

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Eccles -

Gov. Vardaman called me and asked me to call you/attention to the draft of the memorandum regarding Responsibilities of Directors of Federal Reserve Banks, which is to be taken up at the Board meeting this morning. He thinks the entire letter is very weak and that some one like Mr. Thurston, who understands public relations, should be requested to redraft it and put it in better language.

He especially wants you to read paragraphs 2 and 3 of Section I on Page 3--this he thinks is bad presentation. And on Section 4 on Page 4, Examination of Member Banks--he feels this is inaccurate.

V.E.

RESPONSIBILITIES OF DIRECTORS OF FEDERAL RESERVE BANKS

When a new director takes his place upon the Board of a Federal Reserve Bank he naturally does so with a desire to make as substantial a contribution as possible to that undertaking. How effective his initial efforts may be will depend to a large extent upon how familiar he is with the operations of a Federal Reserve Bank, both as a separately chartered institution and as an integral part of a nationwide central banking system. Experience has demonstrated that a new director takes some time to familiarize himself with the many important differences between the overall functions of a Reserve Bank directorate and that of an ordinary commercial bank or other business enterprise. For that reason this memorandum has been prepared and is being sent out by the Board of Governors with a view to directing your attention to some of the important national aspects of System operations and the part which you can play in shaping the course of these operations. It is intended to give you a "bird's eye view" of the System as the nation's central banking organization.

A supplemental statement prepared at your Federal Reserve Bank will be given you by the Bank, which discusses the internal organization and affairs of the Bank.

THE FEDERAL RESERVE SYSTEM

The Federal Reserve Act, passed in 1913, created the Federal Reserve System which is presently comprised of the Board of Governors, the Federal Open Market Committee, the Federal Advisory Council, the twelve Federal Reserve Banks, and nearly 7,000 member banks. As the core of the System, Congress required every national bank to become a member stockholder and depositor in the Federal Reserve Bank of its district. State banks and trust companies may become members voluntarily, with the approