



The Answers of the American Bankers Association



9

IN REPLY TO A QUESTIONNAIRE OF
THE UNITED STATES SENATE COMMITTEE
ON BANKING AND CURRENCY



Published by the Research Council
AMERICAN BANKERS ASSOCIATION
22 EAST 40 STREET • NEW YORK, N. Y.

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THE ANSWERS OF THE
AMERICAN BANKERS ASSOCIATION

In reply to Part 9 of the Questionnaire of the Committee
on Banking and Currency of the United States Senate
Relative to Senate Resolution 125 of the 76th Con-
gress, 1st Session, Authorizing the Committee to
Conduct a Study and Hold Hearings to
Consider and Recommend a National
Monetary and Banking Policy



COMPILED UNDER THE SUPERVISION OF THE
SPECIAL BANKING STUDIES COMMITTEE
OF THE AMERICAN BANKERS ASSOCIATION

Published by the Research Council

AMERICAN BANKERS ASSOCIATION
22 EAST 40 STREET • NEW YORK, N. Y.

April 1941

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PREFATORY STATEMENT

The Administrative Committee of the American Bankers Association, at a meeting held April 21, 1940, authorized the president of the Association to appoint a committee of five to have charge of the preparation of any reports or material to be submitted in connection with hearings of the United States Senate Committee on Banking and Currency on a national monetary and banking policy, as provided for in Senate Resolution 125. This action was reported to and approved, April 23, 1940, by the American Bankers Association's Executive Council, in which, under the constitution of the Association, is vested the administration of its affairs in the interim between sessions of the General Convention.

Following the receipt by the Association of a communication from Senator Robert F. Wagner, chairman of the Committee on Banking and Currency, under date of May 18, 1940, inviting it to prepare replies to certain questions compiled by his committee, the president of the Association, Robert M. Hanes, named a Special Banking Studies Committee of five to study the subject matter of the questionnaire and supervise the preparation of responsive material on behalf of the Association.

Colonel Leonard P. Ayres, vice president of the Cleveland Trust Company, Cleveland, Ohio, chairman of the Research Council and of the Economic Policy Commission of the American Bankers Association, was designated as chairman of this committee and promptly organized it for work, the first meeting being held June 20, 1940. In October 1940, Colonel Ayres was called to Washington for military service, and W. Randolph Burgess, vice chairman of the board of The National City Bank of New York, was appointed to serve as chairman in

Colonel Ayres' stead during his absence. The other members of the committee are Raymond N. Ball, President Lincoln-Alliance Bank & Trust Company, Rochester, New York; Harry A. Bryant, President Parsons Commercial Bank, Parsons, Kansas; A. George Gilman, President Malden Savings Bank, Malden, Massachusetts, and S. H. Squire, President The Tiffin National Bank, Tiffin, Ohio; and the secretary, Gurden Edwards, Director Research Council and Secretary Economic Policy Commission, A.B.A.

The group of 86 questions directed to the American Bankers Association is divided into six parts as follows: I. Deposit Insurance, II. Supervision, III. Legal Status of Banks, IV. Earnings and Interest Payments, V. Bank Organization and Structure, VI. Credit Control. At the first meeting of the special committee in June 1940, sections of the questions were assigned to the members and the preparation of the studies and answers relative to them placed under their supervision. The facilities of the Research Council and other units in the general Association were placed at the disposal of the committee by Executive Manager Harold Stonier.

The secretary of the committee was directed to engage adequate technical assistance and have intensive studies prepared relative to each question, presenting (1) pertinent legal, statistical, and other factual material, (2) a digest of important authoritative opinion, and (3) tentative answer material. This preparatory background material was submitted by the secretary to the members of the committee and in cooperation with them proposed replies were drafted for the questions. As the proposed replies to each of the six groups of questions were completed they were submitted to the entire membership of the special committee and discussed at subsequent meetings. They were also submitted to the following groups in the Association:—

THE NATIONAL OFFICERS:

President, P. D. Houston, Chairman of the Board American National Bank, Nashville, Tennessee.

First Vice President, H. W. Koeneke, President The Security Bank of Ponca City, Ponca City, Oklahoma.
Second Vice President, W. L. Hemingway, President Mercantile-Commerce Bank and Trust Company, St. Louis, Missouri.
Treasurer, B. Murray Peyton, President The Minnesota National Bank, Duluth, Minnesota.
Executive Manager, Harold Stonier.
General Counsel, D. J. Needham.

THE ECONOMIC POLICY COMMISSION:

W. Randolph Burgess, Vice Chairman of Board National City Bank, New York, N. Y., Chairman.
Lindsay Bradford, President City Bank Farmers Trust Company, New York, N. Y.
A. P. Giannini, Chairman of Board Bank of America N.T. & S.A., San Francisco, California.
Charles L. Smith, President First National Bank, Salt Lake City, Utah.
Charles E. Spencer, Jr., President First National Bank, Boston, Massachusetts.
F. M. Farris, President Third National Bank in Nashville, Tennessee.
Richard S. Hawes, Vice President First National Bank, St. Louis, Missouri.
Harold H. Helm, Vice President Chemical Bank & Trust Company, New York, N. Y.
William M. Massie, Vice President Fort Worth National Bank, Fort Worth, Texas.
Winthrop W. Aldrich, Chairman of Board The Chase National Bank, New York, N. Y.
Gwilym A. Price, President Peoples-Pittsburgh Trust Company, Pittsburgh, Pennsylvania.
E. S. Woosley, Vice President Louisville Trust Company, Louisville, Kentucky.

THE RESEARCH COUNCIL:

Mr. Burgess, Chairman.

- Lawrence M. Arnold, Executive Vice President Seattle-First National Bank, Seattle, Washington.
- G. Fred Berger, Treasurer Norristown-Penn Trust Company, Norristown, Pennsylvania.
- John B. Byrne, President Hartford-Connecticut Trust Company, Hartford, Connecticut.
- H. Grady Huddleston, Secretary Tennessee Bankers Association, Nashville, Tennessee.
- Fred I. Kent, Director Bankers Trust Company, New York, N. Y.
- E. J. Miller, President South Texas National Bank, San Antonio, Texas.
- Clarence L. Robey, President Purcellville National Bank, Purcellville, Virginia.
- Earl B. Schwulst, First Vice President Bowery Savings Bank, New York, N. Y.
- Tom K. Smith, President The Boatmen's National Bank, St. Louis, Missouri.
- J. Harvie Wilkinson Jr., Vice President State-Planters Bank and Trust Company, Richmond, Virginia.
- O. Howard Wolfe, Vice President and Cashier Philadelphia National Bank, Philadelphia, Pennsylvania.
- H. Lane Young, President Citizens & Southern National Bank, Atlanta, Georgia.

ADVISORY MEMBERS

- John J. Driscoll Jr., Driscoll, Millet & Company, Philadelphia, Pennsylvania.
- Dr. Virgil Jordan, President The National Industrial Conference Board, New York, N. Y.
- Dr. Herman B. Wells, President Indiana University, Bloomington, Indiana.

A.B.A. STAFF MEMBERS

- W. Espey Albig, Secretary Commerce and Marine Commission.
- Dr. Paul F. Cadman, Economist.

Curden Edwards, Secretary Economic Policy Commission.

Dr. Ernest M. Fisher, Director Research in Mortgage and Real Estate Finance.

Thomas B. Paton, Assistant General Counsel.

Frank W. Simmonds, Secretary Bank Management Commission.

Gilbert T. Stephenson, Director Trust Research The Graduate School of Banking.

The proposed replies were also submitted to A. L. M. Wiggins, President Bank of Hartsville, Hartsville, South Carolina, Chairman Committee on Federal Legislation, A.B.A.; and to Thomas M. Steele, President First National Bank and Trust Company, New Haven, Connecticut, and R. E. Harding, President Fort Worth National Bank, Fort Worth, Texas, the two latter having been designated by the president of the National Bank Division to consult with the chairman of the special committee on points of specific national bank interest. Within the special committee, the president of the State Bank Division, Mr. Bryant, was designated to consult with representatives of that division in respect to points of specific state bank interest, and similarly Mr. Gilman, who was president of the Savings Division, 1939-40, was designated to represent the viewpoints of savings banking. In addition, from time to time a number of special points were discussed with others deemed especially qualified to advise upon them. The committee is deeply indebted to Charles P. Blinn Jr., Executive Vice President Philadelphia National Bank, Philadelphia, Pennsylvania, chairman of the Subcommittee on Section 5219 U. S. Revised Statutes of the Association's Committee on Federal Legislation, and to his associates on the committee, for an exhaustive study made of and replies prepared to the questions raised in respect to 5219 in question 4, subdivision D, section II of the questionnaire; also to the American Institute of Banking Research Committee, G. Fred Berger, Treasurer Norristown-Penn Trust Company, Norristown, Pennsylvania, chairman,

for cooperation in obtaining a cross section survey of banker experience relative to a number of points brought up in other questions.

The members of these various groups were asked by the special committee to review the proposed answers and submit criticisms or suggestions in regard to them. Numerous thoughtful and constructive replies were received and were considered by the committee in revising the proposed answers. These revisions were then resubmitted to the same groups and their replies again considered in preparing further revisions. On behalf of the Special Banking Studies Committee grateful acknowledgment is made to the many individuals who thus rendered it most valuable service in its endeavors to bring seasoned banking experience and judgment representative of all types of banking to its aid in preparing the answers in the following pages. While many suggestions became directly or indirectly part of the report as now drafted, there inevitably remained some differences of opinion among those consulted which could not be wholly harmonized. The report does, however, represent a substantial consensus among them.

This report is submitted with certain other qualifications. The facts presented and the conclusions drawn are based on information and conditions as of the time of the present writing. The answers were prepared by a group of bankers who are well qualified by experience and capabilities to present constructive replies to the questions propounded, and they were advised and assisted by the broader groups indicated above. However, it is not assumed that the results will receive unanimous approval among the 15,000 banking institutions of the country, operated by many men of diverse minds and interests, and subject to the great diversity of local economic and social environments which are characteristic of the dynamic and varied life of the United States as a whole. It is hoped that a broad expression of viewpoint from the banking profession will be called forth by this report.

The present report is limited to responses to the questions propounded by the Senate Committee on Banking and Cur-

rency in its printed questionnaire. The American Bankers Association desires to reserve the privilege of submitting supplementary statements and of presenting oral testimony relating to questions which may come before the committee.

P. D. HOUSTON, *President*

American Bankers Association

April 15, 1941.

INTRODUCTION

Since the following document is both voluminous and detailed it seems desirable to attempt in these introductory pages to summarize briefly the major conclusions, even though it is necessary to omit many matters of lesser importance and to state conclusions somewhat dogmatically.

I. Federal Deposit Insurance

1. While recognizing that federal deposit insurance aided in reestablishing confidence in the country's banks after the banking holiday, the insurance principle must still, in view of previous experience with state insurance funds, be considered as experimental and not yet tested in the crucible of experience under varied economic conditions.

2. The continued success of deposit insurance depends on the prevention of banking troubles rather than on ability to settle them after they occur, and therefore depends in turn on the maintenance of high standards of bank management and supervision, and on sound national economic conditions.

3. Since deposit insurance is still experimental it would be unwise to increase its scope or enlarge the responsibilities of government with respect to it.

4. Since the chief value of the insurance plan is in the prevention of banking losses and since a reserve of about half a billion dollars has already been set up, a gradual reduction in the assessment of insured banks appears reasonable.

II. Supervision

1. Supervision is more necessary in the United States than elsewhere because of our large number of separate banks.

2. A major fault in the supervisory control over banking in the United States has been too liberal granting of charters, and a substantial proportion of the bank failures since 1920 may be ascribed to this cause.

3. The chief function of bank examination is to make an objective and reasonable appraisal of bank assets and liabilities, and it is not suitable as an instrument of credit control.

4. Bank examiners have at times accentuated tendencies towards inflation or deflation by appraising bank assets liberally at times of expansion and severely at times of depression. This fault was recognized in formulating the uniform bank examination plan of 1938.

5. To some extent individual bank examiners have unduly restrained banks from extending credit to their customers through too great inflexibility and through failure at times to follow more liberal policies adopted by the supervisory agencies.

6. Conditions affecting the adequacy of bank capital are so varied that the imposition of statutory requirements for ratios of capital to deposits, employed assets, or other bases applicable to all banks would be unwise.

7. Improved quality of supervision is to be sought not by a reorganization or greater centralization of supervisory powers but rather in greater independence from politics, a better understanding of the problems involved, and a steadily rising level of competence among bank examiners.

8. Better banking is to be hoped for not so much as a result of changes in bank organization as in the encouragement of better bank management.

9. It is suggested that Section 5219 U. S. Revised Statutes, relative to taxation of national banks, be clarified in certain particulars; that the states be authorized to impose upon national banks non-discriminatory sales and use taxes and license fees not related directly to the incidents of banking; and that consideration be given the question of providing an administrative or a more adequate form of judicial determination of the existence of de facto discrimination against the shares of national banks in the application of general property taxes to intangible property.

III. Legal Status of Banks

1. The American Bankers Association has for many years favored the continuance of the dual system of banking, by which banks may operate under state or federal charter, which recognizes the great diversity of economic life in the United States and the desirability of adapting the banking system to the needs and desires of the people.

2. The American people have always distrusted, in banking as in other features of their political and economic life, the dangers of too great centralization of power and the dangers of bureaucracy.

3. For these reasons the American Bankers Association has opposed compulsory membership in the Federal Reserve System and compulsory participation in deposit insurance.

IV. Earnings and Interest Payments

1. Banks cannot maintain their service for their communities without reasonable earnings and dividend payments.

2. For a number of years banks incurred substantial losses which reduced their capital funds, and they need a period of substantial earnings to strengthen their capital positions and attract new capital from other sources.

3. The limitation on interest on deposits by law and by supervisory agencies is still experimental, but has been helpful in adjusting the position of the banks to lower interest rates on loans and investments.

4. Statutory and supervisory control of lending rates or service charges would not be desirable as these are better determined by competition between banks.

V. Bank Organization and Structure

1. The report sets forth fully the historical position of the American Bankers Association with respect to branch banking, which is in brief a position in favor of the continuance of unit banking and the restriction of branch banking within the scope determined by state legislatures.

2. The Association has steadily favored the dual system of banking supervision and has opposed the forced concentration of supervisory power in any single agency.

3. There is nowhere in the United States a banking monopoly, but competition is everywhere keenly alive.

4. A codification and unification of banking law is neither necessary nor desirable at this time.

5. The case for segregation of assets against time deposits has not been proved, and the institution of deposit insurance reduces the need to give consideration to this proposal.

6. The general limitations upon bank participation in the security business in the present law are probably wise, but some liberalizing changes are desirable so that banks may render more adequate service by providing facilities for the pure underwriting of new security issues.

VI. Credit Control

1. No substantial reorganization of the Federal Reserve System is necessary as its greatest strength will always lie in the quality of its personnel and in its insulation from politics and bureaucracy on the one hand and from commercial influence on the other.

2. Methods need to be sought for greater unity of action and understanding among the Federal Reserve banks, the Board of Governors of the Federal Reserve System, and the Treasury, but this is more a matter of personal relationships than of technical organization.

3. One organization change which might be helpful is a greater concentration of the powers of the system in the Federal Open Market Committee, as in that way some misunderstandings might be avoided.

4. The boards of directors of the Federal Reserve banks now represent a wide variety of interests and points of view, and no change in their method of appointment is necessary.

5. The present stock ownership of the reserve banks by the member banks is desirable as it conforms with the principle of making the system a "democracy of credit." Stock ownership

carries no power of control. On the other hand if the stock were transferred to the government there would be danger of too great political influence. While the reserve system must be responsive to public needs and must cooperate with other agencies of government it must also be responsive to financial needs and cooperate with the country's banks. Stock ownership is a symbol of cooperative relationship, in balance with the government controls through the reserve board.

6. No fixed rules can be laid down in advance for monetary policy, but it must be determined from time to time in the light of infinitely varying circumstances.

7. Fiscal policy and credit policy must necessarily be coordinated and work on occasion towards the same objectives, but there are definite handicaps, both political and practical, which hamper the use of fiscal policy as a means of economic or credit control.

Banking Policies in the Present Emergency

The foregoing summarizes the answers to the Senate questionnaire which are without specific reference to the present emergency situation that the country faces. In dealing with any of the foregoing problems, or considering legislation to carry out any of the recommendations which have been made, timeliness is of major importance. In general it may be said that, with the exception of the desirability of some reduction in the assessment on banks for deposit insurance, there is nothing in the foregoing program requiring legislative action at the present time, when men's minds should be engaged in dealing with great national objectives rather than with details of the banking system. It is not a time when people's energies and attention should be taken away from the major task by non-essential readjustments in the banking machinery.

No discussion of the banking system at the present time is complete, however, without a careful recognition of the particular problems for banking arising directly out of the emergency. It, therefore, seems desirable to outline briefly the major elements in the situation which relate to banking and

the sort of action which should be considered:—

1. In World War I, and in other great wars, this and other countries experienced severe inflation. In the absence of appropriate preventive policies the forces now at work will lead to a like result.

2. Preventive action is necessary in three areas:

- (a) bank credit expansion and activity;
- (b) fiscal policies as to taxes and borrowing;
- (c) prices and wages.

3. While at first the greatest danger of starting the spiral of inflation may lie in the area of prices and wages, in the long run credit and fiscal policies will largely determine the amount of additional purchasing power created directly or indirectly by the defense effort, and hence may decide whether the price spiral can be controlled.

4. The present amount of bank deposits is larger than is needed for the present volume of business, or even a much larger volume, and deposits are increasing at a rapid rate.

5. The banks now hold excess reserves permitting a huge additional expansion of deposits, and further gold imports are adding to deposits and to excess reserves except as offset by other factors.

6. Under the weight of this huge surplus of funds, interest rates have declined to levels that discourage savings and investment and create grave difficulties for insurance companies, colleges, foundations, and trust funds. They have been too low for the ready sale of government bonds to investors.

7. The present powers of the Federal Reserve System and the Treasury are not adequate to control the situation if the inflation spiral gets started.

8. The Congress, the banks, and others, should therefore give timely consideration to the proposals for dealing with these problems, made jointly by the several bodies of the Federal Reserve System.

9. This report is in agreement with the Federal Reserve System in the following general proposals:

- (a) That the inflationary powers of the so-called Thomas

amendment of 1933 are now unnecessary, and their repeal would lessen those fears of inflation which often stimulate inflation;

(b) The reserve system should be given additional powers, under proper safeguards and limitations, for reducing excess reserves;

(c) Further imports of gold should be insulated from the banking system if they exert further substantial upward pressure on excess reserves.

10. The report further suggests that at an appropriate time gold coin and gold certificates be restored to circulation.

11. It is recognized that these powers must be used carefully and gradually to avoid shock to the credit system.

12. Further, these steps alone will not prevent inflation. They must be accompanied by a sound fiscal policy and to some extent by direct action to check advances in prices and wages which might start the inflation spiral.

13. Fiscal policy is at the core of the problem of carrying through the financing of the defense effort without inflation or economic dislocation. Proposals of the Treasury for meeting a large proportion of expenditures by taxation and selling bonds to investors rather than banks should receive the whole-hearted support of the banks and the public.

14. In World War I the reserve system was vastly useful in the sale of Liberty Bonds, in dealing with credit problems, and acting as liaison between government and business and finance, a position it is peculiarly designed to fill. Since then the system has grown in experience and in the training of its personnel, and in the present emergency it should be used to the full as an aid to government.

Special Banking Studies Committee

W. RANDOLPH BURGESS, *Chairman*

RAYMOND N. BALL

HARRY A. BRYANT

A. GEORGE GILMAN

S. H. SQUIRE

GURDEN EDWARDS, *Secretary*

I. DEPOSIT INSURANCE

1. Should Federal deposit insurance be retained permanently in substantially its present form? retained in a specified revised form? abandoned if certain specified conditions appear? or abandoned at once?

While recognizing that federal deposit insurance was of very great help in reestablishing confidence in the banking system, and its administration has strengthened the banks coming under its supervision, we believe it should be considered as still experimental. We believe that it should be retained for the present in substantially its present form, and that further observation and study should be made of its operations and effects.

As yet it has not been subjected to a complete economic test. The Federal Deposit Insurance Corporation's operations have been confined largely to a period of recovery in values, in which bond prices have been rising, business improving, deposits expanding and reserves rising, following a considerable housecleaning in banking. A valid appraisal of the soundness of the banking system under the deposit insurance plan can be reached only after experience through at least one period of liquidation of deposits and loan and investment values following a period of prosperity and active business expansion.

Previous experiments in the guaranty of deposits, made in eight state banking systems in the period from 1908 to 1929, apparently fostered unsound banking during years of expanding prosperity. They led the public to place reliance on the guaranty plans rather than on sound bank management for the protection of deposits. This tendency, coupled with lax chartering and supervising policies, resulted in disaster in every instance. In periods of liquidation, both local and na-

- amendment of 1933 are now unnecessary, and their repeal would lessen those fears of inflation which often stimulate inflation;
- (b) The reserve system should be given additional powers, under proper safeguards and limitations, for reducing excess reserves;
 - (c) Further imports of gold should be insulated from the banking system if they exert further substantial upward pressure on excess reserves.
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tional, which followed the boom periods, the rate of bank failures was greater in states having guaranty plans than in states not having guaranty plans, and the weakest banks, which were the first to fail, received the greatest benefits. In Kansas, where the guaranty was optional, the rate of failure of guaranteed banks was greater than that of non-guaranteed banks.

In the light of this historical experience, if the present federal deposit insurance plan is to remain in force, it is essential that the utmost vigilance and diligence should be exercised in enforcing those features in the banking laws, both state and national, which are designed to prevent unsound banking practices, particularly during the period of expanding economy that appears to lie ahead, and that the public should be educated to place confidence in banks because they are soundly and conservatively managed, and not merely because certain deposits are insured.

2. Is it desirable that the insurance coverage be increased to deposits up to \$10,000? \$25,000? \$100,000? to all deposits? to all liabilities?

Deposit insurance was instituted, not so much as a deposit guaranty plan, but rather as an aid in reviving and sustaining the confidence of depositors in their banks. By insuring the deposits of the mass of individual depositors, it aimed to minimize the danger of panic among depositors during periods of economic unsettlement. The present \$5,000 insurance limit per depositor in any one bank protects in full 98.4 per cent of all accounts of insured banks; only 0.9 per cent more accounts would be fully protected if the limit were raised to \$10,000, and 1.3 per cent more if the limit were raised to \$25,000. From the depositors' point of view it is evident, therefore, that an increase in deposit insurance coverage would benefit a negligible added proportion of accounts. From the viewpoint of the Federal Deposit Insurance Corporation it would increase substantially the potential liability of the corporation. An analysis of the accounts of insured banks as of

September 21, 1938, showed that \$21.7 billions of deposits were protected under the \$5,000 limit, whereas \$24.8 and \$28.7 billions, respectively, would have been insured under limits of \$10,000 and \$25,000 and would have represented a larger potential liability for the corporation. This would be influenced by some redistribution of deposits if insurance limits were changed.

We do not consider increased coverage desirable.

3. Should the Government meet deposit insurance losses if the reserves and current assessments of the Federal Deposit Insurance Corporation prove inadequate?

The federal deposit insurance plan should not provide that deposit insurance losses be met by the government if the reserves and current assessments of the Federal Deposit Insurance Corporation should prove inadequate. As a practical matter, the present rate of assessment admittedly would not be sufficient to cover depositors' losses as large as those which occurred as a result of the general breakdown of economic values prior to inauguration of the deposit insurance plan. The ultimate solvency of the plan depends not only on the continued soundness of the structure and operations of the banking system itself but also on a sound national economy.

The scope of the plan should be restricted to an endeavor to insure depositors against losses arising from banking operations themselves. It should not be converted into an endeavor to guarantee the entire national economy by placing behind it the unlimited resources of the government. Within this limitation, the insurance plan, if it is to be considered as a sound proposition, should operate on its own merits, creating its own reserves and meeting its losses out of its normal sources of income. It can at most only contribute to banking soundness, but cannot wholly create or guarantee it.

To place the government in the position of being ready to meet deposit insurance losses to some limited extent would also be undesirable. It would transform the plan from a good bank management and insurance system into a government

guaranty system. This would abrogate on a broad scale the basic economic principle of banking practice that resources and operations should be so managed as to provide adequate reserves against the operating risks which occur in the ordinary course of business. This principle should be true of all banks individually. It has been compromised to the extent that the ultimate responsibility of banks in the insurance plan to provide means to meet their depositors' claims is shared among the group as a whole. We do not believe that this compromise, in which there inheres the danger of subsidizing unsound banking, should be carried further by involving the government in a potential subsidy of weak banking on a national scale.

4. Should the Federal Deposit Insurance Corporation be receiver for all failed insured banks? What would be the advantages? How important is this?

The Federal Deposit Insurance Corporation should act as receiver of failed insured banks to the extent permitted by the present deposit insurance law, which does not give the corporation the authority to supersede the powers of receivership of state bank supervisors in the case of failed banks chartered under their jurisdictions except as the supervisors delegate by appointment their powers to the F.D.I.C. as permitted by their state banking codes.

A number of the state codes have retained the powers of receivership in their own banking departments. Any further extensions of the corporation's powers should come by consent on the part of the states. As long as the corporation conducts liquidation proceedings along acceptable lines, it is to be expected that it will receive such appointments. The position of the dual banking system as a desirable check upon the powers of the corporation is maintained by the law as it now stands.

Much is to be said in favor of the power of the F.D.I.C. to act as receiver. Through insurance and subrogation of the

claims of depositors, the corporation becomes the largest creditor of failed bank members in the insurance plan and stands in the position of primary interest in the receiverships and in the prompt, effective and economical administration of liquidation. The public interest is also well served, since the corporation is in a position to view the effect of liquidation proceedings on the banking system as a whole and to act with the general welfare in mind. From the standpoint of going insured banks and their depositors, their interests are identical with those of the corporation since the cost of insurance and the solvency of the fund are both affected by economies in liquidating operations and recoveries obtained on assets of failed banks.

4. (continued) How much undesirable duplication of effort do you think is involved by the Comptroller of the Currency supervising the Federal Deposit Insurance Corporation's receivership of failed national banks?

We refer this part of the question to the federal officials involved. We do not have the information necessary to answer.

4. (continued) Outline the purposes and practices you think should apply in the liquidation of assets of banks in receivership and of assets which the Federal Deposit Insurance Corporation has acquired or upon which it has made loans.

In the liquidation of assets of banks in receivership and of assets which the Federal Deposit Insurance Corporation has acquired or upon which it has made loans, the corporation should aim to maintain stable values and to secure the maximum possible recovery on assets to satisfy its own claims, as well as those of other creditors and stockholders. Wherever possible it is preferable that liquidation should be carried out gradually in a period of recovery, rather than in a period of economic depression. These observations are general in character, since specific circumstances must be the determining factors in each case.

5. Please state your reaction and the reasons therefor to the contention that the existence of Federal deposit insurance tends to cause bad banking.

While the experience of the eight state guaranty plans referred to in the answer to question 1 showed a tendency to encourage bad banking, it is impossible to formulate as yet a conclusive estimate as to the ultimate results of federal deposit insurance. It has not been in operation long enough to feel the effects of boom psychology and be subjected to the subsequent test of a period of economic reaction. For that reason, as stated in the answer to question 1, it is still to be considered as in an experimental stage.

The statistical record of bank operations under the Federal Deposit Insurance Corporation discloses evidence relating only to the initial part of this experiment. It deals with a banking structure drastically purged of weakness after the nation's greatest economic reaction, and one which has felt the beneficial effects of a period of general recovery but not the effects of expansive optimism and its aftermath. It shows an improvement in the quality of assets of insured banks since the inception of the insurance plan. The following table gives an analysis of assets of insured banks not members of the Federal Reserve System:

**Examiners' Analysis of Assets, Examinations 1933-1939, of
Insured Commercial Banks Not Members of the
Federal Reserve System**

	1939	1938 uni- form ^a	1938 original	1937	1936	1935	1934	1933 ^b
Book value	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Criticized	11.7	14.2	14.1	16.7	17.6	23.7	(c)	(c)
Deductions ^d	1.2	1.5	1.7	1.1	1.4	4.1	6.7	10.5
Substandard	10.5	12.8	12.4	15.6 ^e	16.2	19.6	(c)	(c)
Not criticized	88.3	85.7	85.9	83.3	82.4	76.3	(c)	(c)

- a. Examinations under uniform procedure adopted by supervising authorities in July 1938.
 b. Examination for admission to insurance in 1933 and early 1934.
 c. Not available.
 d. Differences between book values and examiners' appraisals of assets.
 e. Includes all fixed assets.

Source: Annual Report of the Federal Deposit Insurance Corporation for the Year Ending December 31, 1939, p. 49.

The table reveals that smaller proportions of assets are being criticized as losses or substandard, whereas a larger proportion of the assets are not being criticized as compared with the early period of the Federal Deposit Insurance Corporation. Comparable figures for member banks do not exist but available data indicate a similar improvement in quality of their assets.

Fewer bank failures have occurred since the insurance plan was inaugurated. Bank suspensions averaged 635 annually from 1921 to 1929, 2,274 from 1930 to 1933, and only 45 a year since then. Non-insured and insured banks have both participated in this improvement. Bank failures have not wholly disappeared among insured banks.

It is probable that the chief conclusion to be drawn from these data is that, although better bank supervision has been a factor, improvement in the banking picture in general has been a counterpart of the improvement in the quality of assets of the nation and, concomitantly, of the banking system. It is as yet too early to attempt to evaluate what part deposit insurance may also have had in this improvement, or what part it will have in the conditions which will be found to exist in banking following a boom period.

6. Do you favor any change in present law or regulation governing the computation of the base upon which deposit insurance assessments are levied?

We believe that proposals looking to a reduction in the assessment paid by insured banks are worthy of careful consideration. Since the value of the insurance plan is largely in the field of prevention of banking losses it would seem that there should be some limit in the accumulation of reserves. No reserve could be large enough to meet a situation like that of 1931-33, once it was allowed to occur. Deposits on which assessments are computed have been growing more rapidly than employed assets, which determine the amount of risk. Thus, assessments are rising rapidly at a time when

banks are finding increased difficulty in making a living. Some reduction in assessment seems warranted.

There have been three proposed methods of reducing Federal Deposit Insurance Corporation assessments as follows:

1. The Steagall proposal is for a reduction in rate from $1/12$ per cent to $1/14$ per cent or less per annum.
2. Federal Reserve proposal is for elimination from assessment base of reserves required by reserve system against deposits. (Coupled with this proposal is a proposal that reserve requirements should be increased.)
3. American Bankers Association State Bank Division proposal is for elimination from assessment base of the amounts of balances with Federal Reserve bank and other domestic banks.

7. If the deposit insurance assessment is not adequate to build up reserves to cover probable future losses should the assessment be increased?

This question again can be answered only after more experience. Present assessments appear to be more than adequate for any presently foreseeable losses, on the presumption that the insurance plan will be effective in avoiding losses by the process of prevention.

If losses prove heavy the question should then be asked whether the insurance plan were failing in its purpose and should be substantially modified. There is a limit somewhere to the extent to which sound banks should bear the losses of weak banks.

II. SUPERVISION

A. General

1. What characteristics of the banking business justify or explain the relatively greater amount of public supervision which is given to it than to most other businesses?

The American economy is peculiarly reliant upon commercial banks. More than in any other country the bank check is the money of commerce, by which most operations are conducted. Bank credits are required in every phase of the nation's industrial and commercial activities. Banks also hold a large volume of savings and time deposits and thus they have the responsibility of protecting the savers of the nation and facilitating the flow of their funds into the continued expansion of production, which is essential to the nation's daily life and progress. Banking is thus charged with public interest. Supervision has also been necessary in this country because our banking system is made up of large numbers of banks.

2. How does bank supervision affect the outstanding volume of bank credit? In what way does supervision influence the expansion or contraction of credit during the different phases of the business cycle? If supervisory policy were to be so directed as to contribute to the protection of the economy from the effects of undue expansion or contraction of credit, how could this best be done? Would appropriate policy require a revision of supervisory standards during the course of the cycle or can standards be devised which will give the desired results at every stage in the cycle? Appraise the influence of present supervisory standards upon credit conditions now and under other cyclical conditions.

Bank supervision in this country has not been a single force working along consistent and uniform lines throughout

the banking structure. There are 49 different supervisory jurisdictions consisting of the national banking system and the 48 state banking systems, operating under different laws and regulations. In addition supervision is exercised over their members by the Federal Deposit Insurance Corporation and the Federal Reserve System. Furthermore, actual supervision within these various jurisdictions is carried out by large numbers of individual examiners, each of whom exercises a considerable degree of individual judgment. Therefore, supervision in the abstract can hardly be looked upon as a specific and uniform factor affecting the outstanding volume of bank credit.

In general, however, supervisors have tended during boom times to yield to the prevailing trend and be less critical of credits, and during depressions to share in the general tendency to be hypercritical, adding to the influences impelling liquidation. This defect in supervision has been recognized in recent years, especially in the 1938 revision of procedure in bank examinations.

In the deflation period of 1930 to 1933 the supervisory agencies were slow and inflexible in adjusting both their methods of valuing assets and their procedure in dealing with banks under pressure of the emergency conditions. Examiners closed a number of banks which, it is now clear, could have safely remained open, and every bank closing led to more alarm and increased pressure on other banks. Procedures adapted to normal times were wrong for the emergency. Thus the agencies designed to protect banks increased in some measure their difficulties.

The recognition of an emergency of this sort and adjustment of procedure to it are very different from the use of examinations as an instrument of credit control. While in theory supervision might be used for credit control through stricter standards of valuation of assets in periods of expansion and more lenient standards in depressions, such a procedure is not generally practicable. The complexity of the machinery of supervision has already been noted. About the

best that can be done is for the examiner to value and classify the assets of a bank with the greatest possible objectivity at all times with reference both to market values over some period and any other more intrinsic standards of value that may be found, recognizing and trying to avoid the danger of accentuating inflationary or deflationary influences, especially in the action which may be recommended after the appraisal has been made. This is more a question of growth in understanding, and improvement of the quality of the examining force, than a mechanical matter.

The American Bankers Association convention of 1939 adopted the following resolution in regard to the use of bank examinations by the supervisory authorities as a means of credit control:

Various proposals are under consideration at Washington looking toward modifications of our present systems of bank examinations. The factors involved are too numerous and too complicated for discussion in these resolutions. There is, however, one principle concerning which the membership of this Association does desire to make record of its convictions, and that is that no attempt should ever be made to use bank examinations as instrumentalities of credit control. Bank examinations should be just what their designation implies, and no attempt should be made to use them for other purposes.

3. Do you think that the bank failure experience of the period 1921-33 was in any substantial measure due to inadequate principles or practices of bank supervision? If not, to what do you ascribe that unfavorable experience? If not, do you know any means whereby such unfavorable experience can be avoided in the future? If so, have the principles and practices been altered in a proper manner? Please detail. If so, do you have any suggestions as to needed changes of law which will permit more adequate supervision?

The bank failure experience of the period 1921-33 was the result of many causes. Inadequate principles or practices of bank supervision were undoubtedly important among these causes. In the period cited some 13,700 banks suspended. During the previous two decades, which had been characterized by great agricultural prosperity, there had been com-

petition between the national banking system on one hand and the state banking systems on the other in the chartering of banks. The number of banks in the United States was increased from 9,400 in 1900 to over 30,000 in 1921. From that point the number of banks began to decrease as a result of consolidations, voluntary liquidations and failures. By 1929 the number of banks had dropped to 25,000. The chief contributory factor in this decrease was the 5,600 failures which occurred from 1921 to 1929; but during this same period the competitive chartering policies of both state and national bank systems continued, and new charters, exclusive of conversions, were granted to the number of some 6,000 in the state and national jurisdictions. Banking codes and regulations were altered along lines tending to make membership in the respective jurisdictions more attractive. In the granting of charters there was a widespread disregard for the proper relationship between the economic needs of the country and the numbers and localities of banks permitted to open for business. The establishment of banks with small capital in small places was encouraged in a mistaken belief that multitudes of institutions of this kind, especially in the rural sections, were necessary for fostering national development. The coming of the automobile, however, greatly decreased the need for the crossroads bank. In many cases charters were granted to persons without adequate investigation as to their fitness to assume the responsibility of banking. These policies persisted during the 1920s despite the disastrous bank failure rate that prevailed, so that the forces tending to eliminate overbanking and weak banking were largely negated, and between 1929 and the bank holiday of 1933, which was a period of violent shrinkages in business volume and asset values, 8,000 more banks were closed.

The American Bankers Association recognized these facts in a resolution adopted at its 1927 convention, stating that "one of the most pertinent causes of bank failures is the excessive number of banks."

As to the means whereby such unfavorable experience can

be avoided in the future, we would call attention to the resolution adopted by the American Bankers Association in 1935, which said: "Every effort should be made by bankers and they should enlist the support of public opinion, to prevent a new overproduction of banks through the indiscriminate chartering of banks in places which are either not large enough to support a bank or in which there already are available sufficient banking facilities to take care of their reasonable requirements."

Other factors contributing to the bank failure experience of the period 1921-33, in addition to the faults in examination procedure itself noted earlier, were local and national economic conditions and reactions, the promotion of speculative and lax banking institutions in many sections, particularly under state guaranty of deposit plans, and also undoubtedly a considerable element of incompetent bank management among banks in many parts of the nation. As to this latter element, we believe that the added disciplinary powers given to the bank supervisory authorities under the Banking Acts of 1933 and 1935 and under provisions that have been added to many state banking codes will, if they are adequately administered, aid towards preventing recurrence of these experiences.

In the last analysis good banking rests on quality of management, and the most effective means of avoiding bank failures is to improve management through education, wiser selection and training of personnel and better supervision within banking organizations themselves, as well as by public authorities. The educational programs of the American Bankers Association, American Institute of Banking, and state and local banking organizations are designed to aid in this process.

4. To what extent do bank supervisors and examiners give banks "advice" with regard to policies or practices in the operation of a bank which are not the subject of supervisory control enforced by legal sanctions? Do you think that the giving of "advice" and the enforcement of requirements of law can properly be carried out simultaneously by the same agency?

What evidence do you have that the bankers and examiners see a clear demarcation between the two functions?

Practice among bank supervisors and examiners in respect to giving advice regarding the operations of a bank differ considerably in accordance with individual attitudes and situations. While there is some tendency for examiners to go beyond their specific legal functions in this respect, we do not consider that a serious problem is involved in this question. Some examiners are very helpful to banks in going beyond the letter of the law. Others make themselves nuisances. The answer is to be found more in an able, well trained examining force than in trying to draw too many fine legal distinctions. The legal power of the examiner is after all broad enough to provide plenty of room for both helpful and hurtful comments.

5. Submit any arguments or evidence which create a presumption that bank examiners have or have not at any time since 1933 exercised a socially undesirable influence upon the development of recovery in this country.

It is next to impossible to cite specific evidence to prove that bank examiners have at any time since 1933 exercised a socially undesirable influence upon the development of recovery in this country. The events of the period are too complex. We do believe that examiners were much more drastic in their criticisms both of loans and of securities than they were in the late 1920s when they were quite complacent. The policies of examiners with regard to bonds of less than first grade have undoubtedly increased the amount of liquidation in the bond market, depressed prices and in that way retarded economic recovery. The policy in this respect was improved when the agreement was reached in 1938 as to computing bond depreciation in accordance with an agreed formula rather than at market prices at the date of examination.

There is no way of measuring the influence of the examiner in forcing the liquidation of loans or restraining banks from making loans or the effects of such policies. All that can be

said is that the examiners have been a substantial influence in these directions. Opinion would differ as to how far this was necessary and desirable, and how far hurtful.

6. What policy, if any, do you think a commercial bank should follow in order to be able to meet abnormal demands for cash? Do supervisors and examiners in any way influence the policy of banks in this respect?

Conditions differ from community to community, and the local banker's own experience is his yardstick for judging his liquidity requirements. In general, capacity to meet abnormal demands for cash depends on (1) cash reserves, (2) the liquidity, and eligibility for discount or collateral against advances, of the loan portfolio, and (3) the shiftability or marketability of the investment portfolio. There is no fixed rule for the amount of liquidity. It is, in fact, not a problem with most banks today for they hold large amounts of cash and U. S. Government securities.

The ultimate ability of banking to meet cash demands is dependent upon a healthy business situation, the existence of security markets able to absorb a large volume of selling, and the observance of sound governmental fiscal policies. The predominant position now occupied by U. S. Government bonds in secondary reserves and investment accounts of banks places greater emphasis than ever before in the nation's history upon the last named factor. Obviously, the conditions here indicated cannot be provided by the efforts of the banking community alone. They are determined by a sound economic environment to whose creation many factors of a non-financial as well as a financial nature must contribute.

One of the major functions of bank supervision is to assess a bank's liquidity and hence its capacity to meet abnormal demands.

7. Do supervisors and examiners make any attempt to limit the speculative activities of banks? If so, is this desirable? Would you suggest any revision of law or policies in this connection?

Supervisors and examiners do attempt to limit the speculative activities of individual banks. We believe this is desirable. We would not suggest at this time any revision of law or policies in this connection. Some question may be raised whether present supervisory practice is too stringent as to the character of bonds a bank may buy or hold. Some leeway for the exercise of judgment in the purchase of less than first grade bonds would open a possible way for profit and improve the market for many bonds which are not really speculative, were once rated as prime, but are now considered less than prime. Any relaxing of these provisions would have to be very carefully guarded.

B. Asset Quality and Type

1. Does the influence of bank examiners keep many banks from making loans or investments they would otherwise be willing to make? If so, what kinds of loans and investments are thus forestalled?

It would be difficult to determine precisely how many banks are prevented by the influence of examiners from making loans and investments they would otherwise be willing to make. In recent years there has been some evidence, however, that examiners' policies have restricted banks in extending credit. Under the prevailing supervisory practice, there does not appear to be any definite restriction on the kinds of loans and investments undertaken by banks, except in so far as it is prescribed by statute. Bank examiners are now instructed to criticize assets only when the risk involved is unduly large, but a survey of recent experience of bankers reveals that some examiners have not adhered strictly to this supervisory practice, as adopted in the examination agreement of 1938. Many bankers report that they have experienced discrimination by examiners against capital loans as such and, to a lesser degree, against real estate and other long term loans as such.

The difficulties presented by the problem, although not large, appear to arise out of differences in what is considered

sound banking practice. On the one hand, some public officials and bankers have contended that examiners' rigid policies in criticizing loans are retarding the extension of credit by banks. They urge liberality in loan and investment programs. Supervising authorities and conservative bankers, on the other hand, insist that the maintenance of high standards of banking, to prevent large losses on assets, is the primary consideration. The loans and investments which the supervisors' influence prevents banks from making, they contend, are those which embody a risk not consonant with the standards prescribed by the supervisors. The question probably will never be completely solved to satisfaction, because differences of opinion will continue to prevail as to where the line of demarcation between sound and unsound assets shall be drawn. It is a moot question whether the public interest and national economy are best served by a highly dynamic banking system which undertakes noticeable risks in extending credit, thereby contributing to the national progress but rendering itself vulnerable to instability, or by a highly stabilized banking system in which risk and possibility of losses are kept at a minimum, even at the expense of limiting the ability of the system (always remembering that the care of the depositors' funds is paramount) to finance business and industry, except in such cases where the proposed borrower is sufficiently stabilized to warrant bank credit.

2. What is your opinion of current methods whereby the supervisors exercise control over the credit quality of bonds purchased and held by banks?

On the basis of the unfavorable record made by the nation's banks in the decade preceding the 1933 banking crisis, it was inevitable, in the light of historical precedent and experience, that greater controls over bank investment policies and practices would be established by legislation and by regulatory agencies. The present supervisory control over the bonds purchased and held by banks is directed toward the maintenance of a high standard of quality in bank investment

portfolios. Section 5136, paragraph 7, U. S. Revised Statutes, empowers the Comptroller of the Currency to prescribe by regulation limitations and restrictions under which national banks may purchase "investment securities" and further to define the term "investment securities." State member banks are subject to this provision under the Federal Reserve Act, Section 9, paragraph 19. Pursuant to this authority, the Comptroller has promulgated an investment regulation which prohibits members of the Federal Reserve System from purchasing bonds having distinctly or predominantly speculative characteristics. Insured non-member state banks, although not subject to the above regulation, are discouraged from purchasing speculative bonds by the supervisory policy of the Federal Deposit Insurance Corporation.

The principal determining factors in the eligibility or ineligibility of bonds for bank portfolios are quality and marketability. Quality is based on the inherent strength of the issue. A bond is regarded as being of high grade if the risk involved in the issuer's ability to pay interest and principal is small, and as low grade when such risk is large. The principle has become clearly established in banking practice and supervisory policy that banks should not purchase "speculative" bonds, but the inability precisely to define speculation presents an important problem in the administration of supervisory control over bank portfolios. Supervising authorities employ as a guide the bond ratings issued by statistical services. Investment bonds, as defined in the uniform examination agreement adopted in 1938, include general market obligations in the four highest grades and unrated securities of equivalent value. Issues of lower grades or unrated securities of equivalent value are regarded as having distinctly or predominantly speculative characteristics.

Under the current examination procedure, investment bonds are valued at book or cost, less amortization of premiums, whichever is less. Lower grade securities are valued on the basis of average market prices over the preceding 18 months, the average being the mid-point between the high

and low for the 18 months. Obligations in default and stocks are valued at market prices at the time of examination.

Doubt is raised concerning the justification for valuing investment bonds at book value or cost, while lower grade bonds are taken at average market values. Such a procedure could result in a distorted picture of the true capital strength of the banking structure. It fails to recognize that although they are subject to different underlying forces, both investment bonds and lower grade bonds can depreciate in value and that such depreciation has an important effect upon the capital funds of banks. The value of lower grade bonds may be adversely affected in a period of depression, whereas the value of investment bonds can decline in times of increased business activity if the demands for credit to sustain this activity are so great as to cause an increase in interest rates.

The current examination procedure also does not take account of the effect upon bank capital funds of a possible change from the existing abnormally low interest rates. The importance of this factor was exemplified when the European war began in 1939. Insured commercial banks held direct government securities with a book value of \$11,948,000,000 on June 30, 1939. The change in interest rates which developed when the war broke out affected the market value of government obligations. Depreciation from June to September ranged from approximately 3 per cent in bonds and notes maturing within five years to 8 per cent in bonds due after ten years. Basing calculations on the maturity distribution of the insured banks' portfolios, it is estimated that depreciation of their government holdings during the period was approximately \$637,000,000. (This estimate is inaccurate to the extent that the book value of the bonds was below market values in June.) This constituted almost 10 per cent of their total capital accounts and 18 per cent of their surplus, undivided profits and other capital accounts excluding capital stock. If guaranteed government obligations and other high grade investments had been included, the effect of depreciation on capital accounts would have been still greater.

2. (continued) *Particularly what is your opinion of any use made by supervisors in this connection of any recognized rating agencies?*

The use of commercial agency ratings as a guide is advantageous in providing a quick check on the quality of a bond portfolio. However, ratings are subject to limitations which create doubt concerning the desirability of using them as the sole basis for determining investment standards of banks. An important shortcoming is that ratings have not proved to be stable indexes of long term performances and are subjected to change as conditions affecting the credit status of issuing companies change. Rating revisions usually follow, rather than forecast, basic readjustments in the intrinsic worth of individual bond issues. The rating agencies tend to revise their opinion upward when cyclical improvement strengthens the statistical position of a bond, and to lower the rating when the company's position has been weakened by depression forces. In this manner, the ratings may render an issue ineligible for bank investment when cyclical conditions are unfavorable and prices for the issue are low, but after improvement in the company's position and the market value of the bonds, the ratings may be raised to a point where the issue is eligible once more. The problem thus develops that, through use of ratings, a bank is permitted to buy certain securities when ratings and prices are high, but as the ratings are reduced it is under pressure to liquidate them in order to conform with the eligibility regulation.

Within the scope of this reply, it is hardly feasible to treat in an adequate fashion the problems of investment policy and control which arise out of the sensitivity of individual bond issues and investment markets in general to broad trends in business activity, interest rates, investment confidence, technological developments, credit and monetary conditions, government financing, and other pertinent factors. The use of investment ratings on the part of bank examiners as a means to exercise control over the quality of bonds, while

possessing the limitations inherent in the rating system and while no substitute for the judgment of bank officers and directors, provides as good an arbitrary standard as probably can be set up for this purpose at the present time. At times, there may be specific situations where a good investment might be excluded by a bank if the rating standard is rigorously adhered to; however, considering the fact that there are some 14,000 commercial banks and trust companies of greatly varying size doing business in many different areas under management of varying types and abilities, some working tools or yardsticks for guiding and appraising investment policies and practices are necessary in the supervising process. The rating services, to be of maximum value, should be backed up, however, by analytical methods and procedures which aim to anticipate, if possible, revision downward or upward in the rating quality status of the component parts of the investment list. The check on security purchases provided by the rating methods is desirable as a deterrent to banks whose zeal for income and perhaps for trading profits might otherwise lead them into undesirable investment risks.

2. *(continued) What is your opinion of any requirements which supervisors make concerning the marketability of securities purchased and held?*

Under the current investment regulation, to be a legal investment a bond must be marketable, i.e., it must be salable under ordinary circumstances with reasonable promptness at a fair value, there being present one or more of the following characteristics:

- (a) A public distribution of the securities must have been provided for or made in a manner to protect or insure the marketability of the issue; or,
- (b) Other existing securities of the obligor must have such a public distribution as to protect or insure the marketability of the issue under consideration; or,
- (c) In the case of investment securities for which a public distribution as set forth in (a) or (b) above cannot be so provided, or so made, and which are issued by established com-

mercial or industrial businesses or enterprises, that can demonstrate the ability to service such securities, the debt evidenced thereby must mature not later than ten years after the date of issuance of the security and must be of such sound value or so secured as reasonably to assure its payment; and such securities must, by their terms, provide for the amortization of the debt evidenced thereby so that at least 75 per cent of the principal will be extinguished by the maturity date by substantial periodic payments; Provided, That no amortization need be required for the period of the first year after the date of issuance of such securities.

The current marketability requirements appear to be satisfactory, with the possible exception that under (c) above, 75 per cent of the principal of the debt must be amortized within ten years. This requirement discriminates against the smaller business enterprises as regards the extension of bank investment credit, since the investment regulation establishes no specifications with respect to the retirement of eligible bonds of the larger corporations. If recognition is to be given to this type of bank credit as a proper outlet for banking funds, the regulation should be revised with a view toward the elimination of this apparent discrimination between large and small enterprises.

3. What is your opinion of current methods whereby the supervisory authorities exercise control over the credit quality of loans made by banks?

There does not appear to be foundation for any serious criticism of the current general methods whereby the supervisory authorities exercise control over the credit quality of loans made by banks. The principles set forth in the uniform examination agreement adopted in 1938 by state and federal supervisory authorities present no important problem with respect to credit quality of loans. Under this agreement, the only loans subject to criticism by examiners are those which appear to involve a substantial or unreasonable degree of risk to the bank by reason of an unfavorable record or other unsatisfactory characteristics, those loans the ultimate collection of which is doubtful and in which a substantial loss is prob-

able but not yet definitely ascertainable in amount, and those loans regarded by the examiner as uncollectible and as estimated losses. No loan is to be criticized if ultimate repayment seems reasonably assured in view of the sound net worth of the maker or endorser, his earning capacity and character, or the protection of collateral or other security of sound intrinsic value.

The Federal Deposit Insurance Corporation, one of the agencies of bank supervision, expressed its policy regarding quality of assets in its 1939 annual report as follows:

It is not the intention of the Corporation to invade the field of bank management and substitute its judgment for that of bankers in the conduct of their business. The best adaptation of the banking system to the credit demands of the country can be achieved only if bankers are allowed to choose freely among industries, maturities, security, and other characteristics in investing their funds. Even with respect to the amount of risk which they assume, banks must be allowed wide latitude if they are to continue to finance a dynamic business system. So long as the capital ratios of banks remain at low levels, however, the supervisory authorities must attempt to place certain limits to the risks assumed by banks, and insist that banks which do accumulate low-grade assets value them in accordance with sound appraisals and charge losses off promptly.

The 1938 examination agreement embodies this philosophy. The control it places on loans is qualitative in nature—from the viewpoint of soundness as opposed to speculation. Supervisory policy recognizes that the function of extending credit rests in the management of the banks themselves, and not in supervising authorities. Examiners do not make the decisions of a bank to extend or not to extend credit, although such decisions at times are conditioned by its previous experience with the policy of examiners on loans of similar quality. A bank is not likely to extend a particular loan if it feels that the loan will be criticized by the bank examiner.

The criticism which has been directed toward examiners since the supervisory agreement is not a result of the principles adopted, but is probably due to failure of examiners, in individual cases, to subscribe fully to those principles, and to differences in opinion between the banker and examiner

as to judgment of the inherent soundness of specific loans. The only satisfactory way of vindicating such opinions is by following the ultimate course of the credit extension. It would seem advisable, however, that the examiner accept the judgment of the banker who has closer contact with the borrower, provided that this judgment is fortified by adequate credit and other information essential to appraisal of the risk involved.

3. *(continued) Do examiners discriminate against (a) long term loans as such; (b) capital loans as such; (c) real estate loans as such?*

Under the foregoing principles examiners are not supposed to discriminate against (a) long term loans, (b) capital loans, and (c) real estate loans as such. As stated previously, examiners are instructed not to criticize loans on the basis of their maturities or collateral. An inquiry answered by bankers reveals, however, that they frequently encounter examiners who still criticize capital loans and, to a lesser degree, real estate and other long term loans. There still continues to be considerable confusion as to the meaning of Classification II in examinations. This was formerly the "slow" classification, and examiners in many cases continue to put real estate loans or other loans of longer maturity in this classification in violation of the principles and definitions which have been agreed upon.

As long as the present philosophy remains in effect, the supervising authorities should insist that individual examiners adhere to it, and should allow the banks themselves to determine whether acceptance of the types of loans is advisable for their particular requirements.

4. *What determines the relative amounts of various types of assets held by commercial banks? Should Federal law and supervisory policy be altered in any manner with a view to affecting the distribution?*

The major factors determining the relative amounts of various types of assets are as follows:

- a. The nature and character of a bank's deposits, including the percentage of time and percentage of demand deposits;
- b. The demands and requirements of local loans from its customers;
- c. Laws and regulations, state and federal, or both;
- d. Competition of other banks and financial institutions;
- e. The available supply, quality, price and marketability of investment securities;
- f. General economic, monetary and political conditions and trends;
- g. General policies of individual institutions.

From time to time various formulas have been suggested or advocated for determining the types and ratios of assets that should make up a more or less ideal bank portfolio, but in the final analysis the type and distribution of a bank's assets must be determined by the particular problems and conditions which confront the bank management in carrying out its banking functions in its own community, as well as the nation as a whole. The considerations and factors involved in this problem are so varied and changeable that any rigid formula, law, or supervisory policy would probably be unsatisfactory and unworkable.

5. Should commercial banks be permitted by law to invest in high-grade preferred stock? Why or why not?

Banks which are members of the Federal Reserve System are prohibited by existing law from purchasing preferred stock, and even in those states in which such purchases are not specifically prohibited the policy of supervisors and bank management has not favored preferred stock as an investment for banks. At the present time, corporate stock holdings, acquired by purchase or in satisfaction of debts, constitute only one-third of one per cent of the total assets of insured commercial banks.

Commercial banks should not be permitted by law to invest

in high grade preferred stock. Although the change in law would probably have little effect on the policy of bankers, because of general recognition that stock is not a proper outlet for bank funds, there appears to be no reason for removing the legal restriction. Stock, whether common or preferred, represents equity ownership rather than a creditor interest in a corporate enterprise. It has no maturity and its claim to assets of the issuer is enforceable only in case of liquidation. It has the further disadvantage of being able to participate in earnings remaining only after provision for income taxes, whereas in the case of bonds or other obligations interest may be deducted before income taxes. If the government substantially increases income taxes to meet national defense needs, this disadvantage may significantly affect the status of many preferred stocks now regarded as being of high investment caliber.

These considerations militate against the purchase of stocks by banks. The function of a commercial bank should be to extend credit, not to engage, through ownership, in various fields of economic activity.

6. Which, of any, of the following do you consider as inappropriate assets for purchase (a) by banks having demand deposits in substantial volume, (b) by banks having chiefly time and savings deposits:

(a) Real-estate mortgages:

(1) Farm?

(2) Urban, uninsured?

(3) Urban, insured by Federal Housing Administration?

(4) Limited to 3 or 5 years' duration?

(b) Loans to customers for working capital purposes:

(1) Repayable over a period of 5 years; 10 years?

(2) Nominally repayable within 90 days but actually repayable only by liquidating the business?

(c) Stock-market call loans?

(d) Railroad and industrial bonds of corporations with good credit standing?

- (e) *Bonds issued by local industries of good credit standing but having only restricted market?*
- (f) *Finance company paper secured by installment notes?*
- (g) *Acceptances issued by high-grade institutions covering goods in storage?*
- (h) *Notes collateralized by warehouse receipts for commodities:*
 - (1) *Hedged?*
 - (2) *Unhedged?*

Since this question suggests unqualified answers, it would appear that the general principle would apply that a bank whose deposit liabilities are predominantly demand should confine its assets largely to those of a short term, liquid nature, whereas a bank having chiefly time and savings deposits would be justified in acquiring substantial amounts of fixed and long term assets. Accordingly, as a general proposition, it would be inappropriate for a bank having mostly demand deposits to acquire a relatively large volume of (a) real estate mortgages, (b) working capital loans repayable only from liquidation of the business or repayable over a period of 5 to 10 years, (d) long term railroad and industrial bonds, and (e) local industrial bonds with a restricted market. On the other hand, all of the various types of loans and investments of high quality, could be considered as appropriate for a bank with a high ratio of savings deposits.

The more liberalized reserve bank credit facilities provided under the present Federal Reserve Act furnish member banks with the means of obtaining advances on almost any sound asset and hence give greater liquidity to capital assets. No sound banker would be happy in relying heavily on the Federal Reserve System for his liquidity except in periods of pressure or emergency.

7. If any of the items listed in the preceding question are deemed acceptable for a restricted proportion of a bank's assets, indicate the criteria of a proper proportion.

If banks are to serve their community banking needs, it may

be desirable and necessary for them to acquire assets in disregard of what might appear to be proper when related to the particular nature and structure of their deposits. A bank located in an industrial community and with a high proportion of demand deposits, for instance, might well pursue a policy of limiting its earnings assets to short term loans and investments. A local well-established industry, however, may need capital for justifiable plant expansion, and under present laws governing the issuing of securities may find it costly to float an issue of bonds. It would seem proper for the local bank, regardless of its established short term policy for investments and loans, to consider a ten year loan on an amortized basis to provide for this capital expansion, provided that it has satisfied itself that the company's past earning record and outlook for future progress indicate repayment of the loan during the specified period.

It would seem impossible to apply a fixed formula in determining the extent or proportion of deposits or capital funds which might legitimately be invested in various types of assets. For example, many banking laws and regulations contain restrictions on real estate mortgage loans. Regardless of this fact, many banks experienced and are experiencing difficulties with this particular type of loan. The stability or lack of stability of a given community has more effect upon the soundness of loans than laws governing the commitment of banks in such loans.

An important consideration in this question is that in the acquisition of assets which do not possess a ready market and represent long term credits, a bank should recognize that it is subjecting itself to risks which might result from changes in the credit status of the obligors. Because of the longer duration of these assets, which usually cannot be liquidated until maturity, it is more difficult to anticipate such changes than in the case of short term assets. Consequently, a bank should limit its purchases of long term assets which do not have a ready market in accordance with its ability, as measured by the amount of its sound capital funds, to afford adequate protection for de-

positors' funds against the risks involved in such assets. However, as indicated above, a fixed formula cannot be applied, but consideration should be given to the diverse factors peculiar to the bank's requirements.

8. Should banks be permitted to operate personal-loan departments making small loans on a high interest basis (for instance, 4 to 6 percent deducted in advance, on a monthly installment loan spread over 1 year)?

The personal loan business, which, until recent years, has not been carried on extensively by banks, is a legitimate function of chartered banking. It is estimated that over 5,000 commercial banks and trust companies are now servicing their communities with this type of loans. The entrance of banks into this field has already had salutary effects in reducing costs to the small borrower and raising the standards of this business. In many communities it has tended to eliminate the nefarious practices of the old-time loan shark. Personal loans have also provided an opportunity for banks to increase their much needed loan business.

It is true that when interest is deducted in advance and repayments are made on an instalment basis, the rates of interest usually charged by banks on small loans entail an actual cost to borrowers, in terms of simple interest, which is often higher than the interest cost on loans to borrowers for strictly commercial purposes. However, the differential in charges made on loans between small loan departments and the commercial lending departments of banks is necessitated by the high costs which the banks incur in placing small loans on their books and servicing them on an amortization basis. This is especially true in the case of very small loans, for which there is an important demand and through which banks may render a genuine credit service to the public. If personal loan departments were to charge commercial loan rates on these advances they would find themselves operating at a loss. Even rates of 4 to 6 per cent deducted in advance, while entailing a high interest cost to borrowers as compared with other types of loans, do not

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permit satisfactory profits on many small loans when full costs involved in making and servicing them are taken into consideration. Personal loan departments have reduced the cost of credit to the lowest level yet attained in the small loan field, but in order to continue to serve the public, they must charge interest commensurate with the expenses they involve. As indicated in our reply to question 1 under section IV, it is the profit that a bank can make through its activities which enables it to continue rendering essential services to its community.

C. Valuation of Assets

1. What are the purposes served by the valuation of bank assets by supervisors and examiners?

Since a bank's capital funds and valuation reserves represent the marginal and reserve protection to the depositors, present and potential, the chief purpose served by the valuation of bank assets by supervisors and examiners is to obtain an independent and impartial appraisal to determine the actual sound capital position of the bank. In making such an appraisal examiners may detect violations of laws and regulations, as well as any unsound policies, practices and trends, and call them to the attention of the bank's management with suggestions and recommendations to correct the situation and to guide the bank in the future.

2. For purposes of bank supervision and examination what principles should guide public policy with respect to the valuation of bank assets? For these purposes what are appropriate evidences of the value of bank assets? Which of these principles or evidences can and should be law? How do and should these principles manifest themselves in practical application?

The supervision and examination of banks are an integral part of the American banking system and have contributed to its success. The principles guiding public policy in the valuation of assets should be such that they serve to encourage banks

to meet the banking needs of the public, but at the same time to foster the maintenance of a sound banking structure through acquiring bank assets of high quality.

These objectives appear to be embodied, for example, in the uniform plan of examination agreed to in 1938 by the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the directors of the Federal Deposit Insurance Corporation and the Comptroller of the Currency. The objectives and aims of examination are clear; if difficulties arise they are due to the many complex and intricate problems of supervisory administration, of which the appraising and evaluating of bank assets is a major one.

The real cash value of bank assets can be determined only by their market values over a period where a market for them exists. Otherwise they cannot be determined beyond question until they are sold or repaid; defaults are also some indication of value, implying a probable loss of value, but it is usually impossible to determine the extent until the credit is liquidated. In the case of assets for which no market quotations exist, appropriate evidences of their probable value are found in an analysis of credit data pertaining to each individual situation, interpreted in the light of pertinent economic conditions.

It would be inadvisable to attempt to reduce these principles or evidences to law. Experience has shown, especially in recent years, that flexibility in procedure in evaluating assets is sometimes necessary to meet changing conditions and particular cases.

3. Should commercial banks be required by law or practice to charge off their books all losses as determined by bank examiners and supervisors?

In the interests of sound banking, there would be no serious objection to a law or practice that would require commercial banks to charge off losses as determined by bank examiners and supervisors if it were possible to obtain positive, unquestioned evidence that the losses will actually occur. Earnings

statistics reveal that in recent years banks have obtained substantial recoveries on many of the assets which, because realization on them had not been considered probable, were charged off as losses. This suggests that in the past the judgment of supervisors and examiners, and in some cases conservative bankers, has not been entirely sustained with respect to assets which they had considered to be beyond recovery. At times general economic conditions are such that a decision to classify a loan or investment as to its real intrinsic value is a matter of opinion and cannot be based solely on facts. Thus it is not always possible to present unquestioned evidence that the losses will occur, and reliance must be based on opinions. In view of the record it is believed, therefore, that a rigid law or regulation specifically requiring the charge-off of losses as determined by supervisors would be unfair and unsatisfactory. Under the present banking laws, supervisors have adequate powers to deal with banks which continue to follow unsafe and unsound policies.

4. What benefit or harm follows from requiring publication of bank balance sheets? Would you favor any change in the current law on this subject? Can any harm follow from requiring banks to make public the amount of their borrowings?

The public nature of banking makes it desirable, if not necessary, that balance sheets be published from time to time and present laws appear to be adequate. In fact, many banks go further than the law requires in publicizing their statements.

While borrowing by banks is a normal function, recognized in law and practice, the sensitive and critical reaction of the public to banking in general, particularly since the bank holiday in 1933, presents a difficult problem in public relations. The average person, being not too well informed about banking processes, and being eager to protect his bank funds, is naturally suspicious and not always discriminating in interpreting banking figures and information. In spite of this, one is forced to submit to the general proposition that borrowings

are liabilities and should appear as such on the balance sheet. Should the time come when it might be in the public interest to suspend the publication of borrowings, the power to do so should reside in the supervising agencies who might then require publication only in condensed form until an emergency was ended.

D. Capital

1. What principles should guide public policy with respect to the capital of banks? Which of these principles should be enacted into law?

There are two considerations which should guide public policy with respect to the capital of banks. These are the welfare of the depositor and the interests of the shareholder making an investment in bank stock. The capital structure should reflect a reasonable protection to each.

A bank cannot give service to a community or pay dividends to shareholders if its funds are held intact or deposited with a reserve agent. It must loan to borrowers and seek investments. In these operations the element of risk is ever present. In recognition of this fact a proper capital set-up is necessary to afford a margin of protection to the depositors.

On the other hand, the overcapitalization of a bank would be prejudicial to the investor and hamper a bank in making proper returns to shareholders. The level of earnings is not constant, being affected by amount of money employed, loan and investment yields, rates of interest paid depositors, service charges, demand for loans, operating costs, differences in ability and experience of management, and sundry other factors. Conditions vary considerably in banks in the same locality and among banks in wider areas.

Deposits are not constant. Their ebb and flow are neither fixed nor determinable. The character of assets varies greatly from time to time and between different banks. So variable are these factors that adequacy of capital in any one bank must be a matter of supervisory judgment. The only statutory enactments needed in the public interest in respect to the capital of

banks are those providing for minimum capital requirements as at present based upon population of the community to be served, for the creation of specified surplus and for the increase or reduction of capital stock under supervisory approval.

1. (continued) *What is your opinion of minimum capital ratio requirements? What are the respective merits of various capital ratio bases? What is a proper minimum ratio? Outline the procedure for putting your suggestion into effect.*

Comparatively few of the states have laws providing for minimum ratios of bank capital to deposits. The federal banking laws are silent on the subject of capital ratios. However, federal and many of the state bank supervisory authorities have from time to time utilized some form of capital ratio, whether to deposits or to total assets, as a yardstick for the purpose of determining adequacy of capital. The ratio of one to ten (capital to deposits) has most generally been followed. While this has been a working rule-of-thumb there has been growing recognition that the quality of assets is the basic factor in the consideration of adequacy of bank capital.

The annual report of the Federal Deposit Insurance Corporation for 1939 states that the corporation "believes that every bank should have a minimum net sound capital equal to at least 10 per cent of the appraised value of its assets," but also indicates that this formula is not sufficient of itself, adding: "In considering the adequacy of the capital accounts of any particular bank the following important factors are taken into consideration: (a) the quality of the assets, with particular reference to the volume of fixed assets and assets of substandard quality; (b) the management; (c) possible liabilities arising out of fiduciary operations; (d) local economic conditions."

William R. White, Superintendent of Banks of the State of New York, in his report for the year 1940, presents the following discussion of the ratio of capital funds to deposits:

The large volume of losses suffered by banking institutions during the early '30s made it necessary for many of them to obtain new capital funds, usually through the sale of capital debentures or

of preferred or common stock. Supervisory authorities in passing upon the adequacy of the new capital were guided largely by the time-honored rule that capital funds should bear a ratio to deposits of one to ten. Some of the banks which recapitalized on this basis a few years ago, as well as others whose capital structures have in the past been fully adequate, have now reached the point where their capital funds are less than 10 per cent of deposit liabilities. This development has been due mainly not to additional losses but rather to a marked increase in deposits. With few exceptions, the increase in deposits has either been held by banks in cash or invested in government bonds. Is it necessary that funds so held or invested be protected by capital, and if so, what should be the measure of capital protection? Hence, the question is raised of whether the rule that for each \$10.00 of deposits a bank should have \$1.00 of capital is to be applied at all times and under all circumstances.

Banking literature affords little information concerning the origin and development of the so-called one to ten rule. It is interesting to note, however, that the rule represents a principle which in this country predates bank supervision. In the earliest charters issued in this State by special act of the legislature, and in the first charters granted in other states, provisions are found in effect limiting the amount of debts which a bank could have in relation to its capital funds. These restrictions varied rather widely requiring banks to have capital of from 10 per cent to 30 per cent of liabilities. Later as general banking laws were adopted and bank supervision and examination were developed, the rule seems rather generally to have been dropped as a legislative mandate and became instead an elastic administrative principle. Our banking troubles of the early '30s, however, resulted in a revival of support for the rule and in its more frequent and rigid application. This renewed interest was reflected by proposals for legislation both in the states and in Congress, which in effect would have required banks to maintain capital equivalent to 10 per cent of liabilities.

The change in the character of bank assets, which has attended the increase in deposits of the last few years, has demonstrated the impracticability of such legislation. For clearly banks cannot be expected to issue more capital merely to support larger cash balances especially at a time when income from loans and investments is meagre in comparison with past experience. A more practical approach in appraising the sufficiency of capital is to take into consideration the character and composition of assets and the risks attendant thereto. If this is done we may find that in the case of one bank capital funds equivalent to 8 per cent of liabilities is fully adequate while in another case a much higher percentage is insufficient.

... in determining the adequacy of capital many factors in addition to the ratio to deposits should be considered. Until a formula is evolved which will test capital sufficiency on the basis of the risk attendant to each class of assets, it seems advisable that each case be considered separately with primary regard to the character and condition of loans and investments.

It is our opinion that conditions affecting the adequacy of capital are so varied that the imposition of statutory ratio requirements would be unwise.

2. *Are the capital ratios of commercial banks currently controlled by the supervisory authorities? If so, explain the nature and extent of this control.*

A few state laws give supervisory authorities administrative control over statutory capital ratios. Federal and most state laws do not extend specific control over capital ratios, but supervising authorities have been able to exercise indirect control to some extent. The Comptroller's report for 1934 stated that "the Comptroller's Office, under existing law, is in a position to require national banks to maintain adequate, sound capital."

In the licensing of member banks and the admission of non-member banks to insurance after the banking crisis of 1933, federal supervisory authorities were guided by capital ratios in strengthening the capital structure of the banking system. In many cases they required banks to sell stock to the Reconstruction Finance Corporation, and the amount of such stock was based upon the bank's ratio of capital to deposits.

Supervising authorities have continued to be guided by capital ratios in granting approval or refusing to permit the retirement of preferred stock, the contracts with the R.F.C. having required that approval of the appropriate supervising authority be obtained before any of the stock could be retired by the bank. Referring to purchase by the R.F.C. of preferred capital stock of banks the Comptroller's 1936 report stated: "These increases of capital stock were the result generally of continued effort on the part of the Office of the Comptroller of the Currency looking to the improvement in the capital positions of national banking associations, so that all of them might provide the security afforded depositors by a reasonable ratio of sound capital structure to deposits." The office of the Comptroller stated in 1937 that, if the sound capital of the bank would provide at least one dollar of protection for each

ten dollars of deposits after the proposed retirement of preferred stock was effected, the retirement might be made provided the general condition of the bank in all other respects was satisfactory.

The Federal Deposit Insurance Corporation stated in 1936 that it had disapproved retirement of capital obligations in those cases in which the sound capital failed to meet the minimum desired by the corporation after giving effect to such retirement. The minimum was stated to be a sound capital sufficient, with due regard for the quality and character of the assets held, to give reasonable assurance of the maintenance of an adequate margin of protection to depositors and other creditors and in no case equal to less than 10 per cent of total deposits, and, in addition, a sound capital sufficient to assure the proper discharge of other responsibilities and functions of the bank. In its 1939 report the corporation stated that every bank should have a minimum net sound capital equal to at least 10 per cent "of the appraised value of its assets."

State supervisory authorities may exercise similar control through power to approve retirement of preferred stock of banks under their jurisdiction.

The state supervising authorities, in some cases, have also enforced indirect control over capital ratios through departmental regulations such as refusing to permit the payment of dividends if a bank's capital ratio is below a prescribed standard. The superintendent of banks in Iowa stated in 1938 that a bank under his jurisdiction was not allowed to pay a dividend if its ratio of capital to deposits were less "than the measuring stick of the F.D.I.C."

Supervisory authorities may also exercise control over capital ratios through threat of sanctions, although because of the drastic effects of such sanctions they are usually not employed. For example, in 1939 the Federal Deposit Insurance Corporation initiated proceedings to terminate the insurance of 19 banks for engaging in continued unsound or unsafe practices and violations of laws and regulations, all being cited for continued operation with seriously impaired capital, five of them

with inadequate capital. The corporation pointed out in its report for 1939 that every bank should have a minimum net sound capital of at least 10 per cent of the appraised value of its assets and that 2,884 insured banks were below this minimum. Nevertheless, it cited only the 19 banks during the year for having impaired or inadequate capital.

3. Give your reaction to a proposal that supervisory authorities be given the power to require the retention of earnings by banks which are found by their supervisory authority to have an inadequate amount of capital.

Existing banking laws contain provisions which permit banks to pay dividends only out of undivided profits, and require the retention of a specified percentage of earnings if surplus is below a stated per cent of capital. In addition, supervisors tend to guide the policy of banks with regard to payment of dividends, and in many cases they actually determine dividend policy, with a view of strengthening capital funds. They are able to enforce their recommendations under threat of sanctions, such as citation by the Federal Deposit Insurance Corporation for engaging in unsafe and unsound practice.

It is believed that these methods are preferable to a specific legal provision granting supervisory authorities the power to require the retention of earnings by banks where they deem capital is inadequate. It is doubtful whether such a law would accomplish much of its intended purpose. Under existing conditions of the earning power of many banks the building up of capital funds through retention of earnings which otherwise might be paid out as dividends would be relatively slow. For example, data presented in the report of the Federal Deposit Insurance Corporation for 1939, giving the ratios of cash dividends declared to total capital accounts and to total assets of 7,087 insured commercial banks not members of the Federal Reserve System, show that dividends declared by these banks were only 2.6 per cent of their capital accounts and only four-tenths of one per cent of their total assets. A substantial number of the banks paid dividends below these per-

centages, especially among those with a ratio of less than 10 per cent of net sound capital to appraised value of assets. A statutory requirement for retention of earnings under supervisory control thus would have only limited practical effect. Furthermore, it might make investment in bank shares unattractive and discourage existing and potential stockholders from placing additional capital in the bank, which is the most direct and effective approach to the problem of adequacy of capital.

The proposal is also subject to criticism from the viewpoint of bank public relations. The omission of a bank dividend by order of a supervisory authority not having intimate contact with local conditions might result in unfavorable psychology on the part of depositors, and its harmful effects would be greater than the good served by the omission of the dividend. Another consideration is that differences of opinion between management and supervisory authorities regarding valuation of assets and adequacy of capital often arise. It would be more desirable to continue the present method of control, which permits banks and supervising authorities to work out differences on their merits, rather than to establish a specific legal power which, although directed toward sound banking, would embody undesirable complications. The present method serves as a check upon arbitrary supervision, while still permitting supervisory authorities to take drastic action if the management of a bank is proven to be definitely unsound in its dividend policy.

4. Does the taxation of banks in accordance with the provisions of section 5219 of the United States Revised Statutes keep down the volume of bank capital? Do you favor any change in this section of law?

The provisions of Section 5219 authorize, in addition to the taxation of the real property of national banks, the use of any one of four taxing methods, with the combination of two of them upon certain conditions. These methods are:

1. An ad valorem tax on the shares, at no greater rate than

- imposed upon other competing moneyed capital;
2. Taxation of the dividends from the shares as part of the taxable income of the owners or holders, at no greater rate than the income from other moneyed capital;
 3. Taxation of the bank on its net income (excluding that from tax exempt securities) at no higher rate than that upon other financial corporations nor higher than the highest of the rates upon mercantile, manufacturing and business corporations;
 4. Taxation of the bank *according to or measured by* its entire net income *from all sources* (including tax exempt securities), with the same comparative limitations as under (3).

Whenever the third or fourth method of taxing the banks is adopted, the taxing state may also include the dividends of national banks in the taxation of the income of individuals if the dividends of other corporations are likewise included.

From 1864 to 1923 the ad valorem share tax was the only method of taxing national banks authorized, and that method is still used in 32 of the states, although half of them have adopted the classified intangible property tax at a low rate in place of the general property tax. Since 1923, when other methods of taxing national banks were first authorized, eleven states have adopted the fourth or excise method, two states (South Carolina and Wisconsin) the third, or income method, one (Michigan) the second or dividend method with maximum and minimum limits based on the par value of the shares, and only one (Vermont) the second or dividend tax method exclusively, although most of the states which have adopted the third or fourth method also include the dividends of national banks in their personal income taxes. The taxing system of Washington does not include intangibles.

Categorically answering the questions put by the Senate committee, we reply as follows: (1) In the states which include shares of national banks in the general property tax, the taxation of such banks in accordance with Section 5219 does keep

down the volume of bank capital. (2) Yes, we do recommend changes in Section 5219.

In support of the above answers we beg leave to file with the Senate Committee on Banking and Currency a study entitled "Answer to Senate Banking and Currency Committee Question on Bank Taxation" especially prepared for this questionnaire by the Subcommittee on Section 5219 U. S. Revised Statutes of the Committee on Federal Legislation, American Bankers Association, in which the desired changes are specified and the reasons therefor set forth, along the lines indicated in the following brief digest:

The real difficulty with Section 5219 is encountered in the states which, both in their law and in actual practice, still tax the shares of national banks on their full value, or on a high percentage of their full value, at the general property tax rate. Although in most of such states other intangibles such as stocks, bonds, notes and credits are nominally taxed at the same rate, they in fact very commonly escape taxation altogether. This fact is well known to all persons familiar with state tax problems and is frankly admitted in many official reports and other publications of the states in which this form of taxation remains on the statute books. One of the principal reasons for this condition is that the general property tax rate is altogether too high to be applied to intangible property with any hope of enforcement. As a result, in most if not all of these states, shares in national banks are taxed at a rate clearly excessive for any form of intangible property, and much higher than is imposed on other moneyed capital. Such taxation does necessarily keep down the volume of bank capital.

It is true that such taxation is in violation of Section 5219, but in actual practice a bank encounters almost insuperable difficulty in proving unlawful discrimination in favor of other competing moneyed capital by legal evidence, even though everyone knows that shares in national banks are taxed at their full value and that no other form of intangible property is taxed at all. In order that national banks in states in which such conditions exist should be given some practical remedy

in the case of unreasonable burdens or unlawful discrimination, it has been suggested that Section 5219 should be amended so as to provide for a determination by some federal administrative officer or tribunal of the existence of de facto discrimination against national banks.

Taxation by any one of the last three methods authorized by Section 5219 (namely, the dividend tax, the income tax, and the tax according to or measured by income) has almost always been imposed at reasonable rates, and has not tended to keep down the volume of bank capital. We do not feel that any material change in the substance of the law with respect to taxation by these methods is necessary, although the law ought to be clarified (1) by a definite statement that the tax imposed under the fourth method is an excise tax, (2) by requiring a tax under either the third or the fourth method to be uniform throughout the state, and (3) by limiting the rate of the tax under the fourth method to the rate imposed in taxes of like character on other corporations rather than allowing taxes of dissimilar character to be included in the comparison.

Some irritation has been caused among public officials because under Section 5219 national banks cannot be required to pay the sales and use taxes which have become so common in recent years. We feel that such taxes could be authorized in the case of national banks without breaking down the protective principles of Section 5219, and it is therefore thought wise, if Section 5219 is to be clarified generally and brought up to date, to add a new paragraph, authorizing the subjection of national banks to non-discriminatory sales and use taxes, and to license fees which do not relate directly to any of the incidents of banking.

5. Do you have any suggestions for any change of Government policy with respect to retirement of the stock of commercial banks held by the Reconstruction Finance Corporation? Please indicate the nature of any desirable changes.

Under the policy which now obtains, the Comptroller has

authority to approve or disapprove retirement of preferred stock of a national bank, except that the Comptroller's action is not necessary for national banks which, at the time the stock was issued, amended their articles of association prohibiting the retirement of the stock if capital funds were below an amount stipulated in the amendments. Such banks, when their capital funds are above the amount stated, may retire preferred capital stock without prior approval of the Comptroller. His office has the data of all examinations and is in a sound position to judge the reasonableness of the applications for retirement of stock of those banks which do require his approval.

In the case of a state bank, the application is made to the superintendent of banks or bank commissioner. If the bank is not a member of the Federal Reserve System his recommendation is communicated to the Supervising Examiner of the Federal Deposit Insurance Corporation in the district, who in turn sends the state banking official's reaction to the request, together with his own recommendation, to the board of the F.D.I.C. in Washington. The board acts upon the application and its decision is forwarded to the Reconstruction Finance Corporation. The latter corporation accepts the decision, which, if favorable, permits the retirement of stock requested. If the state bank is a member of the Federal Reserve System, approval by the state supervising authority only is required, except in cases in which the Board of Governors of the Federal Reserve System has made approval by it a condition of membership in the system. In our opinion, a due and proper course is being followed and no change of policy is believed necessary.

E. Procedures and Sanctions

1. Are the principles, procedures, and practices which the supervisory authorities require banks to follow available to banks in the form of published rules and regulations, or are they made known to banks on a case by case basis? Which of the two methods would banks prefer?

Supervisory authorities have issued published regulations when statutes require them to do so, but for the most part the principles, procedures, and practices which they require banks to follow are made known to banks through general public statements and reports, advisory opinions, or criticisms in bank examinations on a case by case basis. This procedure has preserved a certain amount of flexibility in adapting examinations to changes in economic and banking conditions. A survey of opinions on this question reveals that bankers prefer that the general rules and regulations under which they must operate should, as far as possible, be made a matter of definite information to them through publication, although it is recognized that there are instances where principles, procedures, and practices can best be made known on a case by case basis as circumstances require.

2. *What are the sanctions which supervisors of commercial banks invoke in order to secure compliance with their requirements? Do you have any suggestions for changes in these sanctions? Specifically, have you any criticisms or suggestions for revision of those sections of law which provide for the removal of officers or directors or the termination of deposit insurance in cases of violation of law, or of unsafe or unsound practices?*

The sanctions which supervisors may invoke to secure compliance with their requirements include the rights to publish reports of examinations, to institute proceedings for removal of officers and directors of banks that continue unsound or unsafe practices or violations of law, and to place banks in receivership; additional powers to terminate deposit insurance for such practices or violations and to suspend banks from central banking credit facilities are vested in federal supervisory authorities.

In general the powers through the years have usually been sufficient to effect the compliance of most bankers with reasonable requirements, although it has been contended by some that these sanctions are too drastic. Experience has shown that

supervisors have been loath to initiate any action looking toward the removal of officers and directors, and have only done so when repeated warnings have gone unheeded, and all other means have failed to correct a flagrant abuse of power or disregard of banking laws. The laws which provide for the removal of officers or directors or the termination of insurance in cases of violation of law, or of unsafe and unsound practices, are in the interest of better banking and for the good of the depositor and we believe need no revision.

3. What rights of appeal and appeal procedures do banks have from the requirements of supervisors and examiners? Do these procedures offer adequate protection?

Banks may ultimately appeal to the heads of the supervisory agencies in the event of disagreement with the requirements made by field examiners or chief district examiners. The latter usually hold conferences with the bank officials concerning the requirements, but if a satisfactory agreement is not reached and it is deemed advisable to enforce the requirements the matter is referred to the examiners' immediate superiors, usually the chief of the division of examination. If conferences with these officials also fail to provide a solution to the problems involved, the matter may be referred for final action to the heads of the supervisory agencies, who are the Comptroller of the Currency in the case of national banks, the Board of Governors of the Federal Reserve System in the case of state member banks, the Board of Directors of the Federal Deposit Insurance Corporation in the case of non-member insured banks, and the superintendents or commissioners of banking (or the banking advisory boards in states where such boards exist) in the case of any state banks. The supervisory authorities work in cooperation in cases where banks are subject to more than one supervisory jurisdiction.

The banking laws prescribe hearings in which banks may present their cases when supervisors seek to invoke sanctions for the purpose of securing compliance with their requirements if preliminary informal conferences fail to reconcile

differences. Although such hearings are conducted by the supervisors through procedures formulated by them and are not attended by outside parties, it does not appear that discrimination or other unfair treatment has been directed against banks involved. It is the aim of supervisors not to carry out the sanctions, but to endeavor to have unsound practices or violations of law corrected before the final steps are invoked. Relatively few cases have involved disciplinary action in recent years, and, judging from the record presented and a survey of bankers' opinions on the question, the procedures devised by supervisory authorities have offered adequate protection to the parties concerned.

F. Relations Among Supervisory Agencies

1. Should the bank supervisory and bank examining functions of the Federal Government be concentrated in the hands of a single agency and a single integrated examining force?

Theoretically a case can be made for a segregation of functions among the federal bank supervisory agencies so that all bank examination would be concentrated in one agency, the insurance function would be in another separate agency, and credit control in still a third. There are, however, a number of practical considerations which make it appear desirable to continue the present general form of organization in Washington.

The first of these reasons is the historical one. The three supervisory agencies have grown up in their present form and have adjusted themselves to the banking system and it in turn has adjusted itself to them so that any change would be somewhat disturbing.

In the second place argument can be made for the present organization from the point of view of efficiency. The Federal Reserve System, for example, benefits from having an examination force which keeps it intimately and currently informed as to changes in the condition of banks. Similarly, the F.D.I.C. would find it difficult to satisfy itself as to bank con-

ditions without its own intimate contact through its own examiners with at least some of the banks.

In the third place the danger of a supervisory office becoming bureaucratic and arbitrary is always much greater when all powers are concentrated in one place. The present division of authority between three agencies gives a greater measure of flexibility and opportunity to try new methods and new adjustments to changing conditions.

It is for reasons of this sort that the American Bankers Association has gone on record in favor of the continuance of the Comptroller's office for the supervision of national banks, and, in general, of the preservation of the present authorities and relationships of the three Washington agencies.

Bankers have been disturbed in recent years by an increasing tendency to subordinate the office of the Comptroller of the Currency to the Treasury, and there is a substantial sentiment in favor of giving the Comptroller a position of greater independence.

The resolutions of the 1939 convention of the American Bankers Association reaffirmed its stand for the preservation of the dual banking system and the autonomy of the laws of the separate states with respect to banking and stated that "we believe this is wholly in keeping with the broad principle that the success and strength of democracy in America is largely due to the sound safeguards afforded by the wisely conceived checks and balances which pervade our composite governmental system. We believe, furthermore, that as regards banking supervision this same principle of checks and balances, which now exists, should be maintained."

2. Should all Federal bank supervisory laws be unified and codified and made to apply uniformly to all insured banks, or to all banks holding demand deposits?

This question appears to be related to the preceding question, though it is not clear exactly what is meant by "unified and codified." We interpret the question as suggesting a step in unification of banking supervision short of that suggested

in the previous question. Instead of having one supervisory agency, we take it that the suggestion is that the procedures of all the federal agencies should be brought into harmony through removing the differences between their basic laws in so far as they overlap, and that these laws should then be made to apply to all insured banks. If our interpretation is correct this would seem to be one step away from the dual banking system, and would sacrifice some of the advantages of that system in its adaptation of banking laws and regulations to meet local problems, practices, and desires. Since the American Bankers Association favors continuance of the dual banking system it would be opposed to this step.

There are, however, other serious difficulties in a unification and codification of banking law. Each one of the present federal banking laws is the result of extended discussion and compromise between different interests and points of view. It is difficult to see how any changes can be made in the wording of the law without in effect substantially amending the law. While there are some arguments to be made for a thoroughgoing re-writing of the banking law, this is clearly a prodigious enterprise involving a thoroughgoing discussion by all parties. It could only be done after a complete study and analysis of the whole problem. Certainly the present period of emergency is not a time for an undertaking of this sort.

It should be added that while there are now some ambiguities in the banking laws they are not serious and are being dealt with adequately through judicial and supervisory interpretation and through specific clarifying changes, limited in scope but effective and satisfactory in practice.

3. Is there a danger that bank supervision in the hands of the Federal Deposit Insurance Corporation will be so stringent, because designed to reduce to the absolute minimum the losses to that Corporation, that the restrictions on bank-credit extension will unduly hamper business enterprise? Has there been any evidence of this during the past 6 years?

