BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date January 17, 1949

To Governor Eccles

From Governor Evans

Subject:

For some time I have been trying to think of ways whereby nonmember banks could be induced to join the Federal Reserve System. I asked Mr. Smead to prepare a memorandum on the subject before he left and I am sending a copy to each Board Member. After you have read it carefully, I suggest that the Board Members get together and discuss what can be done to secure more members.

MSE

Copy

December 20, 1948

To Governor Evans

From Mr. Smead

Sometime ago you asked me to give you a brief memorandum covering some of the more important changes in the Federal Reserve Act that would make membership in the Federal Reserve System more attractive.

I am therefore listing below the changes which I think would be particularly helpful in this respect. There are, of course, other things that can be done*, including some that do not require legislative action, such as giving more prompt credit for country checks. After setting forth the suggested changes, I shall comment briefly on each of them.

1. Remove all capital requirements for admission to membership in the Federal Reserve System.

2. Require all banks that accept demand deposits (or at least all insured banks) to keep reserves with the Federal Reserve Banks, or in vault cash.

3. Permit banks to send all checks, nonpar as well as par, to the Federal Reserve Banks for collection.

4. Revise the method of determining required reserves of member banks so that the requirements will depend upon the type of deposits rather than on location of banks.

5. Distribute a substantial part of the earnings of the Federal Reserve Banks, not needed for expenses and dividends, among member banks on the basis of their required reserves.

Comments

Item 1. It seems to me that there should be minimum capital requirements for the organization of banking institutions, but that once a bank is chartered and is in actual operation no capital impediment should be placed in the way of its becoming a member of the Federal Reserve System, any more than to membership in the Federal Deposit Insurance Corporation. As a matter of fact, if such a limitation is to be invoked, it would be more appropriate

* See page 275 of "Banking Studies"

for it to apply to the right to have deposits insured than to membership in the Federal Reserve System. If all banks that accept demand deposits, or all insured banks, were required to carry reserves with Federal Reserve Banks, that alone would make meaningless the special capital requirements for membership in the System.

Item 2. Recent events have brought to the forefront the purpose for which reserves are required to be carried with Federal Reserve Banks and the need for seeing that the obligation to carry such reserves is equitably portioned among the banking institutions that receive the benefits of the Federal Reserve System.. Nonmember banks now receive, for all practical purposes, many of the benefits of the Federal Reserve System that are available to member banks, without any of the obligations of membership. If there is a member bank and a nonmember bank in a given community the nonmember bank has a decided competitive advantage over the member bank because of the larger proportion of its funds which is available for investment. When reserve requirements were but a small fraction of deposit liabilities and were not greatly in excess of the funds the banks needed to carry on their daily operations, the competitive advantage of the nonmember bank over the member bank was slight. In recent years, however, reserve requirements have had to be increased on several occasions, and they are now so high that membership in the Federal Reserve System has become a burden that member banks may not be able to carry indefinitely and at the same time successfully compete in their local communities with nonmember banks.

Item 3. At the present time large numbers of member banks do not send any of their checks to the Federal Reserve Banks for collection, largely because nonpar items are not collectible through the Reserve Banks. If the Federal Reserve Banks are going to collect checks they should be able to give their member banks a prompt, economical, and complete check collection service. This they cannot do unless they are permitted to handle all items the banks choose to send them. It is not practicable in many cases for a bank to sort out nonpar items from par items and send the par items to the Federal Reserve Banks and the nonpar items to their correspondents for collection. Until this obstacle is removed, by an amendment to the law or otherwise, the check collection system of the Federal Reserve Banks cannot be made to adequately serve the banks and business interests of the country.

Item 4. As has been repeatedly pointed out in recent discussions, the present system of basing required reserves on the location of member banks is inequitable and obsolete. It creates many injustices, in that banks doing the same type of business are subject to different reserve requirements. A change in the law to require that reserves be based on type of deposits rather than the location of the banks is long overdue. The reasons for this change have been fully brought out by Mr. Bopp.

(It is quite possible that the Board should have authority in times of emergency to subject banks to special reserve requirements. As you know, several such proposals have been considered by the Board during the past few years. One proposal, which seems to me to have considerable merit, particularly in connection with the support of the Government bond market, is the so-called ceiling or dual reserve plan under which balances of a member bank with its Federal Reserve Bank in excess of its required reserves on a date specified by the Board would not count as reserves.)

Item 5. Earnings of the Federal Reserve Banks are now running at extraordinarily high levels, and it is quite likely that they will continue to do so for many years to come. If a substantial part of the excess earnings of Federal Reserve Banks were distributed among member banks on the basis of their required reserves, objections to membership in the Federal Reserve System would be greatly reduced. At the present time member bank reserve requirements amount to about $19 billion, or over $10 billion above the statutory minimum requirements. A payment of 3/8 per cent on required reserves in excess of the statutory minimums would amount to about $38 million. If member banks were to receive such a return on their required reserves maintained with the Reserve Banks the financial loss incident to membership would be greatly reduced.

In any attempt to obtain legislation with respect to the above suggestions, it seems to me important that the System, through adequate publicity and personal contacts, convince bankers generally, and in advance, that the Board is interested in the welfare of the banking system as a whole and that it is definitely opposed to preferring one class of banks over another. Complete fairness helps to sell many a worthwhile project, even though it may be costly to some. As an illustration of what I have in mind, I think it is much easier to sell the idea that all banks that are recipients of the benefits of the Federal Reserve System should share in its support than it is to sell the idea of membership in the Federal Reserve System. Anyone can readily see the fairness and equity of requiring all beneficiaries to join in the support of the System, but it is much more difficult for them to see membership in the same light.

(signed) E. L. Smead