COLONEL JORDAN'S REMARKS INTRODUCING
Mr. Robert V. Fleming

Gentlemen:

Our guest speaker this morning is a gentleman on whose friendship and support we of the Army Industrial College count most heavily, and I say that advisedly. In the midst of all the multifarious duties imposed upon him he takes the time each year to come down here and discuss with us a problem on which he is an authority, -The Federal Reserve System.

He has been President of the Riggs National Bank for ten years - all during the period of the depression; he is a member of numerous bankers associations and is First Vice President of the American Bankers Association. We hope next year he is going to be President. He is Treasurer and Trustee of the Corcoran Art Gallery, Treasurer and Director of the Gorgas Memorial Institute; Treasurer of the Chamber of Commerce of the U. S., and Director and member of numerous business and social organizations.

But best of all, we of the Army and Navy have a tie in to him of which we are very proud. He is a Lieut. Comdr. in the U.S. Naval Reserve. It gives me a great deal of pleasure to introduce to you Lieutenant Commander Robert V. Fleming, U. S. Naval Reserve, who will speak to us on the Effects of the Banking Act of 1935 on the Organization and Operation of the Federal Reserve System.

Commander Fleming.

THE EFFECTS OF THE BANKING ACT OF 1935 ON THE ORGANIZATION AND OPERATION OF THE FEDERAL RESERVE SYSTEM, By Ro?? + V Fleming. Sept 17, 1935.

Thank you, Colonel Jordan. Gentlemen:

I am always happy to come here; I consider it a distinct privilege; I feel further that the work which is being undertaken by the Army Industrial College is a fine thing. In case of trouble we know the important part the Army has to play in cooperation with business and I feel that if we in the business field can contribute anything to making the task a little easier it is our duty to do so.

I have not prepared any set address; I feel the best thing will be for me to give you in an off-hand manner some of the high spots of the Federal Reserve System; give you an inkling as to the reasons for the proposed changes in the banking law, and tell you a little about the struggle in connection with the opposite poles of thought; a little about Federal deposit insurance; a little of the law and what it really means and what the broadened powers are. Please do not expect a polished address, but after I have gone into that I hope that the gentlemen present will feel free to ask any questions they like. I am not going to guarantee I will be able to answer the questions as highly an intelligent body as this may ask, but don't hesitate to ask whatever comes in your mind.

I know you have studied the Federal Reserve System. I want to point out in connection with it first, that while it is under Government law the system is self-supporting. There is not a nickel of the tax payers money used to support it. The new Board of Governors of the

Federal Reserve Board, their salaries, all expenses, etc., are paid out of the earnings of the system. Likewise it is true that all the expenses of the member banks are paid out of the operations of the system. As you know, the capital structure of the banks created by subscription to that capital of the member banks is 6% of their capital in surplus. The deposits of the regional banks are the reserve balances of the member banks and on that capital the Federal Reserve System operates, earns, pays dividends and expenses.

I am sure you are quite aware that there are three types of banks in our country, that is, commercial banks: the national banks, all of whom must be members of the Federal Reserve System; state banks that are member banks (they become members through voluntary action); and non-member banks chartered under state law that have not seen fit to become members. The great preponderance of the deposits of the country are in the member banks. The amount of deposits in the state non-member banks is small in comparison; therefore the bulwark and the control of our banking credit lies mainly in the Federal Reserve System although a great many of our troubles come through non-members. The supervision by state authority is not the same as Federal supervision. You must bear in mind also that in many states the office is a political one and there are not the safeguards concerning earnings.

To go into the reasons for the proposals for change in the Federal Reserve System I want first to take up with you the question of the Federal Deposit Insurance Act which has a bearing on the matter. That is known as Title 1. Following the bank holiday which was brought about as you are aware through the stock market crash, fear that gripped the hearts of the people, publicity of R.F.C. loans, runs started due in some cases to bad management and dishonesty, but it was mainly that the banks could not turn their assets into liquid cash as fast as the people wanted it. Something had to be done to restore the confidence of the mass of the people in the safety of their deposits. Guarantee of bank deposits had been tried out in Texas, in Kansas and in the Dakotas, and it proved a failure, but Congress felt that was the only way and that there should be insurance on deposits. Let me say here that each one of the Insurance Acts, we have had two now, was called Federal Deposit Insurance and they are federal only to the extent that they are under Federal law and the directors of the corporation are appointed by the President so there is therefore, Federal supervision. However, there is no government money in the insurance fund.