If the experience of the past is any criterion upon which to base a prophecy as to the future, the answer to this question would be to the effect that no serious danger should be anticipated. The regulations and requirements imposed upon the insured banks by the corporation in its supervision over the period since 1933 have in general not been harsh or unreasonable. Banks have some possible relief from unduly stringent examinations by reason of the option of withdrawing from the insurance plan; non-member state banks which are able to qualify for membership may place themselves under Federal Reserve, rather than F.D.I.C., examination by becoming Federal Reserve members. The national banks under the law are all participants in insurance, but can surrender their charters and apply for state charters in the event undue restrictions are imposed upon them. Similarly, Federal Reserve member banks can also withdraw after surrendering membership.

4. In your opinion is there at present any significant undesirable duplication of bank supervision by Federal and State authorities? If so, what suggestions do you have for remedying this situation?

In nearly every state a program of supervision has been perfected whereby joint examinations of state banks are made by federal and state authorities. In the case of non-member banks, examiners of the Federal Deposit Insurance Corporation and the state banking department join in the examination, and in the case of member banks, the state examiners join with the Federal Reserve representatives. This method is helpful to the banks by obviating the undesirable duplication which would result from separate examinations.

The banking laws in many of the states have been amended to give the state banking department the authority to exchange with federal supervisory bodies information gained through bank examinations, with the result that reports are compared by each department, asset valuations analyzed, and comments upon efficiency of bank management considered. In fact, a

double check is furnished on the whole picture brought out by the examination. By this method the official letter from the department to the board of directors, commenting upon the examination, is much more likely to contain the proper suggestions and requirements. Reports from bankers reveal that a large majority of them are not subject to undesirable duplication of supervision by federal and state authorities. Steady progress is being made toward the elimination of such duplication where it does exist.

Inconveniences are more apt to occur from present overlapping spheres of influence when special situations arise such as mergers or reorganizations. In these cases it has sometimes been difficult to secure the necessary agreement and cooperation of all the agencies concerned.

III. LEGAL STATUS OF BANKS

A. Granting of Charters, and Admission to Insurance.

1. *Set forth your views with respect to the relative merits of granting charters to all banks and admitting to insurance all banks which meet certain specific requirements fixed by law and agree to operate in accordance with all laws and regulations applicable to them as compared with the present system of case by case decisions with respect to the granting of charters and admission to insurance. If you prefer the former alternative, what should be the specific legal requirements?*

The present system of case by case decisions with respect to the granting of charters and admission to insurance should be retained. On several occasions the American Bankers Association has gone on record in favor of the granting of new bank charters only where there is demonstrated economic need for them. Its position was stated in the following resolution "relative to the necessity of limiting the chartering of new banks rigidly in accordance with the economic needs of the country," adopted at the 1935 annual convention:

Every effort should be made by bankers, and they should enlist the support of public opinion, to prevent a new overproduction of banks through the indiscriminate chartering of banks in places which are either not large enough to support a bank or in which there already are available sufficient banking facilities to take care of their reasonable requirements. We recommend those provisions of the Banking Act of 1935 which give the Federal Deposit Insurance Corporation authority to determine whether there exists an economic necessity for the creation of a new bank before a newly-chartered institution shall be admitted to the benefits of the Insurance Fund. We believe the banking profession should give the Corporation the fullest cooperation in this connection at all times.

The 1936 convention of the Association reaffirmed this stand and in 1937 the following resolution was adopted:

We here emphasize again our conviction that the number of chartered banks should be limited rigidly to the economic requirements of the nation. Public opinion not only in the nation as a

whole but in every State should be kept alert against any tendency toward a return to over-banking through the indiscriminate chartering of new institutions in places which are not large enough to support a bank, or in which there are already ample banking facilities. We believe that full public support should be given the bank supervisory authorities, both state and national, in resisting political or other pressure tending to make for unjustified expansion of the banking facilities under their jurisdictions.

A similar resolution was adopted by the convention of 1938. The Association, through its Committee on State Legislation, has made definite effort to foster a policy of sound bank chartering under the case by case system. The 1939 program of state legislation recommended a model bank chartering statute for enactment by state legislatures, which empowers the supervisory authority to refuse any bank charter application if investigation of the proposed bank discloses unfavorable information concerning its organizers or proposed management, lack of need of the community for additional banking facilities, or the inability of the community to support the proposed bank. The model statute further aims to eliminate competition in chartering as between the state and national banking systems by requiring submission of notice of charter applications to the federal supervisory authorities, as well as to competing financial institutions.

The case by case system enables supervisory authorities to restrict charters to banks which would serve public convenience and necessity. A proposal to grant charters to all banks which meet specific requirements fixed by law would be unworkable, because of the difficulty of giving effect in the law to changing economic trends which would make revisions in the requirements desirable. The case by case system affords flexibility in charter actions which could not be practiced under a system of indiscriminate chartering of all banks meeting fixed legal specifications.

2. By what standards should a supervisor determine whether to grant or withhold approval of a consolidation or merger of two or more commercial banks? Should permission be granted for the merger or consolidation of banks which could not legally have interlocking directorates?

A supervisor should be guided by public interest in determining whether to grant or withhold approval of a consolidation or merger of two or more commercial banks. It is in the public interest that a sufficient number of banks be operated to provide ample deposit and credit facilities in every community which can support them on a sound competitive basis. However, if over-competitive conditions or other economic developments in the locality hinder the sound operation of the existing banks as independent units and a consolidation would provide a materially stronger institution, it would be in the public interest to approve a proposed merger. Similar considerations should govern in respect to banks which could not legally have interlocking directorates. The purpose of the restriction on interlocking directorates was to prevent concentration of banking power detrimental to the public interest. The continued operation of weak and uneconomic banking units is more detrimental than the restriction on competition which might result from a merger or consolidation of the banks. If the proposed merger or consolidation would not strengthen the banking facilities of the community, but would serve to circumvent the restriction on interlocking directorates and eliminate wholesome competition between the banks involved, approval of it would not be warranted.

3. Are there too many banks or banking offices in the United States at the present time? To what extent are there communities not adequately supplied with banking facilities? What method do you suggest for determining the proper number of banks or banking offices for the country?

It is not possible to determine precisely what constitutes the optimum number of banks or banking offices for the country as a whole. In a dynamic economy composed of many diverse geographic segments, conditions affecting the public need and profitability of banking vary considerably. In a number of areas the overbanking which developed prior to the banking crisis may still exist in some degree, although in some instances the closing of banks has doubtless resulted in under-

banked localities, while in others a better distribution and coordination of banking facilities may still be called for. Economic developments often tend to alter the basis upon which a bank may operate successfully and usefully in the service of its community, but there is no predictable uniformity in such local trends for the country as a whole.

There appears to be little doubt that there has been substantial improvement during recent years in respect to the number and distribution of banks relative to the economic requirements of the nation. In 1920 there were 31,400 banking offices, that is, head office banks and branches, or one office for each 3,400 persons. Thirteen states had a population of less than 2,500 persons per banking office, two of them having less than 1,000 persons per office. By 1930 considerable improvement was shown in all these figures. In that year there were 27,500 banking offices, or one for each 4,500 persons nationally. The number of states having a population of less than 2,500 per banking office was reduced to five, and no state had fewer than 1,000 persons per banking office. Still further progress had been indicated in the past decade. In 1940 there were only 18,700 banking offices. For the country as a whole, there were 7,000 persons per banking office, or more than twice as many as in 1920. No state had fewer than 2,500 persons per office, and only one had fewer than 3,000.

Improvement also has been recorded in the relationship of the number of banking offices to economic activity as measured by income payments received by individuals in the various states. For the country as a whole, income payments per banking office were 3.6 millions in 1938, as compared with only 2.7 millions in 1930. In 1938 there were only ten states in which income payments per banking office were less than 2.0 millions, as against 21 such states in 1930.

The present number of banks appears to be generally adequate, although in a relatively few localities existing facilities may be deemed insufficient. In such instances adequate facilities should be provided.

As to specific localities, it appears that the most feasible way

of determining whether there are too many or too few banks is through the exercise of judgment by supervision and bank management which are alert to the changes affecting banking in localized areas. Proper supervision should permit the chartering of new banks in communities in which there is a definite need for additional banking facilities and which can permanently support new banks. Supervision should likewise assist in the consolidation or liquidation of uneconomic units whose unprofitable operations might result in public detriment greater than the inconvenience caused by the elimination of their loan and deposit facilities. A well directed supervisory program, therefore, should strive for an equilibrium in the number of banks or banking offices, based on economic conditions in local communities. Supervisors should be guided by a sound chartering policy which endeavors to avoid past mistakes such as were discussed in 1935 by the Economic Policy Commission of the American Bankers Association in the findings of a report on the bank chartering history and policies of the United States and their bearing on the problem of bank failures, which said in part:

The history of bank chartering in the United States shows that for years prior to the depression which began in 1929 there was a wide-spread disregard of the proper relationship between the economic needs of the country and the numbers and localities of banks permitted to open for business.

This disregard prevailed not only among the general public but frequently also among both state and national banking authorities who were responsible and empowered by law to guard against unsound charter policies.

A major cause in the over-production of banks was the competition between the national and state banking systems to outdo each other in respect to the numbers of banks under their jurisdictions.

It also became a matter of public policy in both jurisdictions to encourage the establishment of banks with small capital in small places as a popular political measure, mistakenly considered a means for fostering national development, especially in the rural sections.

These policies were persisted in despite warning voices and the danger signals presented by a disastrous bank failure rate from 1920 to 1929, indicating clearly that the nation had become heavily overbanked. Faster than old banks failed, new bank charters were

granted often to persons unfit to be entrusted with such responsibilities.

Both state and national governments progressively and competitively liberalized their charter provisions to attract new banks.

These conditions contributed heavily to creating a banking structure unable to meet the stresses and strains and the destructive shocks of depressed national conditions which began in 1929.

Analysis of the data shows that there was a distinct causal relationship between the over-chartering of banks and the abnormal bank failure conditions that prevailed from 1920 to the bank holiday in 1933.

4. Are bank supervisors in any substantial degree inhibited from effectively supervising banks by the possibility that they may avoid their current supervision by transfer of charter or change of status with respect to the Federal Reserve System? What evidence is there on this subject? If there is a major problem involved, what solution do you suggest?

Comprehensive, concrete evidence on the question whether bank supervisors are inhibited in any substantial degree from effectively supervising banks by the possibility that they may avoid their current supervision by transfer of charter or change of status with respect to the Federal Reserve System, would best be obtained from the supervisors themselves, who have first-hand knowledge of experience in this regard. We do not believe that there is evidence of any general tendency for supervisors to be inhibited from a proper exercise of their duties for fear of transfer of charter. In recent years supervisors have endeavored to eliminate unsound competitive practices as between the state and national banking systems in respect to the chartering and regulation of banks. The opportunity which the system of dual regulation offers for banks to leave one system and enter the other for justifiable reasons still constitutes a desirable check and balance in respect to supervision, but the emphasis in both state and national systems has been increasingly upon the better serving of the public interest through cooperation among supervisors, rather than offering avenues to avoid current jurisdiction. A notable instance of this cooperation has been the develop-

ment and operation of a coordinated system of examinations. High standards, intelligently administered, in both federal and state jurisdictions serve to eliminate the incentive for banks to change their charter status for supervisory reasons. A bank, which is a member of the Federal Deposit Insurance Corporation, desiring to alter its charter or Federal Reserve membership, must also consider the fact that it will still remain subject to federal supervisory requirements under the corporation unless it is willing to undertake to withdraw from insurance as well.

In recent years there have been somewhat fewer conversions of national into state banks and state into national banks than in the 1920s, whether for the purpose of escaping from certain supervisory conditions or other considerations. Likewise, more banks are entering the Federal Reserve System and fewer withdrawing from membership, as is shown in the table below. The smallness of these figures would seem to indicate that there is no major problem involved in the transfer of banks from their current supervisions.

Changes in Bank Charters and State Bank Membership
in the Federal Reserve System, 1921-1940

Years	Charter conversions		Changes in state bank membership in Federal Reserve System	
	State into national	National into state	Admissions	Withdrawals
1921	65	8	204	19
1922	122	5	95	13
1923	75	19	66	29
1924	26	15	41	26
1925	105	18	40	39
1926	23	21	32	59
1927	33	15	29	26
1928	17	20	23	40
1929	27	36	27	42
1930	36	18	18	41
1931	8	19	23	20
1932	7	8	23	13
1933	23	18	237	6
1934	32	4	125	5
1935	9	12	38	3
1936	9	18	70	7
1937	19	16	58	6
1938	6	12	49	5
1939	13	12	85	4

Source: Board of Governors of the Federal Reserve System.

While the circumstance that there is now a smaller number of institutions in the banking structure is a conditioning factor, we believe that it can be stated that the efforts noted to eliminate competition in charter and regulatory attractions have played a large part in keeping down the rate of shifting. In 1939, only 12 national banks converted to state charters and 13 state banks converted to national charters, the total being less than 0.2 per cent of the 14,534 commercial banks operating on December 31, 1939.

The Federal Reserve Committee on Branch, Group and Chain Banking prepared a survey of 61 conversion and consolidation cases prior to the banking crisis of 1933. The survey revealed that only 13 banks changing from national to state charters considered escape from federal supervision as a factor in their decisions. Some of these banks said the requirements of state supervisors were less severe and others were unwilling to accept the recommendations of national examiners. If the findings of the survey can be considered typical, it can be said that, even in a period before cooperative supervisory efforts had reached the present stage of development, the attempts to escape current supervision constituted only a small percentage of the cases of charter conversion, which in themselves involved a very minor proportion of the operating banks. Thus it appears that the conversions have not represented to any serious degree an effort to inhibit effective supervision. Banks avail themselves of the ability to change their charters under the dual system in most cases in order to secure operating advantages adapted to their particular operating requirements. As long as these advantages are confined within the limits of sound banking principles, the flexibility they produce permits a better serving of the needs of the country by the banking system.

5. What advantages or disadvantages would follow from requiring all banks holding demand deposits, or all insured banks, to operate under national charters and Federal supervision? Under State charters and State supervision?

A requirement that all banks holding demand deposits, or all insured banks, operate exclusively under national charters and federal supervision, or exclusively under state charters and state supervision, would in effect abolish the dual system of banking. The American Bankers Association on several occasions has expressed its viewpoint on the matter of the dual system.

A resolution adopted by the 1930 annual convention of the Association stated: "The Association supports in every respect the autonomy of the laws of the separate states in respect to banking."

A resolution approved by the 1937 convention in Boston stated: "We favor the preservation and continuation of the dual banking system by which banks are free to operate under either state or national charter."

This position was reaffirmed in the conventions of 1938 and 1939 and in the latter year the convention adopted an additional resolution referring to checks and balances under the dual system as follows:

With respect to governmental supervision of banking in the public interest, we believe this is wholly in keeping with the broad principle that the success and strength of democracy in America is largely due to the sound safeguards afforded by the wisely conceived checks and balances which pervade our composite governmental system.

We believe, furthermore, that as regards banking supervision this same principle of checks and balances, which now exists, should be maintained.

The 1940 convention reaffirmed the resolutions of the three preceding conventions relating to branch banking and the dual banking system in the following terms:

We reaffirm the action of the convention at Boston in 1937, and of subsequent conventions, wherein the position of the Association was stated with regard to the dual system of banking, branch banking, and the autonomy of the laws of the separate states with respect to banking and opposing any proposal or device looking to the establishment of branch banking privileges across state lines, directly or indirectly.

We favor such action in the discretion of the officers and committees of the Association and within the scope of the Boston Reso-

lution, as will prevent any further extension of banking contrary to the above principle.

6. Do you favor requiring all banks which hold demand deposits to be insured? Why?

We assume that this question refers to insurance under the Federal Deposit Insurance Corporation, which is compulsory for Federal Reserve member banks and optional for non-member banks which are qualified for membership. We do not favor an extension of federal law which would require all banks that hold demand deposits to be insured in this corporation. We do not favor the creation of any other form of compulsory deposit insurance plan.

The American Bankers Association is on record as being in favor of the maintenance of the dual banking system, which recognizes the autonomy of the laws of the separate states in respect to banking. A federal requirement that all banks which hold demand deposits be insured would violate the autonomy of the states. It is within the province of the respective state governments in the exercise of their state rights to decide whether all banks under their jurisdiction shall be insured in the F.D.I.C. or whether they shall conform to its standards. The banking law of the State of South Carolina provides, for instance, in Governor's No. 319, Laws 1939:

That in addition to all requirements now in effect, no bank or banking institution of any nature hereafter incorporated shall be granted a charter by the Secretary of State, unless and until the State Board of Bank Control has certified that the paid-in capital of such bank or banking institution is sufficient to qualify such bank or banking institution for membership in the Federal Deposit Insurance Fund.

On December 30, 1939, approximately 93 per cent of all commercial banks in the country were insured as members in the F.D.I.C.; they held 97 per cent of the commercial bank deposits. The membership position is shown in the following table:

Distribution of Number and Deposits of Insured and
Non-Insured Commercial Banks, December 30, 1939

Class of Banks	Number of Banks	Per cent of all Banks	Deposits	
			Millions of dollars	Per cent of total
Insured:				
National	5,187	35.7	\$31,559	54.6
State Federal				
Reserve members	1,175	8.1	17,781	30.7
State Federal				
Reserve non-members..	7,176	49.4	6,736	11.6
Non-insured	996	6.8	1,811	3.1
Total	14,534	100.0	\$57,887	100.0

Sources: Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation.

The total number of insured commercial banks was 13,538, with deposits of \$56,076,000,000, and the total number of uninsured commercial banks was 996, with deposits aggregating \$1,811,000,000.

A survey prepared by the F.D.I.C. as of February 1, 1935, revealed various reasons why uninsured banks did not join the temporary deposit insurance fund. Some banks objected to the theory and principle of insurance or to the expense involved; others believed themselves so liquid as to have no need for insurance; the business of others was believed to make deposit insurance non-essential; and still others were disapproved for membership by the Federal Deposit Insurance Corporation.

In some instances banks which operate with deposit insurance are deemed to have a competitive advantage over uninsured banks by reason of the fact that depositors prefer them because of the protection afforded. In some instances, also, uninsured banks have successfully based their claim for public confidence on their own ability to protect their depositors without outside assistance or insurance.

The following table shows the comparative failure experiences as between insured and uninsured banks during four years:

**Suspension Rates of Insured and Uninsured
Commercial Banks, 1936-1939**

Years	Insured banks			Uninsured banks		
	Active banks at beginning of year	Suspensions during year	Suspension rate (per cent)	Active banks at beginning of year	Suspensions during year	Suspension rate (per cent)
1936	14,126	41	0.3	1,248	3	0.2
1937	13,973	53	.4	1,178	6	.5
1938	13,797	49	.4	1,085	7	.6
1939	13,661	32	.2	1,042	10	1.0

Source: Annual Report of the Federal Deposit Insurance Corporation for the Year Ending December 31, 1939.

These figures are inconclusive. They refer to a period of recovery in values, in which improving bond prices, deposit expansion and rising reserves have prevailed. A real comparison as between insured and uninsured banks can be had only when insured banking is called upon to undergo the test of a severe liquidation of deposits and loan and investment values.

Under such a test all previous experiments in deposit guaranty plans have broken down. In the period 1908-17 a wave of various guaranty laws swept over the states of Oklahoma, Kansas, Texas, Nebraska, Mississippi, South Dakota, North Dakota, and Washington. The movement was at its height when the depression of 1920-21 occurred. It subsided and disappeared in the period 1923-29 as one after another of the plans became insolvent, and the laws establishing them were repealed or allowed to become inoperative. In no case were the guaranty funds sufficient during periods of deflation and attendant bank failures to cover more than a relatively small proportion of the depositors' losses caused by suspended banks. The history of these state plans shows that where they were in force they consistently fostered unsound banking during the years of expanding prosperity. They led the public to place indiscriminating trust in loosely run banks which sprang up in large numbers. Among many bankers and depositors alike reliance was placed on the guaranty plans rather than on sound bank management for the protection of deposits. These conditions, coupled with lax chartering and supervising poli-

cies, led to disaster in every instance. In the periods of liquidation, both local and national, which followed the boom periods, the rate of bank failures was far greater in the states in which deposits were guaranteed than in states in which guaranty plans did not exist. In Kansas, where the guaranty was optional, the rate of failure of guaranteed banks was greater than that of non-guaranteed banks. These circumstances left the conviction in the minds of many bankers, particularly in the state deposit guaranty areas, that the idea is inherently unsound and led them to remain outside the present federal insurance plan, even though disciplinary and restrictive measures as to members are incorporated in it with a view of preventing many of the weaknesses which appeared in the state plans.

We do not favor requiring all banks which hold demand deposits to be insured for the further reason that the present power of the F.D.I.C. to exclude weak banks from insurance is desirable. The corporation should not be required to assume the risk of insuring deposits of any institutions which are known beforehand to be unduly likely to become a burden on the fund. The local problems involved in these banks should be left to the state supervisory authorities to work out.

B. Federal Reserve Membership

1. Do you think any substantial economic disadvantages have resulted from the fact that: (a) a considerable number of banks have not had full access to Federal Reserve credit facilities over the past 25 years; (b) a considerable number of banks have not been in the par collection system over the past 25 years; (c) a considerable number of banks have not been subject to the Federal Reserve requirements of reserve against deposits?

(a) It seems doubtful that any substantial economic disadvantage has resulted from the fact that non-member banks have not had full access to Federal Reserve credit facilities. The non-member banks were in fact able to meet their needs almost as well as the member banks because they borrowed

when necessary from their city correspondents, which in turn borrowed from the Federal Reserve banks. There may have been some cases of non-member banks unable to meet their needs in this way but they must have been few.

(b) Likewise in the matter of par collection, any economic disadvantage that has resulted from having some non-par banks does not appear to have been large. In December 1939, 5,396 non-member commercial banks were on the par list and 2,719 were not. These latter, though constituting one-fifth of the commercial banks in the country, are mostly small banks with only two per cent of the aggregate bank deposits. Their checks do not circulate widely beyond their immediate trade areas. As long as the payment of exchange charges is so restricted as to area and amount, no strong argument can be made as to economic damage done. Only if the practice were more widely spread and were to become an important charge on business and to interfere with rapid check clearance would the economic damage be important. The American Bankers Association has historically been opposed to forcing banks into the par collection system.

(c) The economic effects of non-member banks' not being subject to the same reserve requirements as member banks are not so clear. Reserve requirements established by some state laws have been just as severe as those prescribed for member banks, but in more states the requirements are lower, especially since the increases were instituted for member banks in 1936 and 1937. The possible disadvantages of this situation were:

1. That some of these banks may have been in weaker cash position than otherwise in banking disturbances of the early 1930s, and hence more vulnerable.
2. That some banks may have been deterred from joining the Federal Reserve System by reason of its higher reserve requirements.
3. That these lower requirements may have allowed a larger credit expansion in the 1920s than otherwise would have occurred.

