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REPORT ON THE COMMERCIAL BANKING SYSTEM

Federal Reserve System Committee on Legislative Program

(December 17, 1934)

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STATEMENT OF OBJECTIVE

The present report by a Committee of the Federal Reserve System is intended to suggest a program for improving the organization and the control of our commercial banking system. Bank failures, which culminated in a nation-wide bank shut-down in 1933, were a major catastrophe of the depression. After a great struggle, involving financial aid from the Government and from the public, the banking system has emerged in strengthened condition. In the process there have been developed new emergency agencies and functions that have tended to cut across the old conflicting jurisdictional lines, which constituted a source of weakness in the banking structure. It is imperative that the better condition of the banks be maintained and further strengthened, and that improvements resulting from measures taken in response to the emergency be permanently retained.

The program which is presented in this report has to do mainly with means of further strengthening our commercial banking organization and of improving the supervision of banks and of the quality of the credit which flows from them to agriculture, industry and trade.

This Committee recognizes that the more customary function of banks of issue such as the Federal Reserve banks is to influence, by means of its rediscount, bill-market and open-market policies, the volume and cost of credit made available to the banks and by them to the public, adapting these policies to the need for expansion or restraint as conditions dictate. It recognizes also that the influencing of the quantity of credit has an important bearing upon the condition of banks and the quality of their assets. It believes, however, that the defects in our banking system which present the most pressing need for structural and administrative changes are those disclosed by a period of unprecedented bank failures and associated directly with the quality of credit -- i.e. with the quality of bank assets and the soundness of banks. The substance of this report, therefore, has to do mainly with such changes.

#### PROPOSALS

The Committee's proposals are directed principally to improvement in the regulation and supervision of banks with a view to doing all that it is possible to do toward the maintenance of a sound banking system and the prevention of bank failures. Two essential steps

in this direction are: (1) The elimination of the destructive influence on banks of conflicting jurisdictions -- i.e. the unification of commercial banking; and (2) the amalgamation of Federal supervisory and regulatory activities in regard to commercial banks -- i.e. the unification of Federal agencies having to do with such banks.

Membership in the Federal Reserve System. - Division between forty-eight states and the Federal Government of authority and responsibility over the chartering and supervision of banks has been a source of weakness in the banking structure. It has resulted in excessive ease in granting bank charters, has interfered with the effective supervision of banks, and has fostered unsound banking legislation.

Developments leading to the recent banking crisis, and measures taken by the Government to cope with the crisis have cut across the lines of distinction between national and State banks and between members and nonmembers of the Federal Reserve System. Recent experiences have brought into strong relief the close relationship that exists between all banks. Distinctions between the various classes of banks become of little importance when public confidence is undermined by the disclosure of serious weakness anywhere within the banking system. When during the recent banking crisis all banks were subjected to the strain of wholesale withdrawals and liquidation,

all classes of banks turned for assistance to the Federal Government.

This assistance has been given to all classes of banks, whether State or national and whether members of the Federal Reserve System or not. As a consequence, the essential unity of the commercial banking structure has been increasingly recognized, and the movement for overcoming the difficulties arising out of dual control has gained momentum.

A method of overcoming most of the evils of dual control over banking is in fact contained in existing law. The Federal deposit insurance law provides that, in order to participate in the benefits of the insurance, banks must by July 1, 1937, belong to the Federal Reserve System. This provision may be expected to bring the great majority of banks doing a commercial business into the Federal Reserve System and to place them under its supervision.

Apart from the benefit to individual banks of participation in the Federal deposit insurance plan, the broadening of membership in the Federal Reserve System will be advantageous to the banks and will enable the System to function more effectively. In the past nonmember banks have benefited indirectly from the operations of the System through their contacts with member correspondent banks. The correspondent relationship is not, however, an adequate substitute for membership in the System. It does not give to the nonmember banks the same assurance of credit and currency accommodation in time of need as would actual membership, or make available to them direct

access to the other services through which the System facilitates the operations of member banks. Nor does it place the Federal Reserve banks in direct contact with nonmember banks, which are a source of demand for credit and currency accommodation, or afford it an opportunity to examine or supervise such banks, notwithstanding the fact that the condition and operations of these banks affect the strength of the banking system as a whole.

