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THE FEDERAL RESERVE SYSTEM AND THE BANKING ACT OF 1935

As I was on my way here from Washington yesterday afternoon and was turning over in my mind what I should be saying to you today, it occurred to me that I should by all means say something about the richness and diversity of the State of Maryland, which I was crossing. Cutting across the state in a northeasterly direction through Baltimore toward Philadelphia, I had on my right hand a part of the state that I understand is devoted largely to the production of tobacco and of tomatoes for canning. That part of the state also includes Chesapeake Bay with its shipping and its production of sea food. It includes the Eastern Shore with its fertile vegetable farms. It includes also the city of Baltimore, with its important shipping, manufacturing, and distributing activities.

To the left and running far out toward the west is another fertile region largely devoted to the cultivation of vegetables and other farm crops; and in the farther most counties, where the mountains rise, there is coal, buckwheat flour, and maple syrup.

It is the production of commodities such as these that furnishes the basis of the wealth of Maryland and of the business of its banks. Your customers live largely by producing these commodities and exchanging them for commodities produced outside the state. In facilitating this exchange, which is indispensable to the economic life of the state, you bankers perform an essential function. You make it possible for the tobacco, the sea food, and the vegetables produced in Maryland to be shipped outside to other markets, and to be paid for in the simplest and surest way. If it were not for your instrumentality, and if all these exchanges of goods had to be effected by the actual handling of currency, the whole economic process would be disrupted. But, through the utilization of bank credit, the process is facilitated.

This monetary function that you bankers perform involves your cooperation with one another. The banks not only of your state but of the country as a whole and even of the world constitute a net work of credit connections by means of which the trade between different regions is carried on. One of the most important steps ever taken in this country in the way of making this net work more effective was the establishment of the Federal Reserve Banks. These institutions knit the banking business of different communities and regions closely together so that interregional and inter-community payments and exchanges can be smoothly effected. They help to bridge with credit the distances that separate consumers from producers, and the intervals of time that elapse between production and consumption - between seed time and harvest - between the fabrication of goods and their delivery.

Instead of going into special phases of federal reserve policy, I want to survey briefly but comprehensively the structure and functions of the Federal Reserve System as a whole. This means I must mention many things already quite familiar to you; I trust you will understand that I do so not because I underestimate your knowledge of the System, but because I want to fill in the whole picture.

The Federal Reserve Act, which in 1913 established the Federal Reserve Banks, is one of the most important pieces of financial legislation ever passed in this country. It represented the decision reached after many years of dissatisfaction with our banking and currency facilities, brought to a head by the panic of 1907; after a thorough study of banking here and abroad by a National Monetary Commission established by Congress in 1908; and after long and earnest public discussions of banking reform over a period of twenty years or more. Since 1913, on the basis of actual experience and in response to new developments, numerous amendments have been made to the original Federal Reserve Act. During the depression changes were made by the Glass-Steagall Act of 1932, the Emergency Banking Act, the Banking Act of 1933, the Gold Reserve Act of 1934, and other acts. The most recent as well as the most important of these is the Act approved August 23, 1935.

Federal Reserve banks

The work of the System may be considered first from the point of view of the Federal Reserve banks in their relations with the banking institutions of the country, and then from the point of view of the broader responsibilities for credit policy which come under the central organization in Washington, now known, under the Banking Act of 1935, as the Board of Governors of the Federal Reserve System.

The location of the Federal Reserve banks was not determined by Congress, but by the Secretary of the Treasury, the Secretary of Agriculture, and the Comptroller of the Currency acting as the Reserve Bank Organization Committee. To this Committee Congress delegated the authority to designate not less than eight nor more than twelve reserve cities and to divide the continental United States into a corresponding number of reserve districts. These districts, according to the law, were to be apportioned with due regard to the convenience and customary course of business. They may be readjusted by the Board of Governors of the Federal Reserve System. In addition to the twelve reserve banks there are now in all twenty-five branches and two agencies. The Federal Reserve Bank of Richmond has branches in Baltimore and Charlotte.

All National banks were required to become members of the System, subscribing to the capital stock of the Reserve banks, and depositing their reserves therein. State banks were permitted to become members on similar terms, provided they fulfilled certain requirements as to capital structure and as to the general nature of their business. This division of the banks of the country into National and State banks, with different laws, powers, and supervisory authorities, was a basic condition upon which the Federal Reserve System was superimposed, and it is a basic condition to which its operations have always had to be adjusted.

About forty percent of the banks in the country now belong to the Federal Reserve System and these banks account for about seventy percent of the country's banking resources. About 35 percent of the banks in Maryland are members of the Federal Reserve System, and they hold about 50 percent of the banking business in the state. In the United States as a whole the member banks include 5,386 national banks and 1,001 State banks and trust companies. The State banking institutions which are still outside the System are for the most part small. There are about 9,000 non-members; about 1,400 of them have deposits of less than $100,000, and about 2,600 have deposits of less than $250,000.

Under provisions of the Banking Act of 1935 State non-member banks, with certain exceptions, having average deposits of $1,000,000 or over, must become members of the System after July 1, 1942 or lose the right of having their deposits insured with the Federal Deposit Insurance Corporation.

The Federal Reserve banks differ from ordinary commercial banks in both their organization and their functions. Their customers are the member banks who make deposits with them and secure credit or currency just as the public does with the local banks. Of the nine directors of each Federal Reserve bank, three known as Class C directors are selected by the Board of Governors of the Federal Reserve System and six are selected by the member banks, three known as Class A directors representing the stock holding member banks, and three known as Class B directors representing commerce, agriculture, or industry in the district. The chief executive officer of the bank, designated as president under the new banking act, is appointed by the board of directors of the bank subject to the approval of the Board of Governors of the System. The legal requirements for ownership and management of the Reserve banks, therefore, recognize that their functions must be performed in the public interest and that their management must take account of both the banking and the general business interests of the region.

Holding member bank reserves

One of the purposes of the Federal Reserve Act was to provide institutions which would hold the reserves of the nation's banking system. Before the establishment of the Federal Reserve System, National banks were required to keep part of their reserves in their own vaults and part on deposit in other banks, usually metropolitan banks. Banks in the central reserve cities, however, of which there were then three, New York, Chicago and St. Louis, had to hold all their reserves in cash. When there was a general and heavy demand for funds, especially at crop moving times, for example, and country banks everywhere drew down their balances with their city correspondents, a situation was developed in which a currency and credit crisis of greater or less magnitude might readily occur. Country banks then had difficulty in getting money from the city banks, and the public in turn had difficulty in getting money from the country banks and from the city banks as well.

Now all member banks are required by law to keep their reserves on deposit in the Federal Reserve bank of their district and it is the business of the Reserve banks to supply member banks with credit or cash in such emergencies.

The required reserves vary with the type of deposit and the class of of bank. Banks in central reserve cities, which now are only New York and Chicago, are required by law to maintain reserves equal to thirteen percent of demand deposits, that is, deposits which can be withdrawn without advance notice. For exmple, if a customer of a New York bank borrows $1,000, his deposit balance is credited with $1,000 and the bank in turn must provide for $130 of reserve deposit at the Federal Reserve Bank of New York, unless prior to the loan it already had excess reserves of that amount or more. Banks in so-called reserve cities, of which there are about sixty, are required to maintain reserves of ten percent against demand deposits, and all other banks are required to maintain reserves of seven percent. Reserves of three percent against time deposits are required to be maintained by all banks. Member bank reserve balances on deposit with the twelve Reserve banks amount now to over $5,000,000,000. Because of unusual conditions, the total of these balances is about twice as much as the banks are required to have.

Loans to member banks

The Reserve banks also supply funds to member banks either by rediscounting paper or by making advances to member banks, as provided by law and Board regulations, or by purchasing bills and securities, and entering corresponding credits to the account of the member banks, thus increasing their reserve balances. Member banks in turn can increase their loans to the public in the aggregate by an amount several times the amount of the additional reserves.

The Federal Reserve Act, however, makes distinctions as to the character of paper on which loans may be obtained from the Reserve banks. For many years Reserve banks have had the power to discount only short-term self-liquidating commercial paper, that is notes, drafts, bills of exchange and bankers' acceptances arising out of commercial, industrial and agricultural transactions, and to make advances to member banks on their promissory notes backed by paper eligible for discount or purchase or by United States Government obligations. They were not authorized to make advances on a wide range of other assets which made up an important part of the total earnig assets of banks. These included real estate loans, securities other than those of the United States Government, and loans to business men which did not meet the requirements of the narrowly-defined eligible commercial paper.

As a result of many developments in our financial organization, paper which qualified for borrowing from the Reserve banks has constituted a constantly decreasing proportion of the total assets of member banks ever since the System was established. In 1929 it was only about twelve percent of total loans and investments of such banks, and in 1934 it was but eight percent. Consequently, in 1931 and 1932 when the great liquidation occurred, many banks with assets which were good but technically ineligible for borrowing at Reserve banks, were obliged either to dump them on a falling market, suffer severe loss and contribute to the deflation in values or to close their doors.

