

Banking Reform in the New Deal Era *

“Practices of the unscrupulous money-changers stand indicted”, Roosevelt stated on 4 March 1933. “The money-changers have fled from their high seats...”.¹ A few days after the inaugural address, the *Nation* perceived as “inevitable a widespread demand for the complete nationalization of banking”. Roosevelt had “a great chance to remake the banking system from top to bottom”, *New Republic’s* Washington correspondent reported.²

Roosevelt did not hesitate to arouse public opinion against the bankers, but refused to make any radical changes. “The President drove the money-changers out of the Capital on March 4th – and they were all back on the 9th”, disenchanted populist Senator William Lemke complained.³ The Emergency Banking Act of 9 March provided for the reopening of sound banks under continued private ownership.

American banking had been “thoroughly discredited ... and generally execrated”.⁴ By 1932, “private banking had completely destroyed itself ... But the federal government believed in private banking and in private business, and for that reason it saved the banking system”, Federal Reserve Board Chairman Marriner Eccles, a successful Utah banker before coming to Washington, reminded his American Bankers Association (ABA) audience in November, 1935.⁵

The New Deal changes in supervisory practices and statutes – deposit insurance, entry-restrictions, interest rate ceilings, divorce of security affiliates, holding company regulation, expanding categories

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¹ FRANKLIN D. ROOSEVELT, *Public Papers and Addresses* (New York, 1938) II, 12.

² *The Nation*, March 15, 1933, 277; *New Republic*, March 15, 1933, 127.

³ Quoted by BARTON J. BERNSTEIN, “The New Deal” in BERNSTEIN, ed., *Towards a New Past* (New York, 1968), 268.

⁴ A.S.J. BASTER, *The Twilight of American Capitalism* (London, 1937), 61.

⁵ MARRINER ECCLES, *Economic Balance and a Balanced Budget* (New York, 1940), 48.

of paper eligible for discount at the Federal Reserve – were designed to strengthen the nation's banks. Washington's power increased relative to the states and the industry, with federal loans to business and banks and centralization of the Fed.

Deposit insurance

Congress had been grappling with banking reform well before the ultimate crisis which led to the Bank Holiday in early March, 1933. Deposit insurance was the hardest-fought issue. Roosevelt as governor had opposed the idea when put forward for the banks in New York State. "We do not wish to make the United States Government liable for the mistakes of individual banks, and put a premium on unsound banking in the future", he told his very first Presidential press conference off the record (8 March 1933).⁶ As the ABA policy committee insisted, good banking was "the only real guarantee for bank deposits...".⁷

House Banking Committee Chairman Henry Steagall saw insurance as the one indispensable remedy to banish fear. The committee quoted Harvard economist Thomas Carver: "Credit will not expand again until confidence is restored ... the people ... will not have confidence in banks until the Government guarantees bank deposits". His colleague Oliver Sprague too saw the connection between the strengthening of confidence in the banks and their adoption of "a more enterprising lending policy".⁸ In the interest of restoring mass confidence immediately, Representative Arthur Vandenberg wanted insurance to take effect at once. Roosevelt thought this would be impossible, as the soundness of many thousands of state nonmember banks needed to be examined.

⁶ FRANKLIN D. ROOSEVELT, *Public Papers and Addresses*, II, 37.

⁷ AMERICAN BANKERS ASSOCIATION ECONOMIC POLICY COMMISSION, *The Guaranty of Bank Deposits* (New York, 1933), 44.

⁸ 73 Congress, 1 Session, House Report 150 (1933), 6; O.M.W. SPRAGUE, *Recovery and Common Sense* (London, 1934), 38.

The ABA president told bankers to telegraph Roosevelt to veto the bill because its deposit guarantee provisions were "unsound, unscientific, unjust and dangerous".⁹ However, the President signed the Banking Act on 16 June 1933. By January, 1935, the ABA president conceded that the Federal Deposit Insurance Corporation (FDIC) had been "very helpful toward creating that public confidence so essential to restore a sound banking situation".¹⁰

Sensing broad public approval, Roosevelt announced on 14 May 1934 that deposit insurance was a permanent part of his administration's program. Indeed, he now requested "every reasonable protection" for small savers who held shares and certificates in building and loan associations (as savings and loan associations [S&L] were then commonly called).¹¹ The National Housing Act of 27 June 1934 set up a separate Federal Savings and Loan Insurance Corporation (FSLIC). The five-member Federal Home Loan Bank Board established in 1932 was given the additional responsibility of acting as FSLIC's board of trustees. All federally-chartered S&Ls were required to be insured; state-chartered S&Ls could qualify for insurance.

The FDIC's arrival in 1933 meant that three federal agencies were involved in the regulation of commercial banks. Since 1863, the office of the Comptroller of the Currency had been supervising national banks, and since 1914 the Federal Reserve Board was concerned with banks belonging to the Federal Reserve System ("member banks"). The FDIC was administered by three directors including the Comptroller of the Currency *ex officio*.

Supervisory unification

The dual banking system (of state as well as federal chartering and regulation of banks) had contributed to overbanking and relax-

⁹ *New York Times*, June 16, 1933, 14.

¹⁰ RUDOLPH HECHT, "Banking Evolution", *American Institute of Banking Bulletin* 17 (1935), 4.

¹¹ 73 Congress, 2 session, House of Representatives Committee on Banking and Currency, Hearings on S. 3025 (GPO, 1934), 134; ROOSEVELT, *Public Papers and Addresses* (New York, 1938), III, 234.

ation of national bank standards, and hampered effective supervision as well as Federal Reserve efforts to promote "sound banking policy". The seventy-year-old system was "the curse of the banking business in this country", Carter Glass, chairman of the Senate Banking Committee, maintained.¹²

Already in March, 1932, the Federal Reserve Board had insisted that "a unified system of banking under national supervision is essential to fundamental banking reform".¹³ During the banking emergency proclaimed on 4 March 1933, Washington directed all state-chartered banks, including those which did not belong to the Federal Reserve System ("nonmember banks"). Some wanted the President to require membership in the Federal Reserve as a condition for allowing a bank to reopen. The nation appeared to be moving toward unification of banking but, to the disgust of some, "the chance was promptly thrown away".¹⁴ Many opponents of deposit insurance (including Roosevelt) found a redeeming feature in the 1933 Act's requirement that all insured nonmember banks would have to join the Federal Reserve System by 1 July 1936. Steagall, however, opposed the coercion of state banks, and distrusted Federal Reserve officials who did not appreciate many of the small community banks. He fought hard to preserve "independent, dual banking in the United States to supply community credit ...".¹⁵

