BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

Z-2409 (On office copies only)

ADDRESS OFFICIAL CORRESPONDENCE TO THE BOARD

December 28, 1948.

Dear Sir:

There is enclosed, for your information, a copy of a letter of December 6, 1948, from Mr. Allan Sproul, President of the Federal Reserve Bank of New York, with a copy of the Board's reply thereto of this date, regarding the setting up of additional contingent reserves at the end of the current year.

Very truly yours,

S. R. Carpenter,
Secretary.

Enclosures 2

TO THE PRESIDENTS OF ALL FEDERAL RESERVE BANKS

FEDERAL RESERVE BANK

OF NEW YORK

December 6, 1948.

Board of Governors of the
Federal Reserve System,
Washington, D. C.

Gentlemen:

You will recall the discussion at the recent joint meeting of the Board of Governors and the Presidents of the Reserve Banks concerning the amount and disposition of the net earnings of the banks which are to be withheld from payment to the Treasury during the current year, and you will also recall the reservations, expressed by Mr. Rounds of this bank, concerning the procedure which apparently was contemplated in accounting for these funds. Mr. Rounds has now discussed the matter with me; we have jointly discussed it with our Board of Directors, and we all feel strongly that it would be a mistake, and might be a serious mistake, for the Federal Reserve Banks to transfer $40 million (or any similar amount) to reserves for contingencies at this time. It seems to us that much the wiser course would be to transfer this amount to surplus, both as a matter of good accounting and, more importantly at the moment, in view of our relations with the Government security market.

It is our understanding that it is the wish of the Board of Governors (and of the Treasury) to avoid the issuance of a statement amending the statement issued April 24, 1947 concerning the payment to the Treasury of an interest charge on Federal Reserve notes not covered by gold certificates as collateral security. It is our further understanding that it has been suggested that an amended statement would be necessary if funds withheld from the Treasury (in excess of 90 per cent of net earnings during 1948, before payments to the Treasury) are transferred to the surplus account of the Federal Reserve Banks, but would not be necessary if these funds are treated as a deduction from current net earnings, and placed in reserves for contingencies, before the determination of the net earnings figure against which the 90 per cent factor is to be applied. This seems to us to be a mistaken estimate of the situation. Technically, we do not think it would be necessary to issue an amended statement, if less than 90 per cent of net earnings are paid to the Treasury this year and the sum withheld is transferred to surplus. And if the suggested alternative procedure is followed, we believe we shall run grave risk of having a statement dragged out of us, giving the appearance of having attempted concealment by an accounting device and exposing the Government security market to the worst possible interpretations of our action.

First, as to the technical necessity of a statement if the funds are transferred to surplus. The key sentence of the April 1947 statement reads as follows: (there are other implications in the statement, of course)

> "The Board has now decided to establish such rates of interest as will make it possible to transmit to the Treasury approximately 90 per cent of the net earnings after dividends of each of the Federal Reserve Banks for 1947."

This clearly and specifically sets forth a policy and a program for the year 1947, but does not commit the Board nor the System to the same policy and program in subsequent years. If, now, the policy is continued but the formula changed, another statement would not seem to be mandatory. It may be made if desired, but whether made or not the accounting will not be such as to direct particular and probably suspicious attention to our action.

If, on the other hand, we deduct a substantial amount from current net earnings, and then treat the reduced amount of net earnings as the base for a 90 per cent payment to the Treasury, what is our position? Immediately after the year end the statements of condition of the Federal Reserve Banks will show an increase in "Other Capital Accounts" of from approximately $25 million to $65 million or more. This is a large increase in this minor account, of course, but conceivably it might pass unnoticed since the account is an obscure one, and its makeup little understood. The next and much more serious hurdle would be the profit and loss accounts for the year, published by the Federal Reserve Banks as soon as possible after January 1st. Attached is a copy of the statement issued last year by this bank. It shows a deduction from current net earnings ("All Other") of $70 thousand. If we now go forward as proposed in accounting for a reduced payment to the Treasury this year, our statement will show a deduction of $10 million. We do not think it would be possible to increase this item from $70 thousand to $10 million without either volunteering an explanation or having it demanded by a vigilant press and curious bankers. In either case we should have to make an honest explanation which would be an embarrassing explanation. A reserve for contingencies is generally interpreted to be a reserve for possible losses, and the only substantial losses to which we might be exposed are losses on our portfolio of long term Government bonds. In effect, therefore, we would be telling the banking and financial community, as well as the general public, that we are setting up a reserve for possible losses on Government securities. To do so, at this time, would be to invite speculation as to a change in our policy of support of the 2 1/2 per cent rate on long term Government securities and place our open market program in further jeopardy. Finally, and as an added source of publicity and comment, there would be the report issued by the Board of Governors showing the combined profit and loss account of the twelve Federal Reserve Banks. Presumably this would show an increase in "Reserves for Congingencies" from $406 thousand last year to something over $40 million this year. The latter figure might equal 50 per cent or more of the total assets of the System other than cash and Government securities, and obviously the contingency it envisaged would be a loss in the Government security portfolio. When questions about such a drastic change in our accounts are asked of a number of people at the Board and at the twelve Federal Reserve Banks and their branches, the likelihood of embarrassing or dangerous interpretation of the answers is great.

It might be argued that we shall face the same embarrassment if we transferred the funds under discussion to surplus account. We do not believe this would be the case. In the first place, we would be following the practice of the previous year in our accounting, rather than making a change which suggests, if it does not require, an explanation and which would expose us to the charge of having used a bookkeeping technicality to reduce our payment to the Treasury. In the second place, the differences between the figures from year to year would be less in the case of a transfer to surplus, and the general magnitude of the figures would be more nearly of the same order. Finally, a substantial increase in the surplus account of the Federal Reserve Banks could be related to the general increase in the dollar figures representative of our whole economy and in the dollar resources and liabilities of the banking system during recent years. We would not be highlighting a special reserve for a particular contingency.