There is no way of knowing how important these influences were. That they were limited is suggested by the fact that the proportion of the country's bank reserves under the control of the Federal Reserve System was so large that its credit policies could not have been seriously impeded by its lack of control over the reserves of non-member banks. By 1919 member banks held two-thirds of the deposits of all commercial banks. The proportion rose to over 70 per cent in 1922 and since then it has shown an almost uninterrupted increase. By 1933 member banks held over four-fifths of total commercial bank deposits. In 1940 they held 84.2 per cent of the total.

2. Should all insured banks be required to be members of the Federal Reserve System under present requirements for membership? Under some other requirements for membership? If the latter, what alterations and requirements do you suggest?

The American Bankers Association is on record in favor of the dual system, under which the state legislatures exercise the right to supervise banks under their jurisdictions as they deem necessary to the public interest. The American people have always distrusted, in banking as in other features of their political and economic life, the dangers of too great centralization of power and the dangers of bureaucracy.

In carrying on its support of the dual system, the Association has taken a definite stand opposing compulsory membership of insured banks in the Federal Reserve System. At the 1938 annual convention of the Association, the State Bank Division adopted the following resolution:

The Banking Act of 1935 provides that all non-member State banks with deposits of \$1,000,000 or over be required to join the Federal Reserve System after July 1, 1942, or surrender their membership in the Federal Deposit Insurance Corporation.

It is the continued judgment of the members of the State Bank Division of the A.B.A., which Division represents more than 6,000 State banks in the country, that that requirement is unjust. It is the sense of this body of State banks that membership in either the Federal Reserve System or in the F.D.I.C. or in both should be optional to be determined by each bank itself in accordance with the benefits that it may be able to see will be rendered to it by

either or both of those federalized agencies. Membership in either the Federal Reserve System or in the F.D.I.C. should be made so inviting that applications for membership will come voluntarily from the bank rather than through compulsion or coercion of a Federal law. We exhort the officers and (or) legislative committee of the State Bank Division working upon their own behalf and enlisting in any manner as they may deem best the support of other Divisions or officers and committees of the A.B.A. as well as officers and committees of the several State Bankers Associations throughout the country to jointly work for a complete repeal of that compulsory provision of the 'Banking Act of 1935.'

On April 25, 1939, the Executive Council of the Association approved a report of the actions of the Administrative Committee, which specifically had instructed the Committee on Federal Legislation to endeavor to bring about the repeal of that provision of the Banking Act of 1935 which required compulsory membership of insured banks in the Federal Reserve System.

IV. EARNINGS AND INTEREST PAYMENTS

1. Are the earnings and profits of commercial banks of particular public interest? If so, in what respect? If so, evaluate those aspects of law and supervision which pertain thereto, indicating any desirable alteration of law and regulations.

No bank can perform its function of service to its community unless it makes profits and pays reasonable dividends to its stockholders. By establishing its ability to pay dividends it creates its ability to increase its capital through the sale of additional shares of stock when increased volumes of business make enlargements of its capital advisable. Through making earnings in excess of the amounts paid out as dividends the bank builds up its surplus and undivided profits which strengthen the resources of the institution and safeguard its depositors.

If the bank does not make profits it will surely suffer losses, for it cannot long conduct its affairs in exact equilibrium between earnings and expenses, and losses decrease the protection for depositors. The commercial bank has three chief classes of functions. One of them is that of assembling the savings of its community, which may be transformed into capital for business either by the bank or by the savers themselves through investments in bonds or mortgages. The second is providing the deposit currency of day-to-day business. The third is the function of bridging the gaps of time and credit in the local, national, and international exchanging of goods in the many links of the processes of production and distribution.

At every link of the processes of any buying or selling transaction commercial banks extend the necessary credits to farming, manufacturing, brokerage, wholesaling, retailing, transportation, communication, and service. In final analysis

it is the profit that the bank can make through these activities which enables it to continue rendering these essential services to its community.

Existing provisions of law and of supervisory regulations appear to cover sufficiently the accounting procedures by which commercial banks record their earnings. Such other factors affecting earning power as those relating to taxation, and to limitations of allowable interest charges, vary so widely in different states and localities that no general statements concerning them can be formulated.

1. (continued) Are earnings of commercial banks sufficient from the standpoint of the public interest? How do and how have they compared with the earnings of other types of businesses?

Data relating to the earnings of American corporations from 1927 through 1937 are to be found in Statistics of Income published by the Treasury Department. Those for member banks for the same eleven years have been compiled by the Federal Reserve System, and are published in its bulletins. The corporation data give balance sheet and operating items for about 400,000 corporations, while those of the member banks include reports of more than 9,000 institutions in 1927, but of only 6,341 in 1937, representing in the latter year 84 per cent of all commercial bank resources.

For the present purposes the figures used are those showing for each of the eleven years, and for groups of corporations, the percentages that their net profits or losses after taxes were of their net worth. The net worth is considered as being equal to total assets less notes and accounts payable, less bonded debt and mortgages, and less other liabilities. Net worth so computed is equal to the value of capital stock plus net surplus. In the cases of the banks the net worth is considered as being made up of the sum of the capital funds, including surplus and undivided profits. The results are shown in the following table:

Net Profits or Losses as Percentages of Net Worth

Year	Mining and Quarrying	Durable Goods Manufacturing	Chemicals and Petroleum Refining	Other Non-durable Manufacturing	Transportation and Public Utilities	Trade	Service	All Corporations	Member Banks
1927	0.70	6.35	5.63	6.76	5.33	5.73	4.36	5.69	8.66
1928	2.01	8.02	9.56	6.61	5.71	6.68	4.58	6.68	8.96
1929	2.94	9.74	10.29	6.39	6.50	5.13	4.26	6.47	8.75
1930	-.03	2.40	5.21	1.91	3.96	-.54	2.01	2.45	4.56
1931	-2.99	-2.82	1.11	-.18	2.28	-4.82	-2.61	-.82	.19
1932	-2.92	-6.88	.34	-2.21	.62	-7.74	-10.69	-3.08	-4.50
1933	-2.50	-1.59	1.33	2.96	.44	-.54	-10.71	-1.06	-7.26
1934	.74	1.71	3.92	4.19	1.46	2.89	-6.38	1.68	-4.45
1935	.71	5.37	5.89	5.70	1.59	4.27	-5.18	3.37	4.14
1936	2.18	8.72	7.12	7.78	2.86	7.24	-1.26	4.93	8.93
1937	3.60	9.20	6.86	5.46	2.74	6.04	.07	4.61	6.32
1927-37	0.45	3.77	5.14	4.14	3.10	2.41	-1.66	2.81	3.26

Note: Minus (-) indicates net loss.

For the eleven years from 1927 through 1937 the net profits of member banks, considered as percentages of net worth, were lower than those of corporations engaged in the three classes of manufacturing, and they were larger than those of the other corporations. The annual profits of the member banks during the first three years and the last two years of the eleven year period averaged 8.32 per cent on net worth. Their operating results for the six intervening years showed a loss amounting on the average to 1.22 per cent per year.

There would probably be general agreement among competent judges of such matters that the average profits of 8.32 per cent on net worth, made during the first three years and the last two years of the period, were adequate from the standpoint of the public interest. They would be considered adequate because such earnings are large enough to enable the banks to pay reasonable dividends on their capital stock, and to make some additions to surplus and undivided profits. Clearly the earning results of the six intervening years, which amounted on the average to an annual loss of 1.22 per cent on net worth, were not in the public interest. The average profit for the eleven years, amounting to 3.26 per cent annually, was so low as to be inadequate, and not in the public interest.

Banks need a period of substantial earnings to strengthen their capital positions and attract new capital from other sources.

Supervisory authorities have continually emphasized the necessity of providing and maintaining adequate capital in banks, and on many occasions have pointed out that the volume of banking capital has been declining in relation to total assets or deposits. If banking profits are too low, the ability to introduce additional capital of new investors and to accumulate surplus from operations is seriously curtailed, to the detriment of public interest.

2. *Would you favor a requirement for publication of all earnings statements submitted to the supervisory authority?*

There would seem to be little valid evidence in support of a suggested requirement that all earnings statements submitted by banks to supervisory authorities should be published. The weight of argument against such a proposal seems so far to outweigh that which can be adduced in its support as to lead to the conclusion that the suggested change would not be in the public interest.

Earnings statements submitted by banks to supervisory authorities set forth in detailed figures the chief items of current operating earnings and those of current operating expenses. They give details of recoveries, profits, losses, and depreciation, and they show the items of additions to, and deductions from, undivided profits. It is clearly in the public interest that information about the end results of these multiple elements of operations involving earnings, expenses, recoveries, and losses should be made generally available at relatively frequent intervals, and such information is now frequently published by almost all banks.

Results of the current operations of individual banks are matters of legitimate public interest, but the details of the procedures by which those results were attained would be of little or no value to the public. In many instances the publication of detailed information now furnished to supervisory authorities would result in disclosures of confidential matters which

might prove distressing and harmful to many individuals in the community without serving any useful and constructive purpose. Many reports to supervisory authorities require the listing of all losses on individual loans, and it must be true that in many instances the publication of such lists would prove harmful to many individuals, and helpful to few. The majority of depositors would not be able to interpret detailed statements understandingly, and that lack of understanding might at times lead to speculation and alarm, always a peculiar danger in banking.

While for these reasons it would not seem wise to publish the detailed earnings statements reported to supervisory authorities, there is much to be said for a standard form of earnings report to make public the major earnings results.

3. How should supervisory authorities determine the maximum permissible rate of interest payable on time and savings deposits? Should the power of bank supervisors to control interest paid on time deposits be a permanent or temporary power? What is the justification for this particular kind of price control?

Regulation Q of the Board of Governors of the Federal Reserve System prescribes for member banks maximum rates of interest of not over 2-1/2 per cent on savings accounts, not over two per cent on time deposits payable in 90 days or over, but within six months, and not over one per cent on time deposits payable within 90 days. The Federal Deposit Insurance Corporation has issued a corresponding regulation applicable to non-member insured banks. Regulations of banking departments in some states limit such interest payments on savings and time deposits to still lower rates.

Presumably the determinations reached by the supervisory authorities as to maximum permissible rates of interest payable on time and savings deposits should be based primarily on studies of the earnings and expenses of the banks under their supervision. The rates should be set so that a large majority of the banks would have reasonably adequate incomes left

after paying their operating expenses. The supervisory authorities should seek additional criteria for their determination of permissible interest payments through making studies of the income obtainable from portfolios of short and medium term federal securities, since these holdings are now setting the standards of return on a large portion of the earning assets of banks.

The control by the supervisory authorities over the interest payable by banks on time and savings deposits should be exercised as now through regulation rather than by being permanently embodied in a statute. Such control is still experimental in nature, and the experiment has not as yet been long enough continued to afford an adequate basis for reaching definite judgments as to its value.

The justification for this control is to be found in its history rather than in any well-defined tenet of economics or of the theory of money. Regulation Q came into effect after the banking crisis of 1933, and the principal reason for it was the recognition of the fact that excessive competition for deposits had developed among banks during the two decades prior to the banking crisis. In order to bid high for deposits banks had in many cases invested in high yield bonds of low quality and had overinvested, impairing their liquidity. The control of interest was introduced as a means of discouraging unsound practices which the banking crisis had made so evident. Whether this sort of control will prove out under future conditions remains to be seen. In particular it will be interesting to study the long term effect on savings habits.

3. *(continued) Should supervisors also have power to control interest rates charged by banks?*

Rates charged by banks should not be controlled through regulations imposed by supervisory authorities because each bank loan is a separate individual, imbued with characteristics which differentiate it from other loans. Loans differ widely among themselves as to the degrees of risk involved, the spans of time within which repayment may be expected, the likeli-

hoods of requests for renewals or extensions, and the amounts of clerical and supervisory effort which may be involved in servicing them. For these reasons the credits have varying values to the borrowers, and the appropriate charges for them can be judged fairly only by the loaning officers who can know and evaluate the conditions and circumstances which are involved. Maximum interest rates which may be charged by state chartered banks are controlled by state laws fixing legal contract interest rates, and national banks are subject to the same limitations under Sections 5197 and 5198, United States Revised Statutes.

4. Can you visualize any possible developments which would render inadvisable a continuation of the present prohibition on payment of interest on demand deposits? Please enumerate and discuss. What, in your opinion, are the chief justifications for the prohibition at the present time?

It is not now possible to foresee developments which would make it advisable for banks to return to the practice of paying interest on demand deposits. Under present conditions such payments would be not only imprudent, but practically impossible. In 1939 the payment by member banks of interest at the rate of one per cent on their demand deposits would have consumed the entire net profits of those banks, and of course would have involved the disbursement of parts of the capital funds of great numbers of those institutions. In the same year the payment of interest on the demand deposits of the member banks at the rate of one-half of one per cent would have more than consumed all profits after dividends. We cannot foresee how long such conditions are likely to continue, and so it is not possible to visualize developments which would justify a return to the practice of paying interest on demand deposits. The principal justification for the present prohibition against such payments is inherent in the existing impossibility of making them.

5. Does the question of bank service charges need legislation or governmental regulation? Is it in the public interest to

promote or discourage competition among banks in such charges?

Data published in the Federal Reserve Bulletin afford information about service charges of member banks in the years beginning with 1933. The income from such charges has been steadily rising during the seven years from 1933 through 1939. In the first of those years the service charges of all member banks amounted to a little more than 20 million dollars, and by 1939 they increased to over 54 millions. The following table shows for the seven years the percentages that the service charges of all member banks were of the total current earnings, and the percentages that they were of total deposits.

Year	Per cent Service Charges were of Current Earnings	Per cent Service Charges were of Total Deposits
1933	1.67	0.08
1934	2.22	0.09
1935	2.95	0.10
1936	3.10	0.10
1937	3.41	0.11
1938	3.97	0.12
1939	4.20	0.12

Service charges contributed less than two per cent to the current earnings of all member banks in 1933, and they have increased so that they contributed more than four per cent to current earnings in 1939. In general they have amounted to about one-tenth of one per cent of total deposits.

There would seem to be at present no need for legislation or governmental regulation with respect to service charges. Similarly it would seem to be at present not in the public interest either to promote or discourage competition among banks in such charges. This competition is an assurance against the imposition of unfair charges. These charges are a feature of banking which is still in the process of rather rapid evolution and are being adjusted to the actual costs of the service. The banks appear to have benefited from them, the public is accepting them without complaint as a fair charge for service rendered, and serious abuses do not seem to have developed. It would seem to be in the public interest for supervisory authorities to report on them and to study their development, but not as yet to intervene with attempts to regulate them.

V. BANK ORGANIZATION AND STRUCTURE

1. Indicate in detail what, if any, changes you think should be made in existing law which affects the banking structure of the country; that is, branch banking, unit banking, group and chain banking, bank competition, concentration of banking power.

2. Give in detail your appraisal of the following: (1) Nation-wide branch banking; (2) Federal Reserve district-wide branch banking; (3) "trade area" branch banking; (4) prohibition of further extension of branch banking; (5) dissolution of existing branch banking; (6) prohibition of further extension of group and chain banking; (7) dissolution of existing groups and chains; (8) prohibition of the concentration of more than a given percentage of the bank deposits and offices of a given area under common control.

As to the several points pertaining to branch, group and chain banking raised in these two related questions, we submit the following abstract of the actions taken by the American Bankers Association relative to these matters through resolutions adopted or reports approved at its annual conventions:

1913. The convention approved a report of the Association's Currency Commission which among other things had approved a section of the then pending Federal Reserve Act providing authority for national banks to establish foreign branches.

1916. The convention adopted a motion to the effect that the "Association go on record as opposed to domestic branch banking." The convention also adopted a supplemental motion that the Association "go on record advocating the introduction of the amendment to the National Bank Act, which would prohibit national banks absorbing state banks with

branches, thereby accomplishing in an indirect method something that cannot be accomplished by a direct method."

1922. The convention adopted the following resolutions:

Resolved, by the American Bankers Association, that we view with alarm the establishment of branch banking in the United States and the attempt to permit and legalize branch banking; that we hereby express our disapproval of and opposition to branch banking in any form by state or national banks in our nation.

Resolved, that we regard branch banking or the establishment of additional offices by banks, as detrimental to the best interests of the people of the United States. Branch banking is contrary to public policy, violates the basic principles of our government and concentrates the credits of the nation and the power of money in the hands of a few.

1923. The convention adopted the following:

To the end that ways and means may be devised to carry out the spirit of the resolution about branch banking passed by this Association last year, it is recommended to the Executive Council of the Association that it authorize the appointment of a committee with suitable appropriation to safeguard the present unit system of banking.

1924. A resolution of the convention urged enactment at the earliest moment of the then pending amended McFadden bill, which sought to amend the Federal Reserve and National Bank Acts with respect to branch banking. The executive officers and Federal Legislative Committee of the Association were instructed to aid to the utmost in the enactment of the bill. The proposed amendment to the National Bank Act thus approved by the convention prohibited any national bank from establishing a branch in any state which, at the time of approval of the proposed law, did not authorize state banks to have branches; and in those states which permitted state banks to have branches, national banks were to be permitted, upon application to and approval of the Comptroller of the Currency, to have branches only within the corporate limits of the municipality in which they were located, subject to the further limitation that in cities of 25,000 to 50,000 population only one such branch could be established and operated, and only two such branches in cities of from 50,000 to 100,000 population could be established and operated. The proposed amend-

ment to the Federal Reserve Act approved by the convention required any state bank applying for membership in the Federal Reserve System to relinquish any branches located outside its home city limits; any applying state bank located in any state which, at the time of approval of the proposed law, prohibited state banks from having city branches or whose laws did not grant specific authority to have such branches, was required to relinquish any such city branches which it may have had in operation; and no state member bank was to be permitted to establish any city branch in any state which, at the time of approval of the proposed law, prohibited state banks and trust companies from having city branches or whose laws were silent with reference to the authority to have city branches.

1926. In a special session called to consider the branch banking question, the convention recommended to Congress the final enactment of the McFadden National Bank Bill, H.R. No. 2, with the following restrictions on branch banking:

First, that no national bank be permitted in any state to establish a branch beyond the corporate limits of the municipality in which the bank is situated; second, that no national bank be permitted to establish a home city branch in any state which does not at the time of such establishment permit the state banks to establish branches; third, that no state bank be permitted to enter or to retain membership in the Federal Reserve System if it has in operation any branch which may have been established after the enactment of H.R. No. 2 [McFadden National Bank Bill] beyond the corporate limits of the municipality in which the bank is situated; fourth, that no branches which may have been established after the enactment of H.R. No. 2 beyond the incorporate limits of the municipality in which the parent bank is situated, be permitted to be retained when the state bank converts into or consolidates with the national bank, or when two or three national banks consolidate.

This constituted a revision of policy. Whereas the resolution adopted in 1924 was intended to confine branches of national banks to states which permitted branches for state banks at the time of enactment of the proposed legislation, under the 1926 resolution national banks would have been able to establish city branches in those states which, after

enactment of the federal legislation, passed laws permitting establishment of state bank branches.

1929. The convention took cognizance of the multiple banking question in a resolution stating that "new economic forces are actively at work which are vitally affecting our present banking systems both National and State and the trend towards group and chain banking is a matter of vital concern and of far reaching importance to National and State bankers alike"; that "suggestions have been made looking towards an extension of branch banking in the National Banking System and the Comptroller of the Currency has expressed views in favor of branch banking which may lead to the appointment of a Congressional Committee to investigate the subject," and that "we believe all classes of membership in the American Bankers Association should be represented in any further study of the matter to the end that sound conclusions may be reached as to what system or systems would best serve the economic needs of the country." The resolution instructed the Economic Policy Commission of the Association to investigate this question, to represent it in seeking cooperation with any committee which might be appointed by Congress on the subject, and to watch all developments in the interest of the members of the Association.

1930. The convention adopted a resolution recognizing certain economic changes and the desirability of limited branch banking. The resolution stated:

The American system of unit banking, as contrasted with the banking systems of other countries, has been peculiarly adapted to the highly diversified community life of the United States. The future demands the continued growth and service of the unit bank in areas economically able to support sound, independent banking of this type, especially as a protection against undue centralization of banking power. Modern transportation and other economic changes, both in large centers and country districts, make necessary some readjustment of banking facilities.

In view of these facts this Association, while reaffirming its belief in the unit bank, recognizes that a modification of its former resolutions condemning branch banking in any form is advisable. The Association believes in the economic desirability of community-

wide branch banking in metropolitan areas and county-wide branch banking in rural districts where economically justified.

The Association supports in every respect the autonomy of the laws of the separate states in respect to banking. No class of banks in the several states should enjoy greater rights in respect to the establishment of branches than banks chartered under the state laws.

1932. The convention adopted the following branch banking resolution:

The American Bankers Association is designed and administered to give organized representation to the many diverse and at times even conflicting interests involved in the various phases of banking. For this reason the different divisions have been set up to give opportunity for the study and expression of views and the taking of suitable action regarding problems affecting the functional and charter interests of all types of banks, subject to the direction of the General Convention.

Whenever there arise broad questions of policy the carrying out of which may be beneficial to one and perhaps detrimental to another group of members or which may involve the statutory state or national rights and privileges of any banks, the Association feels that it should not attempt to commit our membership as a whole to any rigid line of action but should instead refer such questions in each case to the divisions which have been specifically created to specialize in particular aspects of banking operations and policy.

It is recognized that the subject of branch banking has become a question of such a highly controversial nature as between banks operating under various conditions that the Association as a whole feels it should not attempt at this time to formulate a definite attitude aimed to commit all types of bankers on this many sided question.

We believe, therefore, that any expression and action on branch banking should be left to the specialized consideration of the various divisions.

The Legal Department of the Association in a memorandum dated May 20, 1937, interpreting this action, stated that the "resolution withdraws from positive position opposed to branch banking," and that "any action relative to branch banking was specifically left to the specialized consideration of the various divisions." The memorandum also held: "This resolution delegated to the various divisions the right to take independent legislative action between sessions of the Convention and in effect suspended during the interim all by-laws giving the standing committees of the American Bankers Association jurisdiction of the subject."

1934. The convention approved a report of the Association's Special Committee on Proposed Revision of the Banking Laws. This report recommended continuance without change of the branch banking section of the Banking Act of 1933, the effect of this provision being the authorization of statewide branches for national banks in states in which the laws specifically permitted such branches for state banks. This action of the convention was interpreted in a memorandum of the Legal Department, dated May 20, 1937, as being a revocation of the authority granted to the divisions by the convention of 1932 regarding branch banking policy. The special committee's report also approved in principle the sections of the Banking Act of 1933 which regulated group banking by requiring holding company affiliates of national banks and state member banks to obtain voting permits from the Federal Reserve Board and to make reports and submit to examinations, but recommended that such reports and examinations should be made discretionary on the part of the appropriate supervisory authority.