The new banking act corrects this situation. It authorizes the Reserve banks to make advances to member banks for periods not exceeding four months on any security satisfactory to the Reserve bank, at a rate of interest at least one-half of one percent above the highest discount rate in effect at the particular Reserve bank. This amendment modifies and makes permanent the emergency legislation which it was necessary to pass in 1932.

In addition to the foregoing general powers of discount and purchase the Federal Reserve banks have special powers with respect to loans to commerce and industry for working capital purposes. These powers are granted by Section 13b of the Act. Under this section the Reserve banks are authorized to discount loans made by member banks and other financing institutions to established industrial and commercial businesses for the purpose of supplying working capital. Such loans are to have maturities of not to exceed five years. The Reserve banks are authorized to discount these loans without recourse for as much as 80 percent of any loss thereon. The Reserve banks also have authority to grant commitments to discount such loans. This makes it possible for a member bank to hold in its portfolio loans which the Reserve bank is under obligation to take over upon request, and upon which the Reserve bank assumes 80 percent of any loss. In other words the member bank has an earning asset which is insured 100 percent as to liquidity and 80 percent as to loss. This arrangement is not restricted to member banks; it is open to non-members as well.

Under the same section the Reserve banks are authorized in exceptional cases, and when credit is not available from the usual sources, to make such loans for working capital purposes direct to the borrower.

As of May 13, the Federal Reserve Bank of Richmond had received 594 applications for working capital loans aggregating $24,000,000. Of these, 199, aggregating $11,000,000, had been approved. The Reserve bank's outstanding advances on that date were $4.200,000 and at the same time it had commitments outstanding for another $2,400,000.

These loans have been made to all kinds of enterprises, industrial and commercial. In many cases they have been loans which bankers have not been accustomed to making, and which would not be made were it not for the fact that the Reserve bank stands behind the bank which makes them. But as it is, they constitute secure and liquid assets, yielding a good rate of interest.

Currency issued by Reserve banks

Another activity of the Reserve banks is the issuance of Federal Reserve notes. These constitute the paper money authorized by the Reserve Act for the purpose of supplying the country an elastic currency - that is, a currency whose volume can be readily increased or decreased according to the public demand for it.

Federal Reserve notes are obligations of the United States and are secured by specific collateral pledged by the Reserve bank. The bank is required to keep reserves in gold certificates at least equal to forty percent of the notes in actual circulation. The Federal Reserve banks, of course, do not supply the entire currency of the country. The Government issues other paper money, silver dollars and minor coin, and National bank notes are still in circulation. The larger part of money in circulation, however, consists of Federal Reserve notes.

A member bank that has satisfactory assets can always secure all the currency that it needs. If it has a demand for more cash than it has in its vault, it can readily obtain Federal Reserve notes at its Reserve bank. It can borrow and take the proceeds in notes or it can draw against its account and, if necessary, restore the account to the required level by borrowing. If it receives on deposit from its customers more currency than it needs to keep on hand for current requirements, it can send the excess to the Reserve bank to be added to its reserve balance.

The function of supplying elastic currency is important, but it is less important than the lending power, because currency does not play a major role in present-day business transactions. About ninety percent of our business is conducted by the use of checks. Currency is used, for example, for purchases at retail stores and filling stations, for car fare, and for payrolls, but such uses account for only about ten percent of the total monetary transactions in the country. Such fluctuations in the demand for currency as appear regularly on pay days, during the period of Christmas shopping, and near holidays, are met completely by the machinery provided by the Federal Reserve Act.

Other activities of Reserve banks

Beside their work in holding the banking reserves of the country, in making loans to member banks, and in supplying currency when needed, the Reserve banks have other important functions which facilitate the smoother working of our financial machinery.

The Reserve banks have greatly simplified the procedure whereby banks collect checks drawn on other banks. This has been very useful to business in general because it has permitted more prompt and cheaper settlement of monetary transactions. The Reserve banks in effect act as a nation-wide clearing house, not only for checks, but for other credit items such as notes, drafts, bonds and coupons.

In order to effect the prompt transfer of funds from one part of the country to another without actual movement of currency, the System maintains an inter-district Gold Settlement Fund in Washington. The fund was established by deposits of the twelve Federal Reserve banks, and transfers from one district to another are made daily by debits and credits to the respective accounts of the Reserve banks.

The Federal Reserve System has centralized the work of the fiscal agencies of the United States Government. The Reserve banks act as fiscal agents in connection with the issue and retirement of Government debt and as depositaries of Government funds in administering deposit accounts of the Government in the Reserve banks.

Central control of credit policy

I wish to turn now from this discussion of the functions which the Federal Reserve banks perform for the local banks and consider how these activities tie in with the general responsibility of the System, through its Board of Governors, for the nation's credit policy.