Congress enacted first, under the Banking Act of 1933, The Insurance of Deposit Act (this is more or less a misnomer because it is guarantee of deposits rather than insurance and there is no insurance in it). The first law provided for a temporary insurance fund to be followed after the first year with a permanent insurance fund. The reason for that was that they felt, in order to get money out of hoarding it was necessary that they bring all banks, or as many as would apply for insurance, into the corporation quickly without opportunity for full examination as to whether they could qualify. Therefore, all national banks automatically became members of the temporary insurance fund. The state non-member banks had to become members by January 1st, giving the corporation the opportunity of examining these members banks in a five to six month period. Those that could stand the test of solvency, and the only test necessary was the test as to whether or not their deposits were unimpaired, became members; those that could not, could not become members. Then it was the plan (and the second part was never carried out) for the national banks and state member banks to automatically become members by law, to be examined between January 1 and July 1 when the permanent law was to go into effect. The law provided that if a bank did not pass the test of solvency, the Comptroller of the Currency would put a received in that bank; and in the case of state member banks that could not stand the test, they were to lose membership in the Federal Reserve System. It was planned then that on the 1st of July 1934 all banks would have been examined by the director of the corporation and all those who could stand the test of solvency would be members.

The first insurance fund covered insured deposits up to $2500. And let me say here that $2500 insurance covers 96.80% of the depositors in the United States. The terms of the permanent plan in the Banking Act of 1933 were very unworkable. It was pointed out to Congress that it would not work but they were anxious to pass the bill and would not listen to those who knew its defects. The permanent plan provided for insurance of 100% to $10,000.; 75% of the amount between $10,000 and $50,000., and 50% above $50,000. Whenever the capital fund was depleted by losses the corporation should make an assessment of ¼ of

1% of the insured banks to replenish this capital and to make this assessment only if found necessary. So 97% of the deposits were covered 100% and when you raised the liability by insuring up to $100,000, you see what a tremendous amount of liability was assumed and what a tremendous burden would be thrown on the strong banks of the country to take care of the weaker banks. The liabilities were so increased that every bank knew in case of trouble the whole banking system could be swept away; the whole scheme would fall by its own weight by reason of the drastic provisions.

When Congress met early in 1934 those of us who knew this were able to prevail upon Congress to extend the temporary fund for an additional year in order that there might be time for study. As you probably know, when you get into dealings with Congress everything is a matter of compromise, not always sound sense or logic. You get so many different elements and unfortunately, there is only a small group in either House who know a great deal about banking and you get a cross-section that must be condensed before you can get legislation. However, Congress passed an extension of the temporary fund for an additional year. I failed to mention that the assessment for the temporary fund was ½ of 1%. They extended this for an additional year to raise the insurable amount to $5,000. The number of people insured was increased from 96.80% to 98%. You can see how much the liability was increased.

Under the terms of the temporary fund it was not planned to use the capital of the corporation unless necessary. The assessment brought in in the neighborhood of forty millions dollars. To date they have never had to use very much of that because the Government program has strengthened the structure of the banks and asset values have increased. As to the capital of the corporation, I made the statement that no Government money was in it. The Federal Reserve System has been founded and sustained entirely upon subscription of member banks, and through that a surplus was built up and it was provided that after that surplus reached a certain point 90% of the earnings would go to the Federal Government as taxes. Under the capital structure of the corporation one-half of the surplus of the Federal Reserve Banks becomes part of the capital. The Government was required to return franchise taxes which amounted to one hundred and forty million dollars so that together with one-half of the surplus and the assessment paid by members of the temporary fund the capital of the corporation became three hundred and five million dollars. That has been kept intact. It is Federal insurance as far as supervision is concerned but not as far as assets are concerned. They come from private sources.