1935. The convention approved the report of the Special Committee on the Banking Act of 1935, which included approval of the branch banking section amended to extend seasonal bank branches to resort communities.

1937. The convention adopted a resolution supporting the autonomy of state laws on branch banking and limiting branch banking privileges to state lines. The resolution stated:

We favor the preservation and continuation of the dual banking system by which banks are free to operate under either state or national charter. We also believe that the system of unit banks has been peculiarly adapted to the highly diversified community life of the United States. However, many of the states now authorize by law the operation of branch banks. We believe that national banks should, as they do now, continue to enjoy an equality with state banks of branch banking privileges within those states. The Association supports in every respect the autonomy of the laws of the separate states with respect to banking. We reiterate our belief that no class of banks in any state should enjoy a greater right in respect to the establishment of branches than banks chartered under state laws. We are definitely opposed to any proposal or device looking to the establishment of branch banking privileges across state lines, directly or indirectly.

1938 and 1939. The conventions reaffirmed the 1937 resolution.

1940. The convention reaffirmed the resolution of the three preceding conventions and further resolved that:

We favor such action in the discretion of the officers and committees of the Association and within the scope of the Boston Resolution [1937] as will prevent any further extension of banking contrary to the above principle.

We have no changes to suggest in existing law affecting the banking structure of the country in respect to bank competition or concentration of banking power, referred to in the latter sections of questions 1 and 2, above. Present laws providing for the dual banking system, for branch and unit banking in keeping with economic requirements, and for limitations on concentration are effective and adequate in this regard. Prohibition of the concentration of more than a given percentage of the bank deposits and offices of a given area under common control, as mentioned in clause (8) of the second question, is not called for. In all areas there is banking competition appropriate to the business requirements presented. There is no monopoly in the banking field.

3. Even if no changes are to be made in the Federal law with relation to banking, should that law be rewritten and codified with a view to clarity and removal of ambiguity? If so, submit a rough outline of such codification and indicate at what points the present law is most in need of clarification.

For reply to this question we refer to our reply to question 2, section II, subdivision F.

4. What, if any, merit do you see in the proposal that certain assets be segregated in savings departments to offset time and savings deposits?

Total individual and business deposits in the 15,000 banks of all classes in the United States aggregated about 56 billion dollars as of June 29, 1940. Of this total, 26 billions were classified as time and savings deposits. This is 46 per cent of the total. Deposits of this class were held in 46 million accounts.

Of the total number of banks some 550 were mutual savings banks. They held 11 billion dollars of the savings deposits in 15 million accounts. These accounts are strictly of a savings and thrift nature and this is the only type of deposits which the mutuals accept. They are invested in accordance with provisions looking toward stability. The type of assets of mutual savings banks is thus representative of savings deposit liability.

The non-mutual banking institutions, that is, the national banks, state commercial and stock savings banks, trust companies and private banks numbered 14,470 on June 29, 1940. It is to these banks that the question of segregation applies. They held approximately 15 billion dollars in savings and time deposits in 31 million accounts. They also held the individual and business demand deposits of the country, aggregating 30 billion dollars. Among them practice as to segregation varies.

In several states segregation of certain assets to offset time and savings deposits is in effect, either through statutory requirement or permission. This practice has been mandatory in California since 1929 and is characterized by a leading banker there as having resulted in great public convenience and advantage. The California statute provides for the complete departmentalization of banking by requiring that savings, commercial and trust business be coordinated under one corporation, but that each be kept separate and distinct in capital structure, deposits, investments and records, as though each department were an unrelated bank. In case of liquidation the depositors in one department do not participate in any loss which may arise from conditions in another department. It has been stated that, in favoring this form of segregation, the California legislature took the stand that savings depositors are primarily interested in safety, and that when savings funds are not segregated, but are commingled with commercial money lent for business purposes, they become subject to the credit hazards of commercial loans and lose some of the safety factor provided by the type of investments permissible for savings deposits.

On the other hand, segregation has been deemed unsuccessful elsewhere. After a trial, the Michigan state legislature repealed in 1937 the section of the banking law providing for the segregation of savings and demand deposits. The report on which this action was based pointed out in part that repeal was proposed for the reason that the segregation theory did not operate as intended during the bank crisis, in that the commercial departments of banks generally were liquidated with better results than those obtained in their savings departments whose deposits were invested in slow assets. It was also pointed out that while savings assets were segregated and invested for the most part in capital obligations, each savings deposit was in fact a demand deposit; also, regulations requiring thirty to ninety days' notice of withdrawal proved ineffective, this report found, since such notice was equivalent to announcement that the bank was not in a position to pay its savings deposits in full and "failure invariably resulted." However, bankers in other states, notably Connecticut and Virginia, report that putting time deposits on a definite time basis had proved a salutary measure.

The basic aim sought in legal regulation and banking practice relating to deposits is the maintenance of their security and availability to the depositor in accordance with his contract with the bank. While segregation theoretically has much in its favor as against the policy of commingling commercial, savings and time deposits, and is successfully in practice in some areas, we do not believe it is applicable as a nationally imposed practice since in the light of experience in other areas it is not deemed desirable. Sound banking practice normally protects all types of deposits adequately. Furthermore, the institution of deposit insurance reduces the need to give consideration to this proposal.

5. *Did benefit or harm arise from divorcing banks from securities companies and prohibiting banks from doing securities business?*

We agree in principle with the view that the functions of

commercial banking and investment banking constitute distinct types of financial service, that the attempt to combine them under a single institution created relationships and practices which were not in the best interests either of banking or of the public, and that the divorce of securities companies and business from commercial banking was a salutary measure.

In the period since this measure was put into effect, the volume of capital financing has been relatively small due to subnormal activity in many sources of demand for capital. Therefore there has been no conclusive test as to whether the present investment banking mechanism, from which the capital resources and facilities formerly made available through commercial banking are excluded, would be adequate to carry the volume of capital financing formerly associated with periods of high business activity and essential to the industrial progress of the country.

When the Banking Act of 1935 was under consideration and there were suggestions that banks might be permitted to do pure underwriting (without selling), the Association's Committee on Banking Studies prepared a report setting forth lines along which such a change in the law might be formulated. These recommendations were approved by the Association's Administrative Committee, but were not brought forward since the question did not come up for consideration. We believe the position taken in that report might be considered at this time. The report is as follows:

The Committee has considered the possibility as suggested by leading industrialists that national banks might be appropriately authorized to render the same assistance to industry in financing its needs through the issuance of investment securities as such banks are now rendering to the United States government in connection with the issuance and flotation of its obligations. It seemed to the Committee that it would be possible to amend Section 16 so as to provide that national banks may contract to purchase investment securities (subject to the restrictions and requirements of law relating thereto) remaining unsold after a public offering. Any such amendment would not extend the limits of the present provisions of Section 16 relating to the purchase of investment securities by permitting national banks to originate the issues or to participate in the merchandising thereof to the public but would only authorize the banks to engage in what is technically known as 'true' or

the English type of underwriting. Legislation of this type would enable national banks substantially to aid industry in financing capital requirements as part of the national recovery program at a time when the investing public may be hesitant about purchasing even the most conservative of securities. Should any such legislation be enacted, it is probable that those concerned in the flotation of securities will more readily undertake to market worthwhile issues under government regulation pursuant to the Securities Act of 1933 in view of the fact that they will have the assurance of a secondary market during times when the confidence or resources of the investing public may not be at normal levels. Enlarging the powers of national banks to include the purchase of unsold allotments of investment securities would probably entail an amendment of the Securities Act of 1933 to exclude national banks from the definition of 'underwriter' therein contained when such banks act pursuant to authority granted by the suggested amendment of Section 16.

The Committee has also considered those provisions of Section 16 which limit the investment securities which a national bank may hold at any time to 10 per cent of any one issue unless the total amount of such issue exceeds neither \$100,000 nor 50 per cent of the capital of the bank, subject to the further limitation that the total holdings of the investment securities of any one obligor shall not at any time exceed 15 per cent of the capital and 25 per cent of the surplus of the bank. The Committee suggests that the foregoing limitations, especially the \$100,000 limitation, are somewhat inflexible in that they may approach or exceed, in some instances, a safe margin of the capital assets of the purchasing bank, and in other situations be unnecessarily diminutive when compared with the total capital assets of the institution.

The purpose underlying these provisions might be better served, it would seem, were a limit equal to 10 per cent of the investing bank's unimpaired capital and surplus substituted for the \$100,000 fixed amount limitation. The use of a percentage rather than a fixed amount limitation is not without precedent in the National Banking Act. It will be recalled, for instance, that the limitation placed by R. S. Section 5200 (U.S.C. Title 12, c. 2, sec. 84) on the total liabilities of any one debtor to a national bank is 10 per cent of the aggregate of the bank's paid-in and unimpaired capital and surplus—not a fixed amount limitation.

Section 16 might also be amended to permit a national bank to make a limited investment in the stock of corporations which deal primarily in obligations of the United States government, and in bank and trade acceptances, and thus assist in the functioning of an important part of the machinery of the Federal Reserve Act. Section 25 of the Federal Reserve Act might be amended to permit investment in stock of the Bank for International Settlements. In either such case where a bank has made any such investment, its directors or officers should not be prohibited from acting as directors or officers of the institution in which the investment was made.

The above discussion has been limited to national banks. However, Section 5(c) of the Banking Act provides that 'State member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting and holding of investment securities and stock as are applicable in the case of national banks under' Section 16 of the Banking Act. If Section 16 relating to national banks is amended along the lines suggested herein, such action would confer the enlarged powers upon state member banks, so far as consistent with State law.

6. Do you have any suggestion for changes in the holding company and affiliates provisions of law?

We do not now suggest any basic changes in the holding company and affiliates provisions of law which were accepted in principle by the American Bankers Association at the time the Banking Acts of 1933 and 1935 were under discussion. As indicated in the reply to question 5 referring specifically to investment affiliates, we would not urge any change in the provisions divorcing companies of this type from commercial banking. Several detailed amendments incorporated in the Banking Act of 1935, suggested by the Association and others, appear to have corrected in the light of experience a number of defects in the law as originally drawn.

With respect to holding companies the present law gives the Board of Governors of the Federal Reserve System very substantial powers of control. The Banking Act of 1933 as amended prohibits a holding company affiliate from voting the shares of any bank which is directly or indirectly controlled by it (as defined in the act) unless a voting permit has been granted by the Federal Reserve board and is then in force.

The Federal Reserve board may in its discretion grant or withhold such voting permit as the public interest may require. In acting on the application therefor, the board must consider the financial condition of the applicant, the general character of its management, and the probable effect of the granting of such permit upon the affairs of the bank. The law specifies certain further conditions which must be fulfilled before a permit shall be granted, including an agreement concerning examination of the holding company affiliate

and all its controlled banks. The Federal Reserve board may in its discretion revoke the permit if it appears that the holding company affiliate has violated any of the provisions of the act or any agreement of the kind mentioned above.

It would thus appear that in the Banking Acts of 1933 and 1935 the Congress had given authority to the Board of Governors of the Federal Reserve System to examine, supervise, control and restrict holding company affiliates as may appear in public interest.

VI. CREDIT CONTROL

1. Is there any reason for altering the present number of members of the Board of Governors of the Federal Reserve System, their tenure of office, or annual salaries? What changes, if any, should be made in the requirements for eligibility for nomination to the Board?

The present number of members on the Board of Governors of the Federal Reserve System appears to be reasonably satisfactory. There should be enough members to reflect several points of view and to make it possible for at least two to be away from Washington at the same time, either on holiday or visiting Federal Reserve banks and banking groups in different parts of the country, while leaving an adequate number in Washington to operate. The present number serves these purposes reasonably well. Present tenure of office and eligibility requirements appear to be reasonably satisfactory, although the provision against reappointment is of doubtful merit and might well be reexamined.

Two principal weaknesses in the present set-up of the Federal Reserve board are: (1) the difficulty of making service on the board attractive; and (2) the frictions between the board and the Federal Reserve banks which have recurred at intervals almost from the beginning of the system. The first difficulty is due in part to the salary of \$15,000, which is less than that received elsewhere by men of the very high calibre required, and in part to the lack of any provision for pensions. While the salary is the same as that of cabinet officers, the circumstances are quite different. The cabinet officer usually serves for a relatively brief time and gains sufficient in public recognition to offset in part the financial sacrifice. A Federal Reserve board member, to be of value, must serve a considerable number of years, and, if he does, he finds himself at the

end of the period thoroughly divorced from his old occupation, a little too old to start new enterprises, and without provision for his old age. Many good men have declined appointments to the board. The provision that a Federal Reserve board member who retires without completing his term of service may not serve a bank for two years thereafter, a provision with some justification, has frequently stood in the way of acceptance of the post by experienced bankers.

The Federal Reserve board has been called and should be the supreme court of finance, and requires men of as high calibre as those on the United States Supreme Court. The salaries and pension provision should be equally generous. United States Supreme Court justices receive \$20,000 a year, and after ten years' service may retire at that salary. Similar provisions would be appropriate for the Federal Reserve board.

While some difference in point of view between members of the Federal Reserve board and the officers and directors of the Federal Reserve banks is perhaps unavoidable and not undesirable, differences have often gone beyond that point, and have at times impaired the operations of the system as, for example, in the early months of 1929.

The following causes may be suggested as partial explanation for misunderstandings within the system:

(1) The board membership has included men, in a number of instances, without experience in the complicated problems before them and out of touch with the day-to-day operations which they are called upon to supervise. Their approach to them has, therefore, sometimes tended to be theoretical or at times political.

(2) The directors and officers of the Federal Reserve banks have tended to reflect in some measure the commercial banking and business atmosphere in which they have lived and have at times failed to appreciate the broader national point of view and the practical political requirements of a democracy.

(3) The physical factor of distance between Washington and the operating units of the system results in one group's getting set in some opinion before being really aware of all the facts on the basis of which another group is forming a different view.

For these reasons a new approach is required to the question of the composition and powers of the Federal Reserve board and its relation to the reserve banks. The most promising suggestions for a solution of this problem would appear to be: (1) increasing the personal contacts between members of the board and executives of the reserve banks; and (2) the centering of principal policy decisions in a joint body.

The Federal Open Market Committee, as established by the Banking Act of 1935, is an approach to these two suggestions. Its operations have brought the Federal Reserve board members and executives of the reserve banks together at least four times a year and this has tended to reduce friction. Over a period still further results of this sort may well be anticipated. The full effectiveness of the mechanism is somewhat impaired by the fact that certain important and related policy-making powers, such as control over reserve requirements and margin requirements, are, under the law, still centered in the Federal Reserve board alone. The recent proposal by the several groups in the system that additional power over reserve requirements be placed by Congress in the Federal Open Market Committee would, if adopted, remedy this difficulty in part.

Another suggestion made from time to time in the past having much the same general objectives is that the Federal Reserve board itself should consist partly of reserve bank presidents serving in rotation, in addition to a smaller number of permanent members selected as at present. This proposal would bring to the board a number of men with practical experience in Federal Reserve administration, with intimate knowledge of financial conditions in their own communities. It would have the further advantage of giving the reserve bank presidents a more intimate acquaintance with

the national capital and with the requirements of the national approach to financial problems. The proposal would further dignify the position of the president of a reserve bank.

The general principle of organization to be sought would appear to be that the Federal Reserve System must have the greatest possible freedom from both political and commercial influences in the narrower uses of the terms, while at the same time retaining intimate contact with the flow of the nation's economic, political and social life. Neither a bank in a money center nor a Washington bureau alone can achieve this objective, but it can be reached only through a body in a midway position, which gains its freedom through a balance and harmony of interests rather than through complete isolation. This is difficult to achieve successfully and without friction. A gain has been made in recent years through a greater recognition of the problem. In the last analysis the effectiveness of any plan of organization will depend on the quality of the men who operate it and their understanding of the questions at issue.

This discussion would be incomplete without mentioning the present conflict in function and authority between the Treasury and the Federal Reserve System under the emergency monetary laws. Membership on the board is less attractive as long as this conflict exists.

2. Is it desirable to change the composition of the boards of directors of the Federal Reserve banks to give wider representation to the general public? Are any changes desirable in their method of appointment, or in their annual salaries?

The present composition of the boards of directors of the Federal Reserve banks provides a wide representation of the general public and the various kinds of banks. This is indicated by the following tabulation showing the occupations of the present boards of directors of reserve banks:

Occupations of Directors of the Twelve Federal Reserve Banks for 1941

Occupation or Industry	Number of Directors
Bankers (Class A Directors)	*36
Manufacturers	**29
Transportation	4
Utilities	2
Retail trade	6
Wholesale trade	3
Educators	5
Lawyers—industrial advisers	2
Farmers, ranchers and related occupations	6
Construction and engineering	2
Farm publishers	2
Cotton merchant	1
Real estate	1
Oil producers and refiners	3
Law book publisher	1
Investor in varied local enterprises	1
Textile commission merchant	1
Retired	1
Vacancies	2
Total	108

* 2 of whom are from central reserve city banks, 10 from reserve city banks, and 24 from country banks; 32 of the 36 directors are national bankers and 4 are state bankers.

** Includes manufacturers of paper and paper products; leather goods; hospital supplies; forge and steel products; building materials; cottonseed oil; chairs, safes and metal furniture; auto parts; cotton textiles; industrial equipment; hats; food products; pharmaceutical products; rubber boots and shoes; lumber; farm equipment; automobiles; steel; machinery, tools and vises; tractors, heavy equipment and diesel engines; and other products related to the principal businesses with which the directors are associated.

No changes appear necessary in the method of appointment of directors or in their compensation, which is now in the form of small directors' fees plus reimbursement for traveling expenses. The banks and the Federal Reserve board have taken very seriously the responsibility for selecting directors, and the boards of directors are constituted of men of the highest type.

It is of course difficult to find men with an understanding of the problems of central banking, but such understanding is gradually becoming more widespread. It seems unlikely that any other method of selection would prove more effective in obtaining men of ability and objectivity of judgment, and other methods might prove very much worse.

The greatest present handicap in getting the best men has been the feeling that the powers of the reserve banks are being diminished and taken over by the Federal Reserve board and the Treasury.

3. Would it be desirable to transfer the ownership of the Federal Reserve banks to the United States Government?

The Federal Reserve System should be insulated, both from political control and from commercial control. Under complete political control it is almost impossible to do the difficult things which a central banking system must do, such as raising the discount rate when prosperity is moving too fast. There is constant pressure for low rates for Treasury borrowing, for farm mortgages, etc. Under commercial control the system might be used for profit making purposes.

The reserve system as originally set up derived its independence from a midway position between government and commercial banking. President Wilson called it a "democracy of credit." Member banks own the stock of the reserve banks, but stock ownership in this case does not constitute control. The only voting power it carries is for the election of two-thirds of the directors, but half of this two-thirds must be business men, and these men do not regard themselves as responsible to the member banks but rather to the public generally. The government appoints one-third of the directors through a governmental body, the Board of Governors of the Federal Reserve System, which supervises all of the operations of the system, and whose approval is required in the appointment of the two chief executive officers of each reserve bank.

The chief advantages of stock ownership by member banks are, first, providing a group responsible for selecting qualified directors, and second, giving the member banks a greater incentive for interest and support. Credit policy has two problems: the making of wise decisions and their effective carrying out. The second requires the cooperative understanding of the banking and business communities. That is one of the sound reasons for a democracy of credit rather than dictation

from above. It therefore seems unwise to transfer ownership to the government.

3. *(continued) Should any change be made in the disposition of Federal Reserve bank earnings? In the rate of dividends on Reserve bank stock?*

The Federal Reserve Act has been changed several times as to the disposition of Federal Reserve bank earnings. The question whether any change should be made in the disposition of these earnings is academic at the present time because they are so small that anything earned in addition to expenses and dividends should be added to capital funds. As a matter of fact, it is our opinion that, in view of the small size of the present capital, the \$139,000,000 of surplus which was taken away from the Federal Reserve banks in 1933 as capital for the F.D.I.C. should be returned in some way to the reserve system.

The present rate of dividends on Federal Reserve stock should be continued. While the rate may seem high, it is desirable as a small inducement for banks to join the system. The question may be raised whether the need for earning these dividends puts undue pressure on the reserve system to keep its funds employed; the sum involved, however, is not large enough to have any considerable influence.

4. *Should the Secretary of the Treasury become a member of the Board of Governors of the Federal Reserve System? Should any other Government officials be added to the Board?*

The question of the membership of the Secretary of the Treasury on the Board of Governors of the Federal Reserve System has been debated for many years. We have now had experience both ways, with no conclusive results.

The argument in favor of his membership is that he possesses certain monetary powers—very large ones at present—and that coordination of Treasury and Federal Reserve policy is essential. The Secretary of the Treasury is, moreover, the natural link between the Administration and the Federal Re-

serve board; he is usually an able man who has at times been helpful in reaching sound Federal Reserve decisions.

The arguments against his membership are: (1) he is a member of the President's political family and the Federal Reserve board might be swayed unduly in political directions by his very considerable influence; (2) the Treasury is the country's largest borrower and should not control the country's greatest lender; and (3) the Secretary has a full time job of his own, and when he was a member of the Federal Reserve Board seldom attended meetings.

We favor continuance of the present law under which the Secretary of the Treasury is not a member of the Federal Reserve board. If this conclusion is adopted, however, it becomes essential, especially under present conditions, to arrange for frequent conferences with the Secretary. The Bank of England meets this problem through a "Treasury Committee" composed of representatives of both the bank and the Treasury.

We do not favor adding any other government official to the Federal Reserve board for the same reasons that we oppose membership of the Secretary of the Treasury on it. Furthermore, the arguments which support the Secretary's membership on the Federal Reserve board would not justify the inclusion on it of any other government officials.

5. Would the Reserve System be improved, if a single Reserve bank with necessary branches were substituted for the present 12 banks?

A single reserve bank with branches would not be desirable. The only logical place for such a bank would be in the nation's business and financial center, which is New York. It could not be operated practically from Washington. However, the prejudices against New York and its physical separation from the political capital would make that solution impractical. The present plan of twelve reserve banks supervised from Washington seems the best way out of this difficulty

and the best means of preserving the independence of the central banking system from both politics and profit-making.