When the Federal Reserve System was established it was realized that for certain activities, particularly those related to local banking conditions, a regional organization was necessary. Only in this way could the System meet local bank needs in a country as large as the United

States, with economic conditions varying so much from one section to another. Each regional bank would have intimate knowledge of developments in agriculture, commerce and industry in its district and of the district's special credit needs and problems. The principle was also established by the original Federal Reserve Act that under the authority of the Act and of regulations of the Board in Washington the Reserve banks should have final responsibility in their dealings with member banks.

At the same time, it was also realized that the credit policy of the different Federal Reserve banks must be coordinated so that policies adopted in one district would not be harmful to another. More than that, there should be a credit policy for the country as a whole which would take account of general business and credit conditions. The direction of this policy is the duty of the Board of Governors of the Federal Reserve System, which is the central organization located in Washington. The Board is aided by other organizations which work closely with it, the Federal Advisory Council and the Federal Open Market Committee.

Board of Governors of the Federal Reserve System

Experience has indicated that this power of the Board to affect the expansion and contraction of the general supply of credit is of vital importance to the country, since the volume of credit is a factor in determining the course of business, and proper changes in the cost and volume of credit may tend to moderate excessive expansion or contraction of business, or, in other words may reduce the danger of inflation and deflation.

The Board's ability to influence the volume of credit rests on three important powers: the power to determine discount rates, the power to change reserve requirements, and the power, exercisable through its majority of members on the Federal Open Market Committee, to determine open-market policies.

Discount rates

Discount rates are the rates charged by the Federal Reserve banks on loans to member banks. These rates determine the cost of borrowing by member banks and consequently have a bearing on the cost at which the public can borrow from these banks. Indirectly they affect other rates in the money market. Under the Federal Reserve Act changes in discount rates are made by the various Federal Reserve banks but are subject to review and determination by the Board of Governors. This gives the Board final responsibility over the discount rates, and enables it to keep the cost of borrowing in the different sections of the country consistent with general credit conditions for the country as a whole.

The new banking act strengthens the Board's power to control these rates by making the further provision that discount rates must be submitted to the Board of Governors every fourteen days. This insures frequent review of the rates.

Reserve requirements

The Board of Governors also has the power to change the reserve requirements of member banks. The volume of credit which any member bank may extend is limited by the amount of reserves which are required by law to be maintained against its deposit liabilities. An increase in the reserve requirements reduces and a decrease increases the potential volume of member bank credit. Consequently the power to change reserve requirements gives the Board an important means of controlling the general volume of credit. Formerly this power could be exercised only in the event of an emergency arising out of credit expansion and then only with the approval of the President of the United States. Under the new act these conditions are omitted. The power is to be exercised in order to prevent injurious credit expansion or contraction, provided that reserve requirements may not be reduced below the present requirements specified in the law nor increased to more than twice the amount of these legal requirements.

Open-market operations

The third important means of control over the supply of credit are the so-called open-market operations, responsibility for which under the new banking act will be vested in a new Federal Open Market Committee. This committee will consist of the seven members of the Board of Governors and five representatives of the Reserve banks selected by the Reserve banks in different regions.

Open-market operations consist of the purchase and sale by Reserve banks of certain classes of securities, chiefly Government obligations. These operations have the effect of increasing or decreasing the supply of credit available in the market. By selling securities the Reserve banks withdraw funds from the market and there is a decrease in the supply of credit. Through a purchase of securities a Reserve bank puts funds into the market, thus tending to ease credit conditions.

Purchases and sales of securities by the Reserve banks were unimportant in the early days of the System. It was not until 1922 that they were large enough to affect the money market. At that time it became necessary to take steps to coordinate purchases and sales so that credit conditions for the country as a whole would not be adversely affected. Gradually these purchases and sales have become one of the most important means whereby the System can take the initiative in influencing credit conditions.

The responsibility for determining what security transactions should be undertaken and the authority for enforcing a program were not clearly defined by law until the new banking act. At the time this act was passed an Open Market Committee consisting of representatives of the twelve Reserve banks was authorized to propose purchases and sales. Its proposals were then submitted to the Federal Reserve Board, which had the authority to approve or disapprove but not to initiate a policy.

The new act clearly places responsibility for determining open-market transactions on the new Open Market Committee and directs the Reserve banks to carry out the transactions determined by this committee. This is one of the most important changes in the Federal Reserve System which the new act introduces.