The Committee, therefore, believes that the provision in the law which requires banks participating in Federal deposit insurance to become members of the Federal Reserve System by July 1, 1937, should be retained. In order that this provision may be fully effective and that it may result in maximum advantages to individual banks as well as to the banking system as a whole, the Committee proposes that the Federal Reserve System examine possible ways of making requirements for admission to membership as well as the services of the System conform more closely to the needs of banks now outside the System.

There are many nonmember banks at present whose capital is too small to make them eligible for membership in the Federal Reserve System. The exclusion of several thousand small but sound banks from the System or from the Federal deposit insurance might be a calamity. It is the opinion of the Committee that the public interest requires that all nonmember banks be given an opportunity to enjoy

the benefits of membership in the System and to participate in Federal deposit insurance without hardship attending their transition to the status of member banks.

It is, therefore, proposed that the Federal Reserve Board be authorized, when in its judgment the public interest so requires, to waive existing legal requirements for admission to membership, including minimum capital requirements, to the extent necessary to permit existing nonmember banks otherwise eligible for Federal deposit insurance to become members of the Federal Reserve System. The Board's regulations regarding admissions to membership should also be modified in keeping with the purpose of this proposal. Such banks as are under-capitalized, in the opinion of the Federal Reserve Board, should (1) be required, within such a period as the Board may prescribe in individual instances, to increase their capital (with the aid of Federal funds if necessary) to such amounts as the Federal Reserve Board may deem sufficient, without regard to the amount of capital now required by law for member banks, or (2) be permitted to be consolidated with or become branches of existing banks, when that is a preferable course in the public interest.

No bank chartered in the future should be permitted to be a member of the System with less capital than is required by existing law for the establishment of a new national bank.

Provisions of existing law in regard to the minimum amount of capital which member banks must have include a requirement for banks

having branches, that the aggregate capital of a bank and its branches be at least equal to the aggregate of the minimum amounts that would be required if the head office and branches were separate institutions. It is proposed that such capital requirement be made discretionary with the Federal Reserve Board on the ground that the same reasons that would make it impossible for a community to support a unit bank might prevent the profitable use on a sound basis of the capital required for a branch.

Coordination and improvement of bank supervision. - Coordination of Federal agencies having supervisory and regulatory power over commercial banks is an essential part of a proposal for improving the character of the banking structure.

At the present time activities of the Federal Government having to do with the supervision of banks are divided between the Federal Reserve Board, the Comptroller of the Currency, the Reconstruction Finance Corporation, and the Federal Deposit Insurance Corporation. During the emergency period these agencies have functioned in harmony, but the division of responsibility is not a condition that should be continued permanently. It is unnecessarily burdensome to the banks and costly to the Government, and interferes with the effectiveness that goes with coordinated supervision and concentrated responsibility. This is particularly important because of the recent establishment of a Government agency for insuring bank deposits. The existence of an insurance fund to be used for the payment of insured deposits in closed

banks accentuates the importance of effective supervision, since permanent insurance of deposits is practicable only so long as the banking system remains in sound condition and bank failures are few.

If Federal supervision and regulation of commercial banks is to be fully effective it is essential that the activities of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation and such of the activities of the Reconstruction Finance Corporation as relate to banks, be unified as soon as practicable.

In consequence of its broad responsibility for the maintenance of sound credit conditions, the Federal Reserve System has a vital interest in the character of bank operations and in the soundness of individual member banks and of the banking system as a whole. The examination and supervision of member banks, directly and through the Comptroller of the Currency and in cooperation with State bank supervisory authorities, has been an important responsibility of the Federal Reserve Board in the past, and the extension of membership in the System consequent upon the operation of the permanent plan for Federal deposit insurance will further broaden its responsibility.