6. *What is the present significance, from the standpoint of credit control, (a) of the regulations governing the eligibility for rediscount, (b) of rediscount rates? Does it appear likely that the significance of these regulations will increase materially in the near future?*

(a) Regulations governing the eligibility of paper for rediscount are at present important mostly in setting a standard of quality for the commercial paper which banks hold. Since borrowing is so limited, and since banks hold such huge amounts of government securities, eligibility of commercial paper is no longer important in limiting the amount of Federal Reserve bank credit. (b) The effect of changes in rediscount rates under present conditions is largely psychological. Since member banks are borrowing practically nothing they are not directly affected by any change of rates. However, a change in rates is an indication coming from well informed authoritative sources of a change in money conditions. For this reason any such change may have important consequences.

As long as excess reserves continue as large as at present, the significance of eligibility and the rediscount rates is unlikely to change.

7. *Is it desirable to increase the significance of eligibility regulations and rediscount rates? If so, would it be practicable to do so by selling bonds from the Reserve banks' portfolio in the hope that banks would thereby be put under pressure to rediscount?*

When it becomes necessary to exercise some control over credit expansion, as may well be true before long, some control over excess reserves will be necessary, and that will in turn give greater significance to the discount rate. The rate has always been an important influence in controlling over-expansion. It is likely to be important in the future. There is less likelihood that eligibility regulations will be important,

for banks have so many other means of access to the reserve system, especially through the use of government securities.

The sale of bonds by the Federal Reserve banks would be only partially effective in reducing excess reserves and putting the banks under pressure to rediscount, because the bond portfolio of the Federal Reserve banks is much smaller than the present volume of excess reserves. However, some sales of government bonds from the Federal Reserve portfolio have been desirable as a means of keeping government security prices from rising too far and becoming still more vulnerable to drastic declines.

8. *What is the nature of the tradition with reference to (a) interbank borrowing; (b) rediscounting at a Federal Reserve bank? Do the Board of Governors of the Reserve System, the Reserve banks, or the examiners encourage this tradition?*

(a) Banks have less reluctance to borrow from their correspondent banks than (b) to borrow from the Federal Reserve banks. There is, however, a considerable reluctance for banks to borrow at all. This is especially true when most banks have so much excess funds. It seems likely this would change with a basic change in money conditions.

The Federal Reserve System and the examiners have encouraged the tradition against borrowing in the case of banks showing a tendency toward over-expansion which forced them to borrow more than should have been necessary, but have not discouraged what might be termed normal borrowing to meet needs of business. The question of bank borrowing has hardly arisen in recent years because so few banks have found it necessary to borrow.

9. *Is this an appropriate time to formulate permanent rules of monetary policy? Should such rules be embodied in legislative enactment? If not, should the Board of Governors adopt such rules, and specify them in a public pronouncement? Are the present general objectives adequate?*

Problems of monetary policy arise in such different forms from time to time that it is never possible to determine in

advance exactly what will be the appropriate action at any future time. However it would seem desirable for the Federal Reserve System to study in advance general problems of monetary policy and to make tentative plans for dealing with these problems in somewhat the same way that the war plans division of the army prepares in advance for possible conflict.

As indicated above, because of the difficulty in knowing the form in which problems will occur, it is not desirable to embody rules of monetary policy either in legislative enactment or in public pronouncements of the Board of Governors of the Federal Reserve System.

The Federal Reserve Act has never contained an adequate statement of the general objectives of Federal Reserve policy, and proposals have been made from time to time for inserting in the law a statement of principles along the general lines suggested to the Congress by the Federal Reserve board, as reprinted in its pamphlet entitled "Monetary Measures and Objectives," issued by the board at Washington. This is not essential, however, because the objectives as set forth in the statement referred to are understood and used as its objectives by the Federal Reserve System. The gradual development of a philosophy resulting from experience and discussion is usually a better guide than legal enactments.

10. What are the present criteria of monetary policy? For legislative enactment or Board pronouncement, what are the merits of the following criteria, singly or in some combination? (Specify the combination.)

(a) Stability of prices:

(1) Index of general wholesale prices.

(2) Cost-of-living index.

(3) Nonfarm commodity prices.

(4) Any specially devised composite price index.

(b) A stable relationship between price indexes of various significant groups of commodities.

(c) A price level declining in accordance with increased efficiency of production.

(d) A slowly rising price level.

- (e) *Amount of unemployment.*
- (f) *An index of production.*
- (g) *An index of national money income.*
- (h) *Stability of foreign exchange rates.*
- (i) *Reserve position of Reserve banks.*
- (j) *Stable quantity of money or a secular increase in the quantity of money (including or excluding rate of turn-over of money).*
- (k) *Stable relationship among the various categories of income groups.*
- (l) *Prices of Government bonds.*
- (m) *Interest rates.*

The present criteria of monetary policy are perhaps best set forth in the statement of "Monetary Measures and Objectives," by the Board of Governors of the Federal Reserve System referred to in the previous answer. The important point in this statement is that there is no single guide which can be used in monetary policy, but conditions are so varied that action must be taken on the basis of an estimation of the whole situation and its direction of movement.

All of the economic indexes suggested in this question are of some value in forming a conclusion as a basis for policy determination, but no one of them is adequate as a single guide to policy. They are all useful as indications to be utilized in answering the question whether the situation calls for a policy of restraint, a neutral policy, or a policy of stimulation. No one of these criteria should be included in legislation or made the basis of a Federal Reserve board pronouncement.

11. Specify the action that would be appropriate on the adoption of any of the above criteria.

This is answered by the reply to the foregoing question.

12. Can fiscal policies (such as deficit or surplus financing, control of cash balance, choice of securities to be issued or retired, forms of taxation) advantageously be used as instruments of monetary credit policy? If so, can you suggest any

means by which fiscal policy and credit policy could be more closely coordinated?

Theoretically, deficit or surplus financing, control of cash balances, choice of securities to be issued or retired, and taxation may well be used as instruments of monetary credit policy. In practice, however, there are grave difficulties in using them. The elements of the budget, including taxation and appropriations, have to be planned far in advance, at a time when the requirements of monetary policy are unpredictable. Changes in these elements are dependent upon the action of Congress, and that in turn is dependent on political circumstances and cannot be counted on as an instrument of monetary policy. The control of cash balances and the choice of securities are more closely in the hands of the Treasury, though they are also subject to various exigencies of the Treasury financing program. In times past the Treasury has consulted with the Federal Reserve System as to the effect on the money market of action it might take, but the effects of action in these fields have been rather limited. In a situation such as the present, joint action of the Treasury and Federal Reserve System is necessary, but it is well to recognize the difficulties at the start.

A closer coordination of fiscal policy and credit policy is dependent mainly on two factors: first, the cooperation between the Treasury and the reserve system, and second, the prestige and influence of the reserve system in the government and elsewhere. In England the relationship between Treasury and central bank is extremely close, partly because the contacts can be so frequent. There is a "Treasury Committee" composed of representatives of both the bank and the Treasury which discusses problems of this sort. In this country there has been considerable coordination through the Executive Committee of the Federal Open Market Committee which has frequently met with the Secretary of the Treasury. On operating matters there is also coordination through the Federal Reserve Bank of New York which operates both for

the Treasury and the reserve system. In the last analysis the effectiveness of this coordination depends on the personalities concerned and their recognition of the problem. The prestige and influence of the reserve system might be improved by the suggestions made earlier in this report which would make service on the Board of Governors of the Federal Reserve System in the Federal Reserve banks more attractive to able men.

13. Is it possible for a policy of monetary ease to be carried too far in a period of depression?

Monetary ease may be carried too far in depression. This was illustrated in the brief depression of 1927 when an easy money policy stimulated speculation, and has been illustrated recently. Easy money has carried the prices of bonds to a level where banks and corporations have been timid about buying longer maturities and where the high prices have been so frozen that a reversal of the policy of ease is extremely difficult because of its effect on banks and other holders of bonds. A prolonged period of ease also may have a serious effect on the savings habits of the people. There is little incentive for savings in present interest rates. At the moment this discouragement to savings is being concealed by a flood of newly created bank credit, but in the long run the growth of the country and improvement of the living standard require savings and habits of saving.

A fair return on savings is also essential for those in the vast middle class who have been saving for old age. It is essential for endowed hospitals, universities, foundations, life insurance and pension funds, and similar institutions or funds if they are to continue their necessary service for the people. Life insurance companies, for example, have a vast volume of contracts outstanding computed on the basis of 3 per cent or higher rates. Lower rates over an extended period would be seriously embarrassing.

A still further danger of too easy money is its encourage-

ment of unsound fiscal policies, since borrowing is made so easy.

14. Would there ever be occasion when a policy of monetary ease should be limited, abandoned, or revised before the restoration of full employment, because of danger that the monetary expansion could not be controlled? Or for other reasons?

There are likely to be many such occasions. Every situation is a new and different situation, and it is almost impossible to formulate general rules in advance. Certainly full employment cannot be taken as a complete criterion of the need for a change in monetary policy. Over-expansion in some directions may be taking place before there is full employment, or speculative movements may be gathering such impetus that some early check is desirable. The monetary authorities must look at the whole situation, not at a single part.

15. What facts would indicate that a policy of monetary ease had gone too far? Have there been indications that a policy of monetary ease was carried too far at any time within the last 20 years? Was this an important factor in bringing on the depression of 1929?

While any judgment as to whether a policy of monetary ease had gone too far would have to consider the whole situation, the following indications would suggest too great ease:

1. Bond prices at such high levels that later serious depreciation was probably unavoidable.
2. A rate on commercial loans so low that it could not possibly cover the risk and hence loans involving risk might not be made.
3. A rate on savings deposits so low as to discourage savings.
4. The encouragement of excessive borrowing on securities which in times past has often reflected the difference be-

tween the rate on security loans and the rate of return on investments.

5. Excessive speculation of other sorts.

A policy of ease was probably carried too far in 1927 and acted as an undue stimulant to speculation. There is also good reason for believing that an easy money policy has been carried too far recently. While this has not resulted in speculation it has resulted in the other sorts of difficulties listed above.

16. Is it possible to check monetary expansion without at the same time initiating a contraction of business activity? Is it possible by such means to check price increases in any particular field (for instance in the stock market) without initiating a general contraction of business activity?

It is difficult but not impossible, though dependent on the character of the situation. Business is either moving in one direction or another, and the psychological factor is always important. A check to monetary expansion usually tends to bring about some contraction in business activity, but this may not be serious and may take only the form of a temporary readjustment. The reaction probably depends somewhat on the extent of the previous expansion.

In 1920 the expansion had gone so far that it could not be checked without a contraction. In 1923, on the other hand, a check to monetary expansion was followed by rather mild business contraction. In 1928 even vigorous attempts to check credit expansion did not work and did not affect the course of business, whereas in 1929 the expansion had gone to a point where the monetary check was followed by violent business contraction. The best general conclusion to be derived from these various illustrations would seem to be that the earlier the check is applied the less disastrous the consequences are likely to be; but here again each case is a problem by itself.

An answer to the second part of this question involves the

whole controversy of qualitative or quantitative credit control and no brief or certain answer can be made. The new powers for fixing margins on brokers' loans are designed to deal with a security speculation separately. Our experience with it is too limited to justify any general conclusions. In the past, movements of security prices have been closely linked with general business movements and the two are basically connected. It remains to be seen how far one can be influenced without affecting the other.

17. Why has the rediscount rate apparently lost its effectiveness? Is the discount rate likely to be of any influence in controlling the level of interest rates and the volume of business activity in the foreseeable future?

This was covered previously. The discount rate is less effective because member banks are not borrowing. On the other hand changes in rate still have some psychological effect as indicators of a change in money conditions and policy.

The discount rate is likely to have limited influence unless or until member banks are again borrowers.

18. What factors have been mainly responsible for the low interest rates which have obtained in recent years? What is likely to be the course of interest rates in the near future? Is there any considerable chance of a serious decline in bond prices and necessity for banks to sell bonds with resulting enormous losses to the banks and bank failures? What Federal Reserve policy would you consider appropriate in this connection?

The principal factors in low interest rates are: (1) imports of gold and silver resulting in considerable measure from the devaluation of the dollar and the silver buying program; (2) easy money policies of the Federal Reserve, Treasury and federal lending agencies; (3) lack of commercial demand for money.

Interest rates are likely to continue relatively low in the near future, but not necessarily as low as at present.

A serious decline in bond prices is unlikely in the immediate future because of the large excess reserves and the extensive powers of control over money rates exercised by the government. A serious decline is, however, possible in the future and might be brought about by an inflationary movement which would be a logical consequence of policies pursued in recent years in this and other countries. If inflation develops it might be necessary to institute measures of credit control which, in turn, would depress bond prices. The only other alternative might be a complete regimentation of economic factors.

The Federal Reserve System and other government agencies should begin now to get their houses in order so as to be prepared to face the foregoing eventuality. The following steps are proposed:

1. The repeal of the inflation provisions of the Thomas amendment of 1933 including the repeal of the power to issue greenbacks, to buy silver, and to devalue the dollar. The repeal of these provisions would again concentrate monetary policies more largely in the Federal Reserve System. The present divided authority is an obstacle to effective monetary policy.
2. The Federal Reserve System should be given additional authority to control excess reserves, probably in the form of power to increase reserve requirements under carefully considered safeguards and limitations. By gradual steps, including the sale of government securities and the raising of reserve requirements, the Federal Reserve System should, over a period, get the situation under better control. The longer the present policies are pursued the greater will be the shock when they are changed.
3. Further gold imports should again be sterilized if they again exert substantial upward pressure on excess reserves.
4. At an appropriate time gold coinage and gold certificates should be restored to circulation.

19. *What determines the magnitude of excess reserves held by banks? Are there important variations as to excess reserves in different types of banks?*

The factors in determining the magnitude of excess reserves are currently reported in the Federal Reserve Bulletin in the tabulation entitled "Member Bank Reserves, Reserve Bank Credit, and Related Items."

Yes, these variations are reported from time to time by the the Federal Reserve board. The following table shows the distribution of excess reserves between types of banks.

**Member Bank Reserves with Federal Reserve Banks
December 1940**

(Daily averages in millions of dollars)

Class of banks	Total reserves held	Required reserves	Excess reserves	Per cent held in excess of required reserves
Central Reserve Cities:				
New York	\$6,997	\$3,554	\$3,443	96.9
Chicago	1,142	666	476	71.5
Reserve Cities	4,096	2,208	1,887	85.5
Country Banks	1,815	974	840	86.2
Total	\$14,049	\$7,403	\$6,646	89.8

Source: Federal Reserve Bulletin.

In considering these figures, it should be noted that the New York City banks hold approximately \$3,800,000,000 of deposits of out-of-town institutions, a considerable part of which represents excess reserves which the out-of-town banks have preferred to place with their correspondents rather than with the Federal Reserve banks. Somewhat the same conditions exist in banks in Chicago and with many of the reserve cities. (See also answer to question 29.)

20. *What is the cause of the great volume of excess reserves? Is it likely that the banking system will return to a position where excess reserves will not exist? If so, describe the process by which this will most likely come about.*

The principal cause is gold imports, together with little commercial demand for funds.

The experience of history is that in the long run money which is available is put to use. Therefore, the only safe as-

sumption is that in the long run excess reserves will disappear, although without positive action it will take a long time.

The possible causes for a decrease in excess reserves would be:

1. Increase in currency circulation.
2. Increase in required reserves due to growth in bank deposits caused by deficit financing, commercial loans, or otherwise.
3. Gold exports.
4. Positive action by the Federal Reserve System in reducing excess reserves through the sale of government securities or increasing reserve requirements.

The most likely eventuality is that a change in this situation would be brought about by positive action of the monetary authorities in response to inflationary threats. A resumption of very active commercial use of funds, and rising currency circulation, flowing from an inflationary expansion, are also possible.

21. In the light of experience of the past 10 years, what can be said as to the influence of cheap money (a) on stock-market prices, (b) on commodity prices, (c) on the level of employment?

In the past ten years cheap money has not had its usual results on (a) stock market prices, (b) commodity prices, or (c) employment. This experience has demonstrated that the velocity of money is as important as its volume; that is, there must be confidence before the available money is put to work. It would be a mistake, however, to conclude that recent experience proves the ineffectiveness of cheap money. It simply proves that you have to have both *cheap* money and *active* money to produce the usual results.

22. What, in your judgment, were the causes of the marked increase in the ratio of the volume of time deposits to that of demand deposits which occurred during the twenties? Of the increase in the proportion of demand deposits during recent years? What changes, if any, in banking policy are ren-

dered necessary by major shifts in the proportion of time and demand deposits?

The rapid growth in time deposits in the 1920s reflected in part a transference of deposits from the demand to the time classification, and in part genuine savings reflecting high wages and a comparatively low cost of living, together with a fairly attractive rate of interest on time deposits and active campaigns by banks in soliciting accounts.

The recent increase in the proportion of demand deposits reflects, first, a very rapid growth of demand deposits due to gold imports and deficit financing, and second, a slow growth of savings deposits because of unattractive interest rates and large unemployment.

The recent shifts should cause concern as to the possible effects of low rates for time deposits on the savings habits of the people. We may be drifting toward a period when the commercial banks no longer do a savings business. It would be better to analyze that problem than to drift. We may find it desirable to try new forms of thrift deposits.

As far as monetary policy, as distinguished from banking policy, is concerned, movements of time deposits have less significance than those of demand deposits.

23. Is there any good reason for requiring a different reserve ratio against demand and time deposits?

The question of the reserve ratio against time deposits depends largely on the character of those deposits. If they are really demand deposits dressed up in another form, they should have the same reserve ratio as demand deposits. If they are true savings deposits having a very much lower velocity, however, a lower ratio is justified. There is considerable evidence for believing that time deposits now consist largely of savings deposits, and recent restrictions tend to make that constantly more true.

24. What are the causes of the relatively low rate of turnover of bank deposits in recent years as compared with the period of the middle twenties?

The low rate of turnover of bank deposits is due partly to the very rapid increase in the amount of deposits and partly to sluggish business and financial activity, reflecting general lack of confidence and fear of taxation, government punitive action, and business losses. Many foreign deposits are, of course, frozen.

25. In 1931 a committee of the Federal Reserve System recommended a plan under which the velocity of turn-over, as well as the volume of deposits, would be taken into consideration in computing reserve requirements. Please comment on the merits of this recommendation.

There is considerable theoretical justification for the proposal made by a committee of the reserve system in 1931, but there are two important objections. The first is its lack of simplicity. It is more difficult for people to understand, more difficult to compute, and the consequences are difficult to estimate over a period. In the second place, the plan would probably cause difficulty in serious crises; for crises often cause high velocity of turnover of deposits, and at such times the banks would be required to hold larger reserves just when they would be least able to do so.

These difficulties probably more than offset the advantage of having an automatic means by which in some measure reserve requirements might rise with business activity and so tend to put some pressure on the situation as expansion takes place.

26. Should the problem of excess reserves be dealt with now, or only after undesirable monetary expansion is under way? If no action to reduce reserves is now appropriate, should any legislative power necessary to control excess reserves be enacted now?

The experience of 1937 suggests that at a time when there is still unemployment it is necessary to proceed with caution in dealing with excess reserves or in taking other steps to guard against over-expansion, but on the other hand it is a sound

principle that control, to be effective without causing serious disturbances, ought to begin early. The answer probably is that it would be wise to begin now to get excess reserves under control, but to proceed cautiously in doing it.

In view of the above answer, it would be wise now to put our monetary house in order, including giving the reserve system additional power for the control of excess reserves as set forth in the answer to question 18.

27. *What are the merits and demerits of each of the following methods of dealing with excess reserves?*

- (a) *Raising reserve requirements.*
- (b) *Establishing different and high reserve requirements against additional deposits.*
- (c) *Relating deposit increases to an increasing ratio of capital to deposits.*
- (d) *Supplementing existing requirements with special requirements of reserve privilege bonds.*
- (e) *Sale of bonds by the Treasury or the Reserve System?*
- (f) *Other?*

(a) As set forth in the reply to question 18, this is one of the most effective ways of dealing with excess reserves. It has the great advantages of simplicity and adequacy. It has the disadvantage of placing large additional powers in the Federal Reserve System at a time when the banks are distrustful of additional concentration of power.

(b) The establishment of different and high reserve requirements against additional deposits involves taking the status at some given time as a point of departure, and so it inevitably involves discrimination against some banks in favor of other banks. Any adjustment for this difficulty involves serious administrative problems. It also involves a complicated computation constantly carried forward.

(c) There is no special logic in relating reserve requirements to the ratio of capital to deposits. The amount of capital a bank should have depends on the amount and character of its employed assets, which are far better measures of the

risks to be protected against than are its deposits. Any arbitrary assumption as to the ratio of capital to deposits would be discriminatory and inappropriate. Moreover, the computation of reserves on this basis would have the weakness that in boom times when restraint is necessary banks can readily increase their capital.

(d) Bond prices are too high already, and to give them an additional lift in this way would be objectionable. Since the object of reserves is to limit deposit expansion a requirement as to holdings of bonds does not deal with the real problem. It would put the banks still further in the hands of the Treasury in a wholly arbitrary way.

(e) As indicated previously, some sale of bonds by the Federal Reserve System is desirable, but the Federal Reserve System does not hold enough bonds to affect the situation materially, and it is desirable for the system to hold enough securities to earn its living.

(f) See the reply to question 18.

28. To what extent were the policies followed in the exercise of monetary powers by the Federal Reserve System and the Treasury's management of the inactive gold account in the spring of 1937, and the reversal of those policies in the autumn of 1937, responsible for the changes in business activity which followed them?

The policies of the Federal Reserve System and of the Treasury in 1937 probably were an influence in the money market and in the securities market, and through those channels upon business activity. Just how much responsibility they bear is a moot question, for other factors such as the rapid reduction of deficit financing, government warnings as to prices, an inventory boom and its liquidation, and rumors of revaluation of the dollar were also of great importance.

29. Would you favor the proposal that no inter-bank deposits, other than those with Reserve banks, should be permitted?

There has been built up in this country a system of banking based on correspondent relations between banks in different parts of the country. In a sense this system is a substitute for nationwide branch banking. City banks render a whole series of services to their correspondent banks, such as furnishing information, handling securities for them, making loans, and so on. They are compensated for these services largely by the maintenance of deposits. These deposits are utilized in the mechanism for clearing all sorts of transactions, many of which cannot readily be handled by the Federal Reserve banks. Any disturbance of this general plan of bank operations involves a radical change in the whole banking system without gaining any particular advantages, and would cause added expense for the correspondent banks. Many banks are not members of the Federal Reserve System and perforce must use city correspondents. There is no indication that the general plan of correspondent banking as practiced in the past has serious difficulties or weaknesses.

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