This extension of one year to July 1, 1935, gave the Federal Deposit Insurance Corporation and the R.F.C. an opportunity to correct many of the weaknesses in banks in the country. Through enactment of the Act the R.F.C. was authorized to buy capital notes in some states in order to strengthen the capital structure. In the meantime the examination of all banks in the country brought to light knowledge of the condition of the banks never before known in this country. The Federal authorities knew the picture of the national banks but did not know the non-member bank picture. They were able through the sale of preferred stock to give the bank the right to sell it to shareholders; also to issue common stock, to correct the capital structure of many of the banks, and the banks were made stronger than ever before. Some took stock out so they would have property right, and as fear left the people deposits flowed to the strong banks and in some cases their deposits doubled. It is the usually accepted theory that there should be retain of capital of somewhere around one to ten, i.e., $1. of capital funds as additional protection to the depositor to every $10. of deposit.

In that years period they did have an opportunity of strengthening the capital structure of the banks. There are no statistics on hand so that you can figure whether the insurance of deposits can be worked out on a sound basis but we believe that the new law that has now been drawn probably gives the country as workable a piece of machinery as can be had if the directors of the corporation exercise the proper strength and I emphasize that because there is much importance to be placed on the strong hand that is used in handling the corporation. We believe under the present provisions we will have ample funds to take care of an emergency and the assessment is as low as can be made and still build up a sufficient reserve.

In connection with the new insurance law, the permanent law, we ran into a great deal of trouble with this. It did not look like the permanent law would go into effect. Only about three days before July 1st Congress gave us another extension of sixty days in order that changes could be made. We missed a very disastrous situation just by a hair. The American Bankers Association had the finest sort of cooperation from Mr.

Crowley and the associate directors. They recognized that some of the group were looking at it from an unselfish standpoint and trying to get something constructive. Those of us who had given it deep thought recognized that in the minds of the country this is not the time to eliminate the question of insurance. We have got to see if it cannot be made workable. In the House of Representatives they were insistent on an assessment of 1/8th of 1%, but a great many of the small country banks could not have paid it. The bank would have to absorb its own losses and pay this too and a great many could not possibly have paid it. We, of course, supported the proposals of the F.D.I.C. which was for 1/12th of 1%, which finally prevailed. That law raised one million dollars this year for the corporation. There is a provision in it that in the event the capital funds plus assessments are not sufficient the R.F.C. is required to buy debentures up to two hundred and fifty million, and if not, then the Treasury must buy them. In case of a great depression again the people's money would be protected and Government money would come into it and there would be time to readjust assessment and work out how the money could be paid back. There is no question but that 1/12th of 1% will make the funds safe.

Congress insisted that any bank could become a member of the fund on this old basis of solvency; just $1. of capital was enough. We have known that part of our problem was the easy charter of the state banks. A group could organize a bank where there was no economic necessity and make it a competitor of a good bank, wrecking the bank and themselves.

We had thirty thousand banks in the country and we do not want to see a repetition of that. There was no reason to have competitive banks or competitive branches where there was no economic necessity.

Well, the House stated that any bank could come in that was solvent. We supported the Federal Deposit Insurance provision which states there must be some factors taken into consideration. I will read that:

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In other words, it gives the Federal Insurance Corporation power to look into the necessity of a bank before admitting it to the fund. If there is a need for it the directors of the corporation will grant a charter. That will prevent chartering a whole lot of small banks that would start up and wreck other banks, become a drain on the fund and shake the confidence of the people again. They have other powers such as the right to examine all members of the insurance fund and suspend or expel them for unsound practice after warning and after a hearing. That is very desirable. They also have power for a limited period to buy the assets of a bank or guarantee assets in connection with the consolidation of two banks. As an illustration It is perfectly possible that where the deposits are impaired the capital fund was wiped out. If the capital is intact you can put in more, but you can't put in more if 10% of the deposits have been lost. This gives the corporation the right to go in and buy those bad assets. That is better than to put a receiver in the

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bank and cause suffering and unhappiness to the borrowers in the bank. They can buy these assets; they make take a loss but the deposits will be intact and new capital can be put into the bank and it would probably be successful.

The power to liquidate assets is another power. A bank might come to us and say "We want you to take over the bank". We might make an examination and say we feel that only 90% of the assets are good. They would be in a position to guarantee the balance if we took it over and a forced liquidation would be obviated. They are more important than assessments into the fund.

So much for Federal Deposit Insurance. Let me go into the question of amendments to the Federal Reserve Act. Before Congress had gone very far it was generally understood this last year that there would be no amendments to the Federal Reserve Act; that the only changes would be the Federal Deposit Insurance Act and certain amendments to the Banking Act of 1933 that were necessary to clear up many difficulties. The pressure became very great, with Father Coughlin and others speaking about monetary control. Let me tell you what they were driving at. The pressure become so great that it was necessary to make some changes. These people advocated 100% monetary control on the theory that the people of this country should have credit only to the extent that the Government feels they should have it in order that the Government may control whether business should go up or be contracted. Their proposals centered around the thought that deposits of the country must be put in private banks - that 100% be placed in them and banks would only have time deposits to loan. That would mean that if a borrower went to a bank for a loan the bank would have to go to the central monetary authority and rediscount the paper and if credit was too great they would probably deny the loan. It has this fault it gives the strongest political control to the party in power over the people of the country. No one could enlarge his plant or do anything else if certain powers said he could not have the money. That is back of this insistence on monetary authority. They claim that during the time of emergency the Federal Reserve Board failed to contract credit. Our expansion of credit was on stock exchange collateral. They overlooked the fact that in the 1933 law it gives power to limit the credit on stock and bond collateral. They clam that the Federal Reserve Board should have raised reserves and rediscount rates. It is doubtful is raising the rediscount rates would have had any effect. They had power under the law to raise reserves by declaring an emergency in the United States; the fact that it puts the President on the spot in declaring an emergency nullifies it. Those were the reasons back of the pressure that brought about those proposals.

Governor Eckels made the following proposal he set up machinery which would give centralized control that was practically equal to it. First of all he provided that governors of the regional banks before taking office would have to be confirmed by the Federal Reserve Board. If a man has to be confirmed every year the human equation comes in and if he does not follow the policy of the Board he loses out, so any individual thought or action would be eliminated. He provided that the open mark

(under the old law this consisted of 12 representatives who of regional banks) had the power to recommend purchase or sale of bankers acceptances or U. S. bonds. After they met they had to submit their findings to the Federal Reserve Board. It could exercise veto power. In the old law this open market committee consisted of twelve representatives who were required by law to meet at least four times in Washington and submit their findings to the Federal Reserve Board. The Board could say "no, we won't approve it " and that veto power of the Board did make rather cumbersome machinery. If the Board approved the recommendations of the open market committee either to buy or sell, then any one of the twelve regional banks had the right to withdraw within thirty days by filing notice with the Federal Reserve Board. The machinery was cumbersome and it meant that eight men had to pass on a case before the whole thing could be undertaken.

Governor Eckels proposed that that all be done away with but that it have an advisory board. An advisory board can recommend until it gets blue in the fact but the advice doesn't have to be taken. It was necessary that the viewpoint of the various regions be expressed but we know that no matter how highgrade a man is, if he is appointed for a long term in Washington he loses touch with the conditions back in the country and get a different attitude which is not for the best interests of the nation. He did not like the proposals. He also proposed they be given three powers: the power of open market; power to raise reserves without limit either by reserve districts or in the three classes of cities, or by any one of those classes. Hence the Federal Reserve raise reserves without limit on the banks in the centr

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They also had power in the open market, which was a very important power, of giving the open market committee the right to buy directly from the Federal Government. That last power would have meant that if the Government went on a program of spending that could not be supported willingly by the people, the reserves of the banks could be raised without limit, the depositors money taken, and placed in the Federal Reserve System; the open market committee could take the money and buy directly from the United States Government rather than in the open market. No such power has ever been granted in the world except possibly in China and Russia. The purpose of the proposal, however, was only that there might be control of credit so we would not get into another debacle. His idea was that you have to stop these things before they go too far and that the time to put on the brakes was when everything was rosy.

He also provided, and it was a good provision, that any assets held by a member bank could be used as collateral to loans at Federal Reserve Banks. Just before the bank holiday when people were withdrawing money and the banks could not liquidate their assets, the banks could only borrow from the Federal Reserve on eligible assets. If they wanted to borrow elsewhere they would have to go to the R.F.C. and that subjected them to publicity because it was tax payers' money and the moment a loan was granted and published the people became disquieted and failure of the bank was accelerated. Making assets eligible takes away that cry that came from the demagogue that the public shall

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know what is being done with the tax payers' money. onoy for ederal Reserve is not tax payers' money.

They also braedened the real estate base; they thou h that desirable. Any loan made on real estate could only be made within a known district of 100 miles radius. The proposal was to eliminate these territorial limitations and they were, but I do not think we can know very much about property that is too far away. We always have in mind another Florida land boom for there are always some fools who will go down there and buy up land, and that is band on the insurance fund. The territorial limitation should have stayed in. The law provid d that a national bank could loan 25% on first mortgage loans. Now 100 , of capital or 60% of savings can be loaned. The original proposal provided that you could loan on amortized real estate up to 80%. That is too high. We opposed that. I failed to say that in the question of eligibility of assets we thought there should be a penalty rate h her than the ordinary discount rate because we felt there should be some sli ht brake.

I have given you the major proposals o the overnment; they proposed that the governor of ~~the~~ a bank be a director; we proposed he be confirmed by the Board. We also recommended that one body hen le open market operations instead of this divided situation which I have explained. We felt it was unsound not to have representation of the governors of these regional banks on that committee. These men are charged with the financial conditions in their territory which would brin an intimate knowledge which those men in Washington would insisted there should be a limit on the reserves; wher Our recommendation was a limit on reserves, that th

25% of the deposits. We also recommended that the open market committee should not have the power to buy directly from the U. S. Government. We suggested a penalty rate of 1% on non-eligible paper.

As the law came out the governors of the regional banks are to be elected for five years and only one confirmation necessary in each five years. He becomes a pretty independent individual. The open market committee now consists of a new board, they did away with the old one because Congress did not function as well as it could. The new board is to consist of seven and the open market committee consists of those seven and five of the regional governors. We felt as the President had the right to appoint the Governor of the Federal Reserve System it was unwise to have two Government officials - the Secretary of the Treasury and the Comptroller of the Currency on the Federal Reserve Board. Senator Glass stated very clearly, and Senator McAdoo also, that they thought it unwise. That recommendation was adopted. With no reflection on the gentlemen in office, the Federal Reserve Board should be made an independent body, and in most cases is. The Governor of the Bank of England is entirely independent. In most governments the Crown or Parliament has the right to appoint the Governor or head but the other directors of the central bank are elected by the shareholders, except in Japan.

The open market committee are also denied the privilege of buying direct from the Government. We would have been willing to see some provisions ~~s~~ such as they have in Canada, which provides Government can borrow from the New Central Bank in Canada thairthere are times when private banks could not take care of Government needs and they provided that the central bank could loan the Government up to 1/3 of the estimated budget of revenue for the current fiscal year but that money borrowed must be paid in within ninety days after the close of that fifcal year. If the budget in Candda for a year was three billion dollars the central bank could loan one billion but would require it to be paid ninety days after the close of the fiscal year.

There was another important change in the law. The double liability on bank stocks will be eliminated July 1, 193 . Double liability was found to be unworkable, prevents people putting money in bank stocks, assessments were small, and it is felt that with the deppsit insurance it is unwise to continue it. So it will cease on July 1, 1937, but there is also a provision that a bank must put 1/10th of its earnings to surplus before paying dividends.

Colonel Jordan I have taken a little longer than I anticipated. I think I had better close my part of this program. I shall welcome any questions that may be asked.

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Q - In 1934 ~~when~~ the Government closed so many banks and put receivers in them but some of those banks have paid back as high as 75 or 80% of their deposits. For a long time that money was kept out of circulation. Was it necessary to close banks that could pay out 75 or 80%?

A - That is a nice question and one I have got to answer in view of what occurred at that time. A great many of the banks were forced to close before the holiday; so much money had been withdrawn from them that they just could not go on. We were in a very bad situation. The people of the country had been fanned to fever heat and all each individual wanted to do was to get his hands on his own money. We do not recognize that our individual actions in the composite may destroy ourselves. Things got so bad with the withdrawals of gold that something had to be done and the proclamation that was finally issued had been drafted a week before and negotiations went on between Mr. Hoover, who was then President, and Mr. Roosevelt, who was about to be inaugurated. The two gentlemen could not get together, however, but if the proclamation had been issued earlier a great many more banks might have been saved. They could not get together. Mr. Roosevelt recognized that somebody had to say to the people "Stop". Even after closing the banks they had to lift certain restrictions. The first regulation did not provide for payment of food drafts. Our general counsel told us we could not pay anything but I told them that we were going to pay food drafts and they lifted the restrictions on food drafts. They had to make an examination of the banks as quickly as they could; good idea of the national banks and state member banks b careful examination because once the Government opene

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guarantee to the public that that bank could survive It all had to be done in a great hurry because you could not let the country go without banks. When they rushed the job through many injustices were done; many banks closed today might have been saved. It is hard to judge whether a bank is going to survive or not when you only have ten days. Some of them could have been going banks today. But it was a very rushed job and a very difficult one.

Q - You stated that in the past localized attempts at deposit insurance were failures. What factors would contribute to the failure of state control.

A - They did not have the powers to safeguard it that we have now. The fund was not broad enough and with the easy charter of banks too many started to fail and then in order to assist the banks sufficiently it was tantamount to confiscation and the courts held it was confiscation of property that broke it down. I think the depositors money is absolutely safe under this law but no one can tell for ten or twenty years whether it will work out.

Q - A great many more or less unpleasant comparisons were made between our former banking system and that of Canada. Could it be possible for you to tell us something of the Canadian system as compared to ours?

A - The main thing is that in Canada they have the branch banking system and fewer banks. The banks get together on a concerted policy The Canadian law allows banks to issue currency against asset not have to go to the R.F.C. to borrow in an emergency; th currency against their assets. One of our greatest dif publicity of R.F.C. loans. As soon as a newspaper came out with these loans everyone wanted to get their money out of the bank. In Canada there was no such public exposure.

Q - How many banks are there in Canada?

A - I think about eight member banks. We hear the Canadian banking system praised. It has stood the test in an excellent manner becausedit has not been subjected as much to political pressure. On the other hand, I do not think the services of the banks compare with the banks in this country. In Canada when someone wants a loan he might have to wait a week or ten days and the manager does not have the same incentive to build up the community. It has not developed like we have.

Q - Under the present set-up is there any reason to believe credit expansion will not be the same as it was in 1929

A - It depends on man; the law is there; it depends on whether or not men are going to have the courage and wisdom to apply the law. The expansion in 1929 was a stock exchange expansion. That can not very well happen. That makket was stimulated by "loan to the account of others". A lot of individuals put money in the call loan market supplying a tremendous basis for stock exchanges to borrow for customers. Now they can't loan for the account of another person. If a member bank of the Federal Reserve System borrows and increases collateral it will be suspended. There is no provision which allows the Dederal Reserve Board Board to state the persentage of bank's capital they may hold in loans on stocks and bonds. It

or 500. That gives them control over the stock exchange and

the law it can be controlled. So far as the credit base

cerned, what we are getting now is a broader credit be controlled by raising rediscount rates and reserves of the member banks. If that were done it would make loan money available. Of course, we have not gotten to that point because noone is borrowing but if we got into a period of real inflation and loan started to come piling in and everyone wanted to buy more stocks of goods then the brakes could be put on by these two methods.

Q - How much did the flight from currency to gold have to do with the breakdown and if we revert to the gold standard again would it have the same effect?

A - The flight to gold had a great deal to do with the crash. People started hoarding gold. If you draw the gold out then you restrict the amount of currency, although it was a wise provision calling in the gold. The only one reason for having gold coins in circulation is that it gives the people confidence. We of course have a bullion base now. There is a free gold market so far as European countries are concerned. I think the bullion base we have now is an excellent one because the gold is held and it can't get away from us except through foreign transactions, and we still have our currency base. Our great trouble was that we did not have enough gold base. We are back to the gold bullion basis now.

Q - Are we ever going back to gold coinage?

A - I doubt it very much. There is no reason why gold coin should be used in circulation except to help the confidence If paper money has a gold basis that is all we need. I [illegible] go back to gold coins.

Q - Do you think the gold content of the at its present amount or be made flexible in the future?

A - The question of the content of the dollar is a far-reaching one. My own viewpoint is that devaluation of the dollar does not mean anything so far as internal transactions are concerned. It does mean something when exchanged with foreign countries. I don't know if we can ever get an exchange with England and France. England does not want to make an exchange settlement. They have it pretty well managed and they want to be in a position to come in and get our trade. So far as internation relations are concerned devaluing the dollar has a tendency to increase prices, not as directly, however, as you might think. Of course, the more you devalue it the more dollars you are going to have and the higher the prices will be. I do not believe it will have the same direct effect as between foreign countries. We may have futher devaluation, but certainly not below fifty cents.