The Federal Reserve System is particularly adapted to the performance of supervisory functions. The twelve regional Reserve banks are constantly in close touch with the banks in their districts, with



their management, and with conditions under which they operate. It would appear that no agency has the experience, facilities and contacts which would enable it to deal with the problems of bank supervision as effectively as the Federal Reserve bank of the district in which a bank is located.

The history of State bank insurance plans demonstrates the importance of impartial and effective bank examination if insurance is not to lead to the development of unsafe and incautious banking practices. It also suggests the desirability of conducting bank examinations with a considerable degree of independence of the administration of deposit insurance. This Committee is of the opinion that the unification of examination activities within the Federal Reserve System would afford the best prospect of placing such activities on a more effective basis and of integrating them fully with other phases of bank supervision, including the administration of Federal deposit insurance.

Federal deposit insurance. - Modifications proposed in the Federal deposit insurance plan are based on two principles: first, that insurance of deposits must not be permitted to stimulate irresponsible banking or to undermine the strength of sound and well-managed banks; and secondly, that prevention of bank failures will serve the public interest far better than will reliance solely on a plan for reimbursing depositors after failures have occurred.

It is therefore essential, for the successful administration of the permanent plan for Federal deposit insurance, that the supervision and regulation of the insured banks -- i.e., beginning July 1, 1937, all member banks -- be strengthened and unified. Broadly speaking it should be a part of the plan, not only to guarantee the reimbursement of depositors in the event of a bank's failure, up to the amount of their insured claims, but to accomplish three other major purposes: (1) to reduce the necessity of liquidating banks; (2) to undertake such liquidation as is unavoidable before the capital equity has been absorbed and before the values underlying deposits have begun to be dissipated; and (3) to effect maximum distributions to depositors promptly so as to minimize the hardship and the unsettling effect on values that result from disorderly liquidation and the freezing of deposits.

The operation of such a plan would commence with a close scrutiny of the condition and management of banks with a view to the prompt elimination of elements of weakness. Should it develop that, notwithstanding corrective measures, the condition or the management of a bank were to become such as to place it in an unsound position, special limitations would be imposed on the management of the bank pending its restoration to a sound condition, reorganization, or other disposition.

In addition to the insurance fund, which has been created for the purpose of making distributions to depositors in closed banks, there

should be established a separate "rehabilitation" fund. This fund would be used for making temporary capital advances to assist small banks in adjusting their capital to requirements for membership in the Federal Reserve System, and for making such special loans and capital advances as might be necessary in applying various corrective measures that constitute essential parts of this plan. These would include advances to facilitate reorganizations, approved consolidations, etc. The establishment of a separate fund for this purpose is proposed so that the conduct of rehabilitation activities need impose no risk upon the insurance fund.

The activities by which it is proposed that the Federal Reserve banks should supplement the operation of the insurance fund may be outlined as follows:

1. The Federal Reserve banks would exercise constant scrutiny of the condition and management of member banks, as they are required to do by the Federal Reserve Act, and particularly under the amendments included in the Banking Act of 1933. They would have power, with proper safeguards, to require needed improvement in bank portfolios, the correction of unsafe and unauthorized practices or changes in personnel;
2. They would authorize consolidations and the establishment of such branches as in their judgment were in the public interest, particularly when weak banks might thereby be dealt with in the best interests of their depositors and of the communities which they serve;
3. They would employ the "rehabilitation" fund in making such temporary capital advances as might be necessary in strengthening banks and in applying corrective measures to avoid failures, including advances to facilitate reorganizations, approved consolidations, etc.;
4. When in its judgment, based upon thorough investigation, the condition or the management of any member bank was found to be such as to place it in an unsound condition or to necessitate the conservation of its assets for the protection of its depositors, the

Reserve bank (without legal responsibility for the obligations of such bank) would (a) impose such conditions on the management of the bank as it might deem advisable in order, if possible, to continue it in operation and restore it to a sound condition -- if necessary by reorganization, consolidation or conversion into a branch bank, with due regard to the interests of the bank's depositors and stockholders, and if necessary supplying temporary additional capital from the "rehabilitation" fund; or (b) if necessary, liquidate the bank. In deciding that the condition or management of a bank made it necessary to proceed as outlined above, the Reserve bank would take into consideration such evidence as the integrity and ability of officers and directors; position of the capital account; proportion to the bank's capital of assets criticized by the examiners; violation of law or of the Board's regulations; failure to comply with directions as to the revaluation or writing off of assets, changes in personnel and the correction of unsafe practices;

