.
6. Safekeeping of securities for member banks.

AGENDA

COMMITTEE IV

Rediscounts and open-market operations

I. Rediscounts:

(Introductory)

Function of rediscounts in central regional banking:
1. European background (brief historical treatment).
2. Federal reserve policy (brief historical treatment of recent few years):
(*a*) January, 1922, to spring recession of 1923.
(*b*) Spring of 1923 to close of 1924.
(*c*) Beginning of 1925 to present time.
A. Legal status:
1. Classes of institutions permitted by act to rediscount with reserve banks.
2. Qualifications of eligible paper—
(*a*) As regards form of paper (promissory notes, drafts, bills of exchange, acceptances, etc.).
(*b*) As regards purposes for which paper was originally drawn.
(*c*) As regards maturity.
3. Amounts discountable:
(*a*) For any member bank.
(*b*) By the reserve banks.
(*c*) Of paper bearing the signature of one party.
4. Rates:
(*a*) Method of fixation.
(*b*) Differentials between various types of paper.
B. Need of control:
1. From standpoint of banking requirements, such as—
(*a*) Reserve ratios.
(*b*) Money-market conditions.
(*c*) Gold movements.
(*d*) Foreign conditions, exchange rates, and rates of foreign central banks.
(*e*) Earnings of reserve banks.
2. From standpoint of other economic requirements, such as—
(*a*) Commodity prices.
(*b*) Volume of production.
(*c*) Inventories.
(*d*) Volume of speculation.
C. Methods of control:
1. Discrimination based upon nature of paper and use of proceeds.
2. Rate changes.
3. Rulings and regulations.
4. Fixing basic lines for each rediscounting institution.
5. Moral suasion.
6. Advice and warnings.
7. Exercise of right to arbitrarily refuse applications.
8. Altering volume of open market purchases and sales.
9. Altering volume of direct collateral advances to member banks.
D. Agencies of control:
1. Reserve banks.
2. Board.
3. Advisory council.
E. Difficulties of control:
1. Lack of pertinent analogies in experience of foreign central banks.
2. Varying interest rates existing throughout the country.
3. Correspondent connections of small country banks to larger institutions in the financial centers.
4. Statistical.
II. Open market operations:

(Introductory)

Function of open market operations in central and regional banking:
1. European background.
2. Federal reserve policy (brief treatment of development).
A. Value of (in relation to)—
1. Individual banks.
2. Credit control under Federal reserve.
3. Development of bill market.
4. Gold flow.
5. Dollar credits.
6. Foreign credit and currency situations.
7. Earnings of system.
B. Legal status:
1. Classes of permissible purchases.
2. Institutions dealt with.
3. Rates.
4. Differentiation from rediscount operations.
C. Control:
1. Need of—
(*a*) From standpoint of banking requirements.
(*b*) From standpoint of other economic requirements.
2. Methods of—
(*a*) Rate changes.
(*b*) Rulings and regulations.
(*c*) Treatment of applications.
3. Agencies of—
(*a*) Federal Reserve Board.
(*b*) District banks.
4. Difficulties attending Federal reserve participation in open market:
(*a*) Eligibility limitations.
(*b*) Foreign demands.
(*c*) Absorption of funds by securities market.
(*d*) Attitude of individual banks.
D. Special problems:
1. Do open market activities enable reserve banks to keep outstanding more credit than would otherwise be possible?
2. Can open market sales be employed as a substitute for discount-rate increases in such a way as to avoid the unpopularity of such increases?
3. Do open-market purchases force more rapid credit expansion by member banks than do reduction of rediscount rates?
4. Have the effects of dealings in Government securities been similar to dealings in bank acceptances?
5. Should the reserve banks continue to deal with other than member banks in making purchases and sales?
6. Should open-market powers include different types of paper than is now permitted?
7. In general, should open-market activities be continued or abandoned?
III. Finances:
1. Gross earnings—
(*a*) Sources and amounts (classified).
2. Expenditures—
(*a*) Purposes and amounts (classified).
3. Net earnings—
(*a*) Analysis.
(*b*) Surplus account.
(*c*) Dividends.
(*d*) Franchise payments.
4. Building and equipment accounts.
IV. Gold policy:
Consideration of such topics as—
(*a*) Should a portion of the gold now in this country be "earmarked" and not considered a part of the reserve fund?
(*b*) International movement of gold.
(*c*) Cooperation with foreign banks of issue.

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