When a permanent insurance plan was under consideration, the FDIC warned that insured banks which were not Fed members "would menace the fund".¹⁶ Yet the Banking Act of 23 August 1935 gave the 981 banks with deposits over \$1 million until mid-1942 to become members, and exempted 6,701 smaller ones.¹⁷

Eccles continued to battle for unification after 1935. He was concerned that otherwise banks might give up their Fed membership, limiting the system's "ability to make its monetary and credit policy

¹² 72 Congress, 1 Session. Senate Committee on Banking and Currency, Hearings on Operation of the National and Federal Reserve Banking System (GPO, 1932), II, 395.

¹³ Hearings on the Operation of National and Federal Reserve Banking System, 653; *Federal Reserve Bulletin* 18 (1932), 207.

¹⁴ JOHN T. FLYNN, "Wanted: Real Banking Reform", *Current History* 39 (1934), 401.

¹⁵ *Congressional Record* 77 (1933), 4033.

¹⁶ *Id.* 79 (1935), 11776

¹⁷ *Id.*

effective".¹⁸ Thus, reserve requirement increases did not affect nonmember banks. In November, 1936, he tried to persuade Roosevelt that under a divided banking system currency management "becomes almost a mockery ...". Two years later he warned the President that "Our banking system remains fundamentally unsound ... The effective organization of the banking system is a basic and essential part of any comprehensive program of preparedness".¹⁹ The 1938 *Annual Report* of the Board of Governors of the Federal Reserve System detailed "confusion of duties and responsibilities among different Federal and State authorities".

Eccles' position was also favored by leading economic experts, businessmen, and bankers. Princeton's Edwin Kemmerer told the Economic Club of Chicago in April, 1933, that bringing all banks into the Fed would put an end to the "competition in laxity" frequently deplored by Eugene Meyer (Hoover's Federal Reserve Board head). We could then "enter upon a leveling up policy of progressively strengthening and improving our commercial banking system".²⁰ A distinguished commission reported to Columbia University president Nicholas M. Butler in 1934 that "the present absurd arrangement called for integration of the nation's banking system under the Federal Reserve".²¹ Impatient with "a system that has failed so abysmally as ours", Yale economist Ray Westerfield pointed out that "political control of banking always has been and will be much worse in state capitals than in Washington".²² Unless all banks were required to be Fed members, "a genuinely effective system of regulation" was impossible, given the "inherent weakness of the dual system", Harold G. Moulton of the University of Chicago insisted.²³ The roster of those favoring compulsory Federal Reserve membership

¹⁸ 74 Congress, 1 Session. Senate Committee on Banking and Currency, Hearings. Banking Act of 1935 (GPO, 1935), 428, 302 (hereafter Senate 1935 Act Hearings).

¹⁹ SYDNEY HYMAN, *Challenge and Response* (Salt Lake City, 1978), 219, 253; *Federal Reserve Bulletin* 25 (1939), 364.

²⁰ EDWIN W. KEMMERER, *Banking Trends* (An Address before the Economic Club of Cleveland, 11 April, 1933) [Typed MS, NYPL], 11; on Meyer see EMANUEL GOLDENWEISER, *Monetary Management* (New York, 1949), 40.

²¹ *Economic Reconstruction*. Report of the Columbia University Commission (New York 1934), 64-65. Among the members were John Maurice Clark, Wesley C. Mitchell, and Josef A. Schumpeter.

²² RAY B. WESTERFIELD, "The Banking Act of 1933", *Journal of Political Economy* 41 (1933), 749; "National versus State Banks", *American Academy of Political and Social Science Annals* 171 (January, 1934) 19.

²³ HAROLD G. MOULTON, *Financial Organization and the Economic System* (New York, 1938), 361.

extended beyond leading banking economists to include such eminent persons as Thomas Lamont of J.P. Morgan & Co., Winthrop Aldrich of Chase National Bank, James P. Warburg of Bank of Manhattan and GE's Owen Young, among others.

Yet the FDIC changed its tune after 1935. Chairman Leo Crowley became "absolutely opposed to using the FDIC as a vehicle to unify the banking system", as he informed the National Association of Supervisors of State Banks (11 November 1938).²⁴ Steagall carried the battle for completely voluntary Fed membership for insured state banks to victory in legislation signed by Roosevelt on 20 June 1939.²⁵

Supervisory examinations

Via the FDIC, the federal government reached insured nonmember banks. When examining these state banks, the agency applied federal banking standards. Given its financial responsibility in the event of failure, the FDIC felt that it had to be "in a position to exert effectively its influence for the maintenance of the banks in a sound condition".²⁶

Supervisory examinations became more careful in the 1930s. By appraising assets at depressed market value, examiners were said to have intensified the credit contraction. Some blamed much of the post-1929 economic collapse on examiner insistence on hurried liquidation of loans and collateral. Roosevelt's Comptroller of the Currency called for appraisals on the basis of "fair values" which assumed economic recovery. In March, 1934, examiners were told to be "as lenient as circumstances will permit". Washington encouraged banks to be more generous in lending in 1933-1934, but examiners remained critical. For several years after the Bank Holiday, many examiners and bankers continued to have an "unduly conservative attitude toward loans".²⁷

²⁴ NASSB, *Proceedings of the 32nd Annual Convention* (New Orleans, 1938), 90.

²⁵ A reluctant Senate went along. *Congressional Record* 84 (1939), 7202 (Steagall). The repeal was section 2 of a law extending the period in which officers of member banks could renew or extend loans they had borrowed prior to 16 June 1933. 53 Stat. 842 (1939). By 1939, there were 1,234 state member banks; these held two-thirds of all state bank assets. Some 1,300 more would have had to become members if the 1935 provision had not been repealed.

²⁶ FDIC *Annual Report* 1940, 12.

²⁷ COMPTROLLER OF THE CURRENCY, *Annual Report* 1934, 3,4; ASSOCIATION OF RESERVE CITY BANKERS, *Answers to the Questionnaire on National Monetary and Banking Policy* (Chicago, 1941), 21.

Examiner appraisals had tended to accentuate swings in the business cycle. Generous appraisals stimulated lending when times were good; during downturns, criticisms of loan portfolios discouraged lending. University of Chicago economist Jacob Viner therefore advocated the coordination of examination policy with credit control policy. Eccles, who shared this philosophy, faulted the Comptroller in November, 1936, for having "repeatedly pursued a policy of restraint when correct central bank policy called for easing restraints", and *vice versa*.²⁸ From 1933 to 1937 supervision had indeed run counter to monetary policy.²⁹

Small banks were complaining that examiners were being critical of small loans made to average people, an upstate New York legislator informed Roosevelt in March, 1938, when the economy was again in the midst of a serious downturn. Eccles, asked by the President to draft a reply, reiterated that examination policy should take account of changing economic conditions.³⁰

Roosevelt then instructed the Federal banking agencies "to coordinate and liberalize their examination policies", but the Treasury Department, home of the Comptroller of the Currency, resisted. Even so, Eccles wrote the President on 24 June 1938, the changed procedure would "stop the deflationary trend resulting from contraction of bank credit under the pressures of previously prevailing bank examination policies and restrictive investment regulations".³¹ Bank investments were to be judged on the basis of "inherent soundness", and bond issues too small to be listed with the SEC were made eligible for purchase. Revised rules stressed "intrinsic value rather than liquidity or quick maturity" for loans.

The FDIC claimed to have been applying these loan principles since September, 1934. However, Homer Jones, an economist on the scene, later recalled that FDIC examiners "harrassed the shell-shocked bankers".³²

The new federal examination principles gained the support of most state supervisors, and took effect in September, 1938. The

²⁸ ECCLES, quoted in HYMAN, *op. cit.*, 219-20; JACOB VINER, "Recent Legislation and the Banking Situation", *American Economic Review*, 26 Supplement (1936), 110.

²⁹ CLARK WARBURTON, *Depression, Inflation and Monetary Policy* (Baltimore, 1966), 322.

³⁰ MARRINER ECCLES, *Beckoning Frontiers*, (New York, 1951), 272 ff.

³¹ *Ibid.*, 276.

³² HOMER JONES, "Banking Reform in the 1930's" in GARY M. WALTON (ed.), *Regulatory Change in an Atmosphere of Crisis* (New York, 1979), 82.

Board of Governors expected that small and medium sized businesses would now find bank credit more readily forthcoming and also relieve "pressures that tend to reduce outstanding credit or prevent extension of new credit to sound borrowers".³³ As a minimum, the new procedures would not aggravate the cyclical extension of bank credit.

On 23 November 1938, Eccles told Roosevelt that monetary policy was "largely useless" unless "closely integrated with bank examinations and investment policy". He feared that in their concern for bank solvency the FDIC and the Comptroller were tightening examination procedures. A month later, he again mentioned the "unsatisfactory setup with respect to Federal banking supervision". Banks "are frequently subject to outmoded, unintelligent, and officious examiner criticism", the head of the Reconstruction Finance Corporation (RFC), Jesse Jones, likewise complained in the spring of 1939.³⁴

Eccles accepted reappointment in 1944 on the understanding that Roosevelt would push for regulatory unification under the Federal Reserve,³⁵ but the President would not budge: Eccles detected a "nostalgic affection" for local grass roots institutions, and a fear of their destruction by banking giants if forced to join the Fed. As Roosevelt stated already in his January 1932 gubernatorial message: "each community must be enabled to keep control of its own money within its borders".³⁶

Eccles' drive for unification proved futile, but he did succeed in broadening the statutory definition of paper eligible for rediscount at a Federal Reserve Bank to include all "sound assets", irrespective of maturity. The provision in the Banking Act of 1935 would

"make it possible for banks, without relaxing prudence or care, to meet local needs both for short-time and for long-time funds, and to be assured that in case of need they can obtain advances from the Reserve banks on the basis of all their sound assets, regardless of their form or of the nature of the collateral"

³³ *Federal Reserve Bulletin* 24 (1938), 563.

³⁴ ECCLES' Nov. 1938 letter quoted in DONALD F. KETTL, *Leadership at the Fed* (New Haven, 1986), 58; Dec., 1938 letter quoted in HYMAN, *op. cit.*, 255; JONES in 76 Congress, 1 Session, Senate Committee on Banking and Currency, Hearings on S. 1482 (GPO, 1939), 407.

³⁵ HYMAN, *op. cit.*, 211.

³⁶ ECCLES, *Beckoning Frontiers op. cit.*, 269; *Public Papers of Governor Franklin D. Roosevelt 1932* (Albany, 1939), 31.

as the House Banking Committee explained.³⁷ With the assurance that "all sound assets can be liquidated at the Federal Reserve bank in case of emergency", banks no longer needed to be "restricted to super-liquid loans", Eccles pointed out.³⁸

After the Bank Holiday, bankers had put their institutions in as liquid a condition as possible in order to qualify for deposit insurance. Roosevelt, like Hoover before him, saw the "free flow of credit" as one of the keys to economic recovery. He sent a message to the ABA convention (5 September 1933) urging increased loans to business. In October, 1934, addressing the ABA in person, Roosevelt called on bankers to join "an alliance of all forces intent upon the business of recovery", and to assume their traditional responsibility by taking up the burden which had been assumed by federal credit agencies. "... I ... expect that private business generally will be financed by the great credit resources which the present liquidity of banks makes possible".³⁹

"Banks today [1939], by and large, are about as free with credit as banks ever should be", was the judgment of a vice president of the Federal Reserve Bank of New York. With respect to short term credit, a later investigator found "no gap of consequence".⁴⁰ Yet a careful scholar thought that the complaints that banks "shied away from risks, and especially from longer term credits ... [were] apparently with good reason ...".⁴¹ Many "still shell-shocked by the events of the Great Depression", often lent only to "first-class risks".⁴²

The federal government found the record of bank lending disappointing. Between 1929 and 1933, total bank loans had tumbled from \$36.1 to \$16.5 billion. The \$17.5 billion in 1937 was the highest in the New Deal period. Adjusted for consumer price level changes, loans declined 38.8 percent between 1929 and 1933 and a further 6.1 percent between 1933 and 1937. Relative to current dollar GNP,

³⁷ 74th Congress, 1 Session, House Report 742 (1935), 11.

³⁸ Speech to N.Y. Chapter of AIB, 1 December, 1938 in ECCLES, *Economic Balance*, 168; testimony in 74 Congress, 1 Session: House Committee on Banking and Currency, Hearings on Banking Act of 1935 (GPO, 1935), 184 (hereafter, House 1935 Act Hearings).

³⁹ ROOSEVELT, *Public Papers and Addresses*, III, 438.

⁴⁰ L.R. ROUNDS (FRBNY), "Industrial Loans and Federal Reserve Banks" in George B. Roberts (ed.), *A Forum on Finance* (New York, 1940), 97; DOUGLAS R. FULLER, *Government Financing of Private Enterprise* (Stanford, 1948), 172.

⁴¹ LESTER V. CHANDLER, *America's Greatest Depression* (New York, 1970), 151.

⁴² BENJAMIN H. BECKHART, *Federal Reserve System* (New York, 1972), 273-4.

bank loans were only 19.33 percent in 1937, compared with 29.38 percent in 1933 and 34.75 in 1929.

Federal lending to business

Whatever the actual record of bank lending, the widespread perception that more was needed led to the creation and expansion of lending agencies in Washington. Convinced that established small businesses were unable to obtain working capital loans with a maturity up to five years, the Administration sponsored the Industrial Advances Act of 19 June 1934, authorizing the RFC and the Federal Reserve Banks to enter this field. By the end of 1939, the Fed had approved 2,781 out of 9,418 applications, for \$188 million in all. Most of these loans were made by the end of 1935, as the RFC became the major lender. The RFC claimed to be granting loans to applicants with a reasonable expectation of being able to repay, yet through the end of 1940 had approved altogether 9,384 industrial loans. The small volume of industrial loans made by the Fed and the RFC led Douglas R. Fuller to conclude that "unsatisfied demand was lacking".⁴³ Industrial loans from the agencies amounted to about three percent of total commercial and industrial loans made by banks by the end of 1940, but ten percent of their term loans.

The November 1935 ABA convention called on all bankers "to facilitate in every effective way the retirement of government agencies from credit activities".⁴⁴ By 1935, rural banks felt they could once again handle all sound short term credit needs of their localities. Agricultural banks resented competition from Production Credit Associations (which first appeared in 1933). The president of the ABA complained about "very limited" opportunities for profitable lending, as government agencies charged borrowers low rates while Postal Savings offered depositors relatively high interest rates.⁴⁵

⁴³ FULLER, *op. cit.*, 109.

⁴⁴ ECCLES 14 November 1935 address, p. 16 (TMS Board of Governors Library); Jones convention address, *Commercial and Financial Chronicle* November 30, 1935 Supplement, 39.

⁴⁵ R.S. HECHT, in *NASSB Proceedings of the Thirty-Fourth Annual Convention* (New Orleans, 1935), 46. President Wiggins told the 1943 ABA convention that, especially in

In early 1937, however, bankers were reported to be "generally apathetic concerning possible competition; they are uncertain as to the actual effects of this competition, and are not keenly aware of the indirect influences which Government lending exerts on interest rates and on general credit structure".⁴⁶ Government lending slowed down, and in the fall of 1937 the industrial loan program was suspended.

On 18 February 1938, however, the program was resumed. The RFC asked all the banks in the United States to cooperate in lending and to forward to the RFC any application they felt unable to accept. During the years 1938-1940, RFC loans to business (together with a nominal \$12.3 million disbursed by the Federal Reserve) represented some five percent of the credit extended by banks and life insurance companies. The RFC had become "the world's biggest and most varied banking organization", Jones boasted, but "has never made a loan ... that the borrower could get on fair terms from private sources". "Congress never had the thought of creating a government bank to compete with private enterprise or to socialize banking", Jones insisted.⁴⁷

Federal lending to business "faithfully sought to avoid making loans that commercial banks would make", a scholarly investigation concluded. Most borrowers from the RFC were "at, or under, the margin of creditworthiness" by ordinary bank standards. As of mid-1939, \$1 billion of loans by federal agencies (over 11 percent of their loans outstanding) were in technical default.

In a period of declining interest rates, federal lending programs to business, agriculture and housing were found

"to reduce the costs of credit to borrowers, to increase the ratio of debt to equity, to lengthen the final maturities of loans, and to promote the principle of periodic amortization of loans. Thus, they have tended on the whole to cause private lending agencies to liberalize their credit terms and readjust their credit practices".⁴⁸

agricultural sections, competition from federal lending agencies had seriously reduced banks' interest income (TMS, ABA library). See also MAUREEN O'HARA and DAVID EASLY, "The Postal Savings System in the Depression", *Journal of Economic History* 39 (1979), 750-51.

⁴⁶ AMERICAN BANKERS ASSOCIATION COMMITTEE ON BANKING STUDIES, *Government Lending Agencies* (New York, 1937), 35.

⁴⁷ Radio speech in *Congressional Record* 86 (1940), 6196; JESSE H. JONES, *Fifty Billion Dollars* (New York, 1951) 3, 191.

⁴⁸ RAYMOND J. SAULNIER, HAROLD HALCROW and NEIL JACOBY, *Federal Lending and Loan Insurance* (Princeton, 1958), 252, 257, 147.

Federal loans and loan insurance programs ranged from 20 to 30 percent of the volume of total federal expenditures during most of the '30s. Federal loans to business amounted to 1.1 percent of net corporate debt by the end of 1939, while commercial banks held 14.0 percent.

Federal loans to banks

Banks, too, borrowed from the federal government. Under the Emergency Banking Act of 1933, 4,200 banks sold \$782 million of preferred stock, and 2,913 banks sold \$343 million in capital notes to the RFC. Only 206 banks thus assisted later closed, with under \$14 million in losses to the RFC.