5. If it should become necessary to liquidate a member bank, the insured amounts owing to depositors would immediately be made available from the Federal deposit insurance fund; and

6. If in consequence of the insurance limit immediate distributions to depositors should result in tying up an excessive volume of deposits pending liquidation of a member bank's assets, and to the extent that expected recoveries on the assets of the bank should warrant, additional amounts would be made available by means of special advances from the insurance fund.

At least for an initial period of years, the Federal deposit insurance fund should be maintained and operated independently of the "rehabilitation" fund and be used solely to effect authorized distributions to depositors.

The maximum limit on the insured liability of any one depositor is now \$5,000 under the temporary Federal deposit insurance plan. More than ninety-seven percent of the insured accounts in banks now participating in the fund are fully insured under this limitation, and the total volume of insured deposits is estimated to be about forty-five

percent of the aggregate deposits of these banks. It is believed that such a limit should be retained on amounts to be made immediately available under the permanent plan for Federal deposit insurance, with provision for supplemental distributions as already noted in item number 6, above. Additions to the Federal deposit insurance fund should originate largely from payments by the participating banks. The existing law which provides for unlimited assessments, based on the amount of the banks' total deposits, should be amended to prescribe a definite annual maximum of assessments based on a bank's total deposits.

In view of the proposals for a closer supervision of member banks and for affirmative action before the dissipation of assets in an unsound bank could proceed very far, it should be possible through relatively small limited annual payments by such banks, perhaps supplemented for a time by Federal appropriations, to build up the insurance fund sufficiently to make possible substantial immediate distributions to depositors in such banks as it might be necessary to liquidate, and to absorb insured losses.

At the outset, the "rehabilitation" fund should be established and maintained if possible through the sale of Federal deposit insurance obligations and/or by such Federal appropriations as might be necessary.

It is anticipated that the cost of operating the proposed plan

will be incurred mainly in supervising member banks and in taking active steps to avoid failures, rather than in absorbing losses resulting from compulsory liquidations. Aside from the expense of supervision, the cost of operating the plan should, therefore, fall mainly on the "rehabilitation" fund. If this expectation is borne out by experience, contributions to the insurance fund might be diverted to the "rehabilitation" fund, or the two funds might be combined.

Supervisory activities of Federal Reserve System. In the future conduct of the supervisory and regulatory activities of the System greater authority should be delegated in the first instance to the Reserve banks, subject to review by the Board and with appropriate provision for determination by the Board of matters involving policy. There should be provision for appeal and hearings by the Board, but, in the interests of simplicity and expedition, these should be limited so far as possible through the provision of suitable procedure for appeal and hearings before a committee or council of senior officials at the Reserve banks, the decisions of which should become effective after a designated period if not reversed by the Board.

The Federal Reserve banks should conduct all examinations of member banks. They should be required to examine each bank only once a year, but should be authorized to examine more frequently such banks as might require special attention. This should increase the

effectiveness of examination activities and more particularly it should promote concentration of effort in the prompt correction of unsafe practices and the elimination of elements of weakness. The Reserve banks should be authorized, but not required, to assess the expense of examination upon the banks examined and, in recognition of the fact that the System as a supervisory agency is concerned with examinations chiefly from the point of view of maintaining sound conditions in the banking system as a whole, it is proposed that the cost of at least one examination a year be absorbed by the System.

Banking facilities. - Subject to regulation and review by the Federal Reserve Board, the Federal Reserve banks should have full authority in regard to the establishment of new member banks, the approval or disapproval of applications for admissions into the System, and the expulsion of banks from the System, and in regard also to consolidations, etc., and the establishment of branches by member banks. The proposed centralization in the Federal Reserve System of complete authority in regard to the creation of new member banks, and in regard to consolidations and the establishment of branches by member banks would enable the System to pursue a policy directed toward readjusting existing banking facilities in accordance with local needs. The objective of such a policy would be to make adequate banking services available to all communities on a sound basis.