Other work of the Board

The Board of Governors has a variety of other duties which tie in with its general responsibility for supervision of the System. These include the examination of Reserve banks, passing on applications of State banks and trust companies for membership in the System, obtaining condition reports from State member banks, administration of those provisions of the Clayton Anti-trust Act which relate to interlocking bank directorates, regulation of the maximum rate of interest to be paid by member banks on time and savings deposits, regulations under the Security and Exchange Act governing the margin requirements for loans on securities listed on the stock exchanges, and maintenance and operation of the inter-district Gold Settlement Fund.

Information bearing on credit policy

It has always been a part of the System's work to watch credit trends and to develop a better general understanding of the facts bearing upon credit policy. Information bearing on banking conditions throughout the country and on production, employment, trade and prices, has been regularly collected. In its monthly publication, the Federal Reserve Bulletin, and in its Annual Reports, the Board has undertaken from the beginning to give the public a comprehensive view of current banking and financial developments at home and abroad and also to furnish detailed information on conditions of banks throughout the country and on the business situation. Each of the Federal Reserve banks also publishes a monthly review of the business and banking conditions in its district.

There is no central bank in the world which makes available such exhaustive information on domestic banking and business developments and on the formulation of its credit policy as that which is published by the Federal Reserve System.

In the foregoing description of the System and its functions I have had occasion to mention most of the important changes effected by the Banking Act of 1935, but I think it is desirable to summarize them for the sake of completeness. I omit reference to Title I of the Act, for it deals exclusively with deposit insurance. I also omit reference to Title III, for the changes it effects are mainly technical and by way of clearing up previously existing provisions. The following changes are summarized from Title II:

1. Since March 1 the chief executive officer of each Federal Reserve bank is designated president instead of governor, and the deputy governors are designated as vice presidents.

2. The Board is given authority to waive in whole or in part the statutory requirements relating to the admission of State members to the Federal Reserve System, if such waiver is necessary to facilitate the admission of any State bank which is required to become a member in 1942 in order to be an insured bank or to continue to have its deposits insured.

3. The old designation of the Board as the Federal Reserve Board is changed to Board of Governors of the Federal Reserve System. An important change in the composition of the Board became effective February 1 when the Secretary of the Treasury and the Comptroller of the Currency ceased to be members, and the number of members was changed from eight to seven. The regular term is now fourteen years, and no member having

served a complete term of fourteen years can be reappointed. The title of the chief executive officer of the Board has been changed from Governor to Chairman.

4. The Board is required to keep a complete record of the action taken by the Board and by the Open Market Committee upon all questions of policy and of the reasons underlying such action and to include a copy of the records in its annual report.

5. The Federal Reserve banks may make advances to member banks with maturities of not to exceed four months, secured to the satisfaction of the Reserve bank, and at a rate of interest not less than 1/2 percent higher than the Reserve bank's discount rate. This is the authorization I have already discussed which enables member banks to borrow from the Reserve bank not merely on so-called eligible paper, but on any good assets.

6. The Open Market Committee is made to consist of the members of the Board and of five representatives of the Reserve banks, and is given definite authority over the open market operations of all the Reserve banks.

7. The express stipulation is made that direct obligations of the United States and obligations which are fully guaranteed by the United States may be bought and sold by Reserve banks without regard to maturities, but only in the open market. This is to prevent direct purchases of issues of government securities from the Treasury.

8. Federal Reserve bank discount rates are required to be established every fourteen days, or oftener if deemed necessary by the Board.

9. The Board of Governors, on the affirmative vote of four of its members may by regulation change the requirements as to reserves to be maintained against time and demand deposits by member banks; but the change shall not make the required reserves less than now established by law nor more than twice that now required. Formerly the existence of an emergency and the approval of the President were necessary conditions of such action by the Board.

10. National banks may make real estate loans up to 50 percent of the appraised value of the mortgaged property for periods not exceeding five years; except that if the loan is on an amortization basis it may be made up to 60 percent of appraised value and for a term of not longer than ten years. Real estate loans must not exceed the capital and surplus of the bank, or 60 percent of the bank's time and savings deposits, whichever is greater.

There are two important changes effected under the new banking legislation and I should like in conclusion to emphasize them.

First there are the provisions that fix responsibility more definitely for the the determination and direction of national credit policy through control of open market operations, of discount rates, and of reserve requirements.

Second there are the provisions that broaden the classes of member bank assets eligible as security for loans from Reserve banks, and encourage local banks to meet a wider range of credit needs in their communities.

It must be recognized, however, that if the System is to achieve as much as we all hope, it will need more than these new provisions. It will need the cooperation of business men, bankers, and the general public. For that reason I appreciate the opportunity I have had of discussing with you the System's powers and purposes.