To sum up, we do not believe it is technically necessary for the Board of Governors to issue a statement amending its statement of April 24, 1947 if we pay less than approximately 90 per cent of our net earnings to the Treasury in 1948. If no statement is issued and inquiries are subsequently made, or if a statement is issued in the first instance, we could say that the formula for assessing the interest charge on uncovered Federal Reserve notes for 1948 has been calculated so as to pay approximately 80 or 75 per cent (or whatever the percentage is) of our net earnings to the Treasury, that the reduction from the 90 per cent paid in 1947 was deemed desirable in order that a larger amount might be transferred to the surplus accounts of the Federal Reserve Banks in the light of the expansion of our whole economy during recent years, and that the formula may well be a variable one from year to year. There might still be undesirable interpretations of this action, but the risk of a universal and almost inescapable assumption of a reserve for losses on Government securities would be much less than if we adopt the device of a reserve for contingencies.

Our directors and officers respectfully urge the Board, therefore, to adopt an accounting procedure at the year end, which will provide for transfer to the surplus account of the Federal Reserve Banks of whatever funds are withheld from the Treasury. We believe that this will be better accounting, will run the least risk of adverse publicity and adverse public reaction, and will help to avoid possible serious repercussions in the Government security market. Since we have the impression that a majority of the Board and of the Banks have always preferred this procedure, and would have continued to advocate it had it not been for the collateral question of the statement to be issued, and since we are convinced that the need for a statement will be less and the materials for a statement, if issued, will be better if we do not now depart from our recent accounting practice, we have no hesitancy in urging this course upon you.

Yours faithfully,

(signed) Allan Sproul

Allan Sproul,
President.

Enclosure

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

December 28, 1948.

Mr. Allan Sproul, President,
Federal Reserve Bank of New York,
New York 45, New York.

Dear Mr. Sproul:

This is in reply to your letter of December 6, regarding the setting up of additional contingent reserves by the Federal Reserve Banks at the end of this year.

You have set forth very clearly reasons why you think it preferable to credit to surplus rather than to contingent reserves the amounts which have been deducted from current net earnings. Were it not for the circumstances under which the formula for distributing earnings was developed, the plan you suggest might be the most advisable to follow.

As you mention, at the recent joint meeting of the Presidents with the Board on December 1, 1948, this matter was discussed, and it was the general opinion of the Presidents that, while ordinarily it would be preferable to transfer the amounts withheld to surplus, the present arrangement should be continued in order to avoid the necessity of raising at this time the question of an amendment to the existing procedure under which 90 per cent of the net earnings of the Federal Reserve Banks after dividends are paid to the Treasury. The Board concurs in this view.

In your letter you express the opinion that, technically, it would not be necessary to issue an amended statement if the amounts in question were transferred to surplus.

Regardless of any question of technicality, the Board believes that such a course would not be in keeping with the arrangement. The press statement issued April 23, 1947, regarding the payments to the Treasury appeared also in the Federal Reserve Bulletin, the Annual Report of the Secretary of the Treasury, and, in condensed form, in the Board's Annual Report. The whole tenor of the statement was that of a continuing arrangement made in lieu of payment of a franchise tax. In view of the circumstances leading up to the adoption of the arrangement, with which you are familiar, the Board believes that it would not be appropriate to make the transfers to surplus without reopening the matter with the Government officials with whom it was discussed and the issuance of an amended statement.

There remain, therefore, the alternatives of revising the arrangement and issuing a new statement or of continuing under the present understanding, which is satisfactory to the Treasury.

The Board does not believe that the crediting of 10 million dollars to contingent reserves by your Bank or the crediting of 40 million dollars to contingent reserves by all twelve Federal Reserve Banks during the year would call for the issuance of an explanatory statement, as it is consistent with practices currently followed by both banks and business organizations and the amounts are not out of line with the size of the Banks. It would not seem that the setting aside of contingent reserves of 40 million dollars by organizations with total footings of approximately 50 billion dollars could reasonably be considered excessive or likely to bring forth substantial criticism.

If a question were raised regarding the appropriateness of the reserves it might be pointed out in addition that the Reserve Banks ship many millions of dollars of currency daily and carry their own risks on such transactions, that they have premium accounts of approximately 80 million dollars on their books brought about largely by operations in recent months, and that in all of the circumstances it was considered desirable to make the transfers to reserves for contingencies.

Attached is an illustration of how the Board proposes to show the profit and loss account of the Federal Reserve Banks in the Annual Report. The figures shown in the example are, of course, merely illustrative.

In view of the interest of the other Federal Reserve Banks in this question, the Board is sending to the other Presidents copies of your letter and of this reply.

Very truly yours,

(Signed) S. R. Carpenter

S. R. Carpenter,
Secretary.

Attachment

Form of Profit and Loss Section of Statement of Earnings and Expenses of Federal Reserve Banks to be Included in Annual Report

(The figures shown are illustrative of the proposed set-up.)

Current net earnings	$230,000,000
Additions to current net earnings:	
Profits on sales of U. S. Govt. securities (net)	3,700,000
All other	--
Total additions	3,700,000
Deductions from current net earnings:	
Special depreciation on bank buildings	300,000
All other	--
Total deductions	300,000
Net additions	3,400,000
Transferred to reserves for contingencies	40,400,000
Paid U. S. Treasury (interest on outstanding F. R. notes)	163,000,000
Net earnings after reserves and payments to U. S. Treasury	30,000,000
Dividends paid	12,000,000
Transferred to surplus (Sec. 7)	18,000,000