The purchase of \$12.5 million in the reorganized National Bank of Detroit (24 March 1933) marked the first time since Andrew Jackson's day that the federal government owned bank shares. Roosevelt tried to reassure bankers that government would not seek to dominate banks in which the RFC had a financial stake. While the RFC was not disposed to interfere with bank management, Jones added, "there will be no reluctance about protecting the Government's investment".⁴⁹ RFC capital advances of \$800 million in late 1933 enabled some 4,500 banks to qualify for deposit insurance as solvent institutions. By the spring of 1934, the RFC owned 31 percent of the capital of the top 100 banks. Looking back in 1940, Jones was convinced that without the RFC's capital investment program the entire banking system would have failed.⁵⁰

Branch policy

The New Deal left the states in control of a highly significant aspect of bank structure, branching. The wave of failures left many

⁴⁹ JONES speech to Harvard Business School alumni, 16 June 1934 (MS, 3M500 University of Texas).

⁵⁰ ABA *Journal* 26 (May, 1934), 54; JONES speech 27 March 1940 quoted in ALBERT V. ROMASCO, *The Politics of Recovery* (New York, 1983), 57.

communities with few (if any) facilities.⁵¹ In response, states eased restrictions on branch banking. Between 1930 and 1940, states which forbade all branching declined from 23 to 11; statewide branching states increased from 11 to 22. The Banking Act of 1933 authorized national banks to branch to the same extent as state-chartered banks. The ABA, made up overwhelmingly of unit banks, endorsed the 1933 compromise, which precluded the extension of branches across state lines. Advocates of single-office (unit) banking believed that deposit insurance would "restrain the tendency to branch banking". Representative Thomas Goldsborough counted on the strength of the independent banks to render branch banking ineffective.⁵²

When considering branch applications of insured nonmember banks, the FDIC applied a needs test so as to prevent the opening of "unnecessary and unprofitable ones". Branches increased from 2,786 in 1933 to 3,531 in 1940; the total returned to the level previously reached in 1930. Branches were 12.9 percent of all banking offices in 1930, and 19.5 percent by 1940. Less than seven percent of the nation's banks had even one branch. Unit banks provided about 75 percent of the nation's banking facilities and held almost half of total deposits. Opponents of statewide branching feared "the concentration of the wealth and of the credit of that state in the hands of a few for them to control", in the words of Father Charles F. Coughlin.

"An extension of the privilege of branch banking ... is the cardinal point in banking reform", Morgan's Lamont wrote to Roosevelt on 27 March 1933, expressing a widely held view.⁵³ Much wider branching, advocated by leading businessmen and economists, would have strengthened the banking system by providing greater diversification, but there was little political support for the change.

⁵¹ In mid-1935, there were six bankless towns which had a first class post office, 174 with a second class post office, and 3,714 with a third class post office. AMERICAN BANKERS ASSOCIATION COMMITTEE ON BANKING STUDIES, *The Postal Savings System of the United States* (New York, 1937), 46.

⁵² *Congressional Record* 77 (1933), 5897; House 1935 Act Hearings, 288.

⁵³ Lamont Papers, 127-31 Harvard University Library. LAMONT favored "some form of regional branch banking". Letter to Arthur Bull, Evanston Trust Co., 23 November 1932. Box 140-10; CHARLES E. COUGHLIN, *Driving Out the Money Changers* [Broadcasts January 1-April 16, 1933] (Royal Oaks, Mich., 1933), 8.

Entry restraints

Another way of strengthening banks was to restrict the opening of new ones to avoid the problem of overbanking. Ogden L. Mills as Hoover's Secretary of the Treasury deplored "the excessive growth in the number of banks" from 1900 to 1920: the states and the Comptroller of the Currency had been too free in granting charters. Many small banks had not been able to secure good management, Mills argued. "It is absurd to think that there can be 30,000 bankers in the United States really competent to operate in splendid isolation", the eminent monetary economist Irving Fisher pointed out.⁵⁴

The ABA president also spoke of the "overproduction of undesirable banking institutions"; there were "far too many banks" by 1921. Over the next dozen years thousands closed, but in 1935, bankers were concerned "to prevent a new overproduction of banks". Convention after convention emphasized that "the number of banks should be limited rigidly to the economic requirements of the nation".⁵⁵ There were 14,344 in 1940, the same as seven years earlier. Population per bank was 9,059, an increase of over 3,900 during the 1930s.

Under the Banking Act of 1935, organizers would now have to demonstrate that the new national bank and insured state bank would meet "the convenience and needs of the community to be served". Crowley did not wish to see a return to the era of "too many banks". Overcrowding had led to "speculative and destructive practices in an effort to earn sufficient income to pay the expenses".⁵⁶ The applicant for deposit insurance would have to satisfy the FDIC that the proposed institution "is essential to a community". Existing banks needed "adequate earnings", and would be protected against "excess competition resulting from the competition of uneconomic banks". Most states would not authorize a bank unless the FDIC was willing to insure it.

⁵⁴ SECRETARY OF THE TREASURY, *Annual Report 1932* (GPO, 1932), 30-31; IRVING FISHER, *Booms and Depressions* (New York, 1932), 133.

⁵⁵ RUDOLPH S. HECHT, "Banking Evolution", *loc. cit.*, 6; ABA convention resolutions 1935, 1937 in ABA RESEARCH COUNCIL, *The Answers of the American Bankers Association in Reply to Part 9 ...* (New York, 1941), 69-70.

⁵⁶ CROWLEY in House 1935 Act Hearings, 48, 14.

There was "close cooperation to prevent the chartering of uneconomic and unsound banking units", the FDIC reported in 1939. Federal and state authorities agreed to avoid what they viewed as the evil of overbanking. This restraint of trade "was probably inimical to the recovery in the 1930's", Homer Jones argued in 1979. He lamented the demise of "a century of freedom in the chartering of banks".⁵⁷

Holding companies

Another measure taken in the interest of sound banking was regulation of ownership of banks by holding companies. The Banking Act of 1933 aimed to discourage bank holding companies, and some anticipated their gradual disappearance. On 29 April 1938, Roosevelt, who did not like the idea of outsider control of banks, proposed to bar further expansion of bank holding companies, and to allow a reasonable time for their gradual dismemberment. Instead, when Congress acted eighteen years later, bank holding companies gained recognition as a legitimate form of organization.

Deposit interest regulation

Another approach intended to safeguard the nation's banks was regulation of interest paid on deposits. To cover interest expense, banks were believed to have made speculative loans and bought doubtful securities. From 1914 to 1933, banks overreached for earnings as deposit competition became excessive, the ABA stated in 1941.