As a consequence of bank failures many communities at the present time lack adequate banking facilities. In some instances their needs

may be met best through the organization of new banks and in others it may prove desirable to authorize the establishment of branch banks. There may be instances in which the banking requirements of a community could be met, and the public interest best served, through the consolidation of two or more existing banks or the absorption of one bank by another, particularly in the case of banks that have no prospect of making adequate earnings on a sound basis.

Decisions in regard to such matters should be reached only after thorough investigation, through the regional facilities of the System. Such decisions should be based upon consideration of the public's need for banking facilities, the prospects of earnings that a bank would have, the adequacy of resources that would be available to the bank, and the ability and integrity of its management.

The System's policy in this regard should be directed mainly to the following:

1. Establishment of adequate banking facilities in communities in which they are now lacking;
2. Admission of small nonmember banks to the System and the subsequent adjustment of their capital to minimum requirements; and
3. Readjustment of banking facilities which it is found after thorough investigation cannot continue to operate independently on a sound basis.

Codification of banking law. - This Committee has not undertaken to make comprehensive recommendations regarding restrictions which



should be imposed by law or regulation on banking practices and operations. The problems in this field are complex and require thorough and intensive investigation. The Federal Reserve Board and banks have always deemed it a part of their function to consider and recommend needed banking legislation. The System's research and experience have continually been used as a basis for such recommendations. The System, with the Board at its head, should re-examine, through a committee or otherwise, the whole field of banking law, and make a report that would represent a codification, simplification and rationalization of legislation dealing with banks.

The undertaking of this broad task, however, the accomplishment of which necessarily will require time, should not delay the enactment of amendments designed to correct technical or administrative defects in the law or to make other changes the need for which is clearly evident. Senate bill 3748, which failed of enactment at the close of the last session of Congress, contained a number of such amendments. The Committee recommends that a similar bill be drafted and that it include the following additional provisions:

1. Permanent authorization, under proper safeguards, for emergency advances by Federal Reserve banks to member banks along the lines of Section 10 (b) of the Federal Reserve Act;
2. Permanent authorization for the use of obligations of the United States Government and its agencies as collateral for Federal Reserve notes, when approved by the Federal Reserve Board; and
3. Restoration of the franchise tax.

Procedure should be established on a permanent basis for the consideration of banking legislation to be recommended from time to time by the Federal Reserve System. It is this Committee's belief that in general the banking laws should in large part lay down principles, and leave discretion to the Board in their application, in the light of constantly changing conditions.

Reserve requirements. - A committee of the Federal Reserve **System** has made an extensive study of the subject of reserve requirements and in its report has recommended changes in existing legal requirements including revisions to take into account not only volume but also activity of deposits.

Existing reserve requirements recognize roughly the principle that activity should be taken into consideration in determining reserve requirements. This is indicated by the provision of lower requirements for time than for demand deposits and for demand deposits of country banks than for demand deposits of banks in Reserve or central Reserve cities. But the present requirements, owing to defects inherent in the rules, generally work contrary to the System's credit policy rather than in harmony with it. It is believed that the new proposal would materially improve this condition.

Further study is being given to the specific provisions and to the working in practice of the reserve proposals that were made by the Committee on Bank Reserves. Subject to the outcome of this further study, the present Committee expresses itself as favoring, in principle,

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those proposals, including the recognition of the importance of activity as well as volume of deposits in determining reserve requirements.

It is further proposed that the authority of the Federal Reserve Board to raise or lower member bank reserve requirements, which is contained in paragraph 2 of Section 19 (c) of the Federal Reserve Act, be clarified and made less stringent. At the present time this authority requires approval by the President and is conditioned upon the Board's declaration "that an emergency exists by reason of credit expansion," clearly a limitation inconsistent with conditions under which the Board might be called upon to exercise its authority in the direction of decreasing as well as increasing reserve requirements.