The Banking Act of 1933 established controls over member banks' rates on time deposits. In advocating extension of these controls to insured nonmember banks (1935), the FDIC stressed this

⁵⁷ FDIC *Annual Report 1936*, 23; *Annual Report 1939*, 24; HOMER JONES, "Banking Reform in the 1930's", *loc. cit.*, 81-82.

would increase bank safety. However, there appears to have been no consistent inverse relationship between rates paid on deposits and asset quality.⁵⁸

After 1933, banks complained that competition from Postal Savings and savings and loan associations deterred deposit rate reductions. The 2.5 percent ceiling rate set in 1935 did not restrict insured banks for many years to come. By 1938, the main impact of Regulation Q was outside the financial centers, bringing into line the exceptional cases.

Interest could not be paid on demand deposits after 16 June 1933. Glass wished to stop banks from sending funds to the money centers. This was believed to deprive localities of loanable funds while fueling stock speculation. Actually, these balances were used to compensate correspondent banks for their services, as well as to deal with seasonal variations in loan demand. Interest payments "did not draw funds out of rural areas", a recent analysis concluded. The contemporary notion that banks paying interest on demand deposits held riskier portfolios had no factual basis, according to another careful study.⁵⁹ The ban pleased bankers: the consensus in 1941 was that they could ill-afford to pay any interest on demand deposits.

Security affiliates

Prohibition of certain investment banking activities was also in the interest of commercial bank safety. Financial-center banks had organized security affiliates, corporate entities owned by the identical shareholders; these numbered 180 by 1930. Other banks engaged in various aspects of the securities business through their bond departments: at the peak in 1928, there were 460. Altogether, 591

⁵⁸ ARTHUR J. ROLNICK "The Benefits of Bank Deposit Rate Ceilings: New Evidence on Bank Rates and Risks in the 1920's", *Federal Reserve Bank of Minneapolis Review*, 11 (Summer 1987), 2-18, used explicit data to support the long-held view that there is a correlation between deposit rates and bank risk. Earlier studies by Albert Cox and by George Benston relied on proxies to find absence of such a correlation.

⁵⁹ BRIAN C. GENDREAU, "Bankers Balances, Demand Deposit Interest, and Agricultural Credit Before the Banking Act of 1933", *Journal of Money, Credit and Banking* 11 (1979), 513; GEORGE BENSTON, "Interest Payments on Demand Deposits and Bank Investment Behavior", *Journal of Political Economy* 72 (1964), 449.

commercial banks actively purchased and sold new and existing securities in 1929. By then, they matched the venerable private investment banks in volume of securities underwriting and distribution.

For a time it appeared that affiliates would dominate investment banking. In addition to underwriting corporate and government securities, affiliates commonly retailed securities, sponsored investment trusts, and owned securities which could not lawfully appear on bank balance sheets. Reputations suffered when prices of bank affiliate-sponsored securities tumbled. Reviewing the prior decade, Aldrich (recently named head of Chase National Bank) concluded in March, 1933, that "intimate connections between commercial banking and investment banking almost inevitably leads to abuses". The Senate Banking Committee enumerated eleven possible ways in which an affiliate could impair the bank's position. Conflicts of interest appeared to be inevitable. Depositors were placed at risk in the quest for speculative profits. Poor bank loans might be converted into security loans. Customers willing to buy bonds would receive generous loans from the issuing bank. Almost \$8 billion in foreign securities were among the "utterly worthless investment securities" correspondents sold to unsuspecting banks, Glass claimed. Banks "closed because they overpurchased the very securities that the large banks have forced upon them", according to Senator Frederic Wolcott.⁶⁰

Securities activities of banks had been a significant factor in bank failure, it was widely believed then and later. However, a study of 105 suspensions which occurred in 1931 found that depreciation of bonds was "the primary cause of failure" in altogether six cases, and "an important contributing cause" in but four others. A Federal Reserve committee concluded (1932) that, though there had been cases where security affiliates had "worked to the detriment of the banks", whatever evils they had developed related primarily to investment practices rather than banking conditions.⁶¹ A study covering 1921 to 1932 found no significant difference between all issues of the eight largest affiliates and the eight largest private investment banks. "The

⁶⁰ *New York Times*, March 9, 1933, 1 (Aldrich); *Congressional Record* 75 (1932), 9883 (Glass); 9906 (Wolcott).

⁶¹ Federal Reserve System, Committee on Branch, Chain and Group Banking, Report, VIII, 105 (TMS, 1932).

belief in the utter financial depravity of integrated as compared with specialized investment banking is a myth", George Edwards later concluded.⁶² The senate committee had generalized from a few cases.

The Banking Act of 1933 provided for a complete divorce of commercial from most private sector investment banking by 16 June 1934.⁶³ The destruction of "most of this country's financial machinery for originating and marketing securities" at such a time was deplored by Leonard Ayres, an eminent banker-economist. Lamont of J.P. Morgan & Co. (which was also required to separate its investment banking activities) felt that the 1933 law had "destroyed the vital machinery of underwriting securities".⁶⁴

As capital available for floating new issues shrank drastically, leading industrialists favored modification of the ban. In 1935 Glass was willing to authorize limited amounts of corporate securities underwriting, but Roosevelt remained opposed, lest banks "go back to the old practice of selling securities to their trust funds or to their neighbor's trust funds", and also engage in speculation.⁶⁵

Deflation and failure

Statutory and regulatory concern for bank soundness was understandable in view of the dismal record of the early '30s. However, bank failures, often cited as a major cause of the Great Depression, were more the consequence of that calamity. The 1933 *Annual Report* of the Federal Reserve Bank of New York stated that "[t]he immediate cause of this extraordinary record of bank failures during recent years undoubtedly was the most severe business de-

⁶² GEORGE W. EDWARDS, "The Myth of the Security Affiliate", *Journal of the American Statistical Association* 37 (1942) 232; TERRIS MOORE, "Security Affiliate Versus Private Investment Banker", *Harvard Business Review* 12 (1934), 484.

⁶³ Already in 1931, Chatham-Phenix National Bank dissolved its affiliate, followed by Bankers Trust Co. and Bank of Manhattan Trust Co. before the year was out. BARRIE A. WIGMORE, *The Crash and Its Aftermath* (Westport, Conn., 1985), 221.

⁶⁴ LEONARD P. AYRES, *Economics of Recovery* (New York, 1934), 57; THOMAS W. LAMONT, "As to the Operation of the New Deal", 5 (MS, 158-33, Baker Library, Harvard University).

⁶⁵ FRANKLIN D. ROOSEVELT, *His Personal Letters 1928-1945* (New York, 1950), III, 500; ROOSEVELT, *Complete Presidential Press Conferences* (New York, 1972), VI, 2 (12 July 1935).

pression in the history of this country", citing the deflation as one factor.⁶⁶ However, highly contractionary monetary policy aggravated deflation. The Federal Reserve itself was a prime factor in the economy's decline.⁶⁷

Clark Warburton indicted the Fed for neglecting to take "more positive measures" when the system belatedly developed concern over bank suspensions. He attributed "the immediate direct cause of the March, 1933 banking crisis" to the 20 percent contraction in member bank reserves from mid-January to the first week in March, 1933, which the Fed could have counteracted. Most Fed officials had only "limited understanding" of the relation between bank failures, deposit shrinkage and weakness in bond prices.⁶⁸ Banks' attempts to liquidate in the face of the tight money situation created by the Fed were a main cause of the fear and panic of 1932 and early 1933.

Lamont saw "the vicious circle of deflation" as "self-perpetuating"; "the deflation ... is at the root of most of the difficulties", he informed Roosevelt on 27 March 1933. For three years, the nation's banks had "fought a hopeless battle against a worldwide deflation", an economist pointed out already in July, 1933. That September, the ABA president rejected as "for the most part untrue" the view that bank failure was caused by mismanagement and/or dishonesty, citing the deflation as a key aspect.⁶⁹

⁶⁶ FEDERAL RESERVE BANK OF NEW YORK, *Annual Report 1933*, 11. Earlier, the Federal Reserve Board explained the 5100 bank suspensions of 1930 through 1932 as due to rapid shrinkage in market value of securities, real estate and commodities, and the decline in borrowers' income (*Annual Report 1932*, 9).

⁶⁷ JAMES D. HAMILTON, "Monetary Factors in the Great Depression", *Journal of Monetary Economics* 19 (1987), 145, 167. PAUL B. TRESKOTT estimated the deflationary direction of monetary policy beginning in December, 1929, finding a shortfall of over \$500 million in open market acquisitions in the year ending in mid-1932. "Federal Reserve Policy in the Great Contraction: A Counterfactual Assessment", *Explorations in Economic History* 19 (1982), 218. A contrary position exonerating the Fed is taken by WIGMORE (*op. cit.*, 550-51). LAMONT described the Federal Reserve Board's policy in the recent emergency as "liberal and farsighted". Lamont Papers 140-10, letter of 3 January 1933 to A.L. Bingham.

⁶⁸ Clark Warburton cited in MILTON FRIEDMAN and ANNA J. SCHWARTZ, *A Monetary History of the United States, 1867-1960* (Princeton, 1963), 358; WARBURTON, *op. cit.*, 321. In the three years ending in the first quarter of 1932, effective bank reserves shrank by 30 percent relative to trend (*ibid.*, 320); from the spring of 1928 to the end of February, 1933, the shrinkage was 40 percent (*ibid.*, 69).

⁶⁹ FRANCIS H. SISSON, address in *Commercial and Financial Chronicle* Supplement September 23, 1933, 30; Memorandum, Lamont Papers 127-31; R.B. HEFLEBOWER, "Should Banks Take the Blame?" *Bankers Magazine* 127 (July, 1933), 21. In October, 1933 IRVING FISHER wrote "debt and deflation ... had wrought havoc up to March 4, 1933 ...", "The Debt Deflation Theory of Great Depressions", *Econometrica* 1 (1933), 346.

Federal Reserve reform

Roosevelt had long thought that the Fed was too much under the influence of a coterie of New York bankers, though he did not advocate public ownership of the Fed. District reserve banks had been banker-dominated and more powerful than the Board itself before 1933. Eccles saw himself as doing battle to wrest from the banking crowd "the powers they held over the nation's money mechanism and to return [*sic*] those powers to Washington".⁷⁰ Glass, however, insisted that the Fed was "a regional banking system with supervisory control by a central body". Glass, a key legislator at the time the original act was under consideration in 1913, denounced Eccles' 1935 proposals to set up "a central bank, to be managed by the Government, without the Government owning a dollar of proprietary interest in the [Reserve] banks".⁷¹

The Banking Act of 1935 markedly increased the powers of the Board in Washington over them. A.P. Giannini, head of the Bank of America, the outstanding bank west of the Mississippi, favored the measure because it would end New York's domination. The 1935 act formalized the transfer of power over the nation's monetary affairs from Wall Street to Washington, which had been underway since the Crash.⁷²

Limited reform

The 1933 and 1935 Acts did little "to correct the fundamental weakness of the banking system", the *New Republic* commented at the time. In reporting out the 1933 bill, the Senate Banking Committee

⁷⁰ ECCLES, *Beckoning Frontiers*, 248. Secretary of the Treasury William Woodin (who had earlier been on the board of the Federal Reserve Bank of New York) said the bank was operated by an insiders' clique. H. PARKER WILLS, who quoted this observation, said the same was true "at other Reserve institutions". "The Future of the Federal Reserve System", *Commercial and Financial Chronicle*, November 24, 1934, 3212.

⁷¹ Senate 1935 Act Hearings, 197.

⁷² On 18 June 1934, JESSE JONES stated that "the control of credit has been transferred from New York City to Washington". Speech at George Peabody College, Nashville, 6, in Jones Papers, 3M 500. See ELLIOTT V. BELL, "The Decline of the Money Barons", in HANSON W. BALDWIN ed., *We Saw It Happen* (New York, 1938), 139-140.

explained that in view of the immediate emergencies it had deferred "a completely comprehensive measure for the reconstruction of our banking system".⁷³ But this was not to be: the President did not see the need for radical reform. Roosevelt "took the status quo in our economic system as much for granted as his family", noted Frances Perkins, a cabinet member throughout his presidency. With respect to banking reform, the President showed "his most conservative inclinations", as Helen Burns concluded.⁷⁴ While the possibility of nationalization was used "to bring banks in line with the New Deal",⁷⁵ not even in March, 1933, did Roosevelt consider nationalization as an option.⁷⁶ Roosevelt brought to Washington from Albany "a willingness to follow the lead of conservative bankers as long and as far as he could, and also a readiness when politically necessary to cut loose and castigate the bankers for their conservatism", Frank Freidel noted.⁷⁷

Roosevelt, however, insisted on reminding the ABA convention in October, 1934, that

"the old fallacious notion of the bankers on the one side and the Government on the other as more or less equal and independent units has passed away. Government must be the leader, must be the judge of the conflicting interests of all groups in the community, including bankers".

As if to underscore the lesson, six months later Roosevelt stated in his first radio chat of 1935 that "private banking actually exists by virtue of the permission of and regulation by the people ... speaking through their Government".⁷⁸

Perceiving political advantage, Roosevelt attacked the sins of bankers. Right through (and after) the 1936 election, bankers' protests helped: the more they complained, the more the public was

⁷³ "The Balance Sheet of the New Deal", *New Republic*, June 10, 1936, 150; 73 Congress. 1 Session. Senate Report 77 (1933), 2.

⁷⁴ FRANCES PERKINS, *The Roosevelt I Knew* (New York, 1946), 328; HELEN M. BURNS, *The American Banking Community and New Deal Banking Reforms, 1933-1935* (Westport, Conn., 1974), 182.

⁷⁵ SUSAN ESTABROOK KENNEDY, *The Banking Crisis of 1933* (Lexington, Ky., 1973), 168.

⁷⁶ JAMES E. SARGENT, *Roosevelt and the Hundred Days* (New York, 1981), 103. Senator Bronson Cutting considered it a "great mistake" that Roosevelt did not nationalize the banks on 4 March 1933. "Is Private Banking Doomed?" *Liberty*, March 31, 1934, 10.

⁷⁷ FRANK FREIDEL, *Franklin D. Roosevelt: The Triumph* (Boston, 1956), 192.

⁷⁸ *Public Papers*, III, 146; 28 April, 1935 chat in *Public Papers IV*, 139-40.

convinced that the President sided with the people.⁷⁹ Even so, the popular rabble-rouser Father Coughlin denounced the New Deal in 1936 as “government of the bankers, by the bankers, and for the bankers ...”.⁸⁰ Actually, they were “damned by Washington”: the Administration had been “against bankers as a class”, a leading Washington financial journalist reported in 1940.⁸¹ But the castigation was mainly verbal.

In 1933, J.S. Douglas, an early foe of the New Deal, voluntarily closed his Bank of Clemenceau in protest against Roosevelt’s policies, feeling that “no honest man can remain in the banking business”.⁸² The Arizona banker proved to be mistaken. Banking suffered net losses in 1932, 1933 and 1934, becoming profitable once again in 1935. Over the next five years, net profits averaged a 5.7 percent return on capital. The RFC bank capital program and deposit insurance gave many thousands of banks a new lease on life. The head of the FDIC wrote to Jones when he retired from the RFC in February, 1945, “... in you I had a friend who shared my own sincere belief that the small bank is the real backbone of the nation’s financial structure and that its survival must go hand in hand with the welfare of small business”.⁸³

Banks “have never been in a sounder financial condition”, a spokesman for the ABA reported in June, 1940. He assured the Senate Banking Committee that

“whatever the demands of this country and no matter how great the credit requirements may be in this emergency which seems to lie ahead, the chartered banking system is able, has the resources, has the attitude, has the interest and the desire adequately to serve the credit needs of business and industry in this country”.⁸⁴

⁷⁹ REXFORD G. TUGWELL, *The Democratic Roosevelt* (Garden City, N.Y., 1957), 383; TUGWELL, *F.D.R.: Architect of an Era* (New York, 1967), 159.

⁸⁰ Quoted in DAVID H. BENNETT, *Demagogues in the Depression* (New Brunswick, N.J., 1969), 78.

⁸¹ UTHAI V. WILCOX, *The Bankers Be Damned* (New York, 1940).

⁸² Quoted in LARRY SCHWEIKART, *History of Banking in Arizona* (Tucson, 1982), 86.

⁸³ Leo T. Crowley to Jones, 14 February, 1945 in JONES Papers, 3M479, University of Texas.

⁸⁴ 76 Congress, 3 Session, Senate Committee on Banking and Currency, Business Loans by Federal Reserve Banks Hearings (GPO, 1940), 38. The FDIC’s *Annual Report* for 1940 stated that “the loans and securities of the banks are probably of higher average quality than ever before in our history” (p. 3)

Banking had recovered from the trauma of the early ’30s under a President whose great-grandfather had been the second head of the Bank of New York 150 years earlier, but who had a distaste for the industry.

Bank runs became a thing of the past as the FDIC and the Federal Savings and Loan Insurance Corporation restored public confidence in privately-owned depository institutions. Enlarged Federal Reserve authority enabled the central bank to provide the fractional reserve banking system with emergency liquidity, as well as the potential to conduct a more effective monetary policy. Since 1933, the American economy has enjoyed the longest interval in the nation’s history without financial panic or breakdown of the banking system.

Deposit insurance, one of a number of New Deal measures which enhanced the economic security of the multitudes, came to be accepted overwhelmingly by business. Yet at best it was a palliative: it would not be needed if all banks were Federal Reserve members and branch banking were liberalized, as Kemmerer and other leading economists argued at the time.

The New Deal left the banking structure essentially as it found it, bequeathing an agenda for banking reform. Major problem areas resulting from acts of omission in the ’30s include the dual banking system, division of responsibilities of the three federal banking agencies, and limited branching. Also remaining to be resolved in the 1990s are such acts of commission as deposit insurance premiums unrelated to risk, restrictions on bank underwriting of corporate securities, and the ban on demand deposit interest.

In retrospect, the New Deal did not push for any fundamental changes in commercial banking. “We must not rest satisfied until we enjoy what we never have had, a sound banking structure”,⁸⁵ Mills urged early in 1936. As of 1991, we still cannot rest satisfied.

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⁸⁵ *Liberalism Fights On* (New York, 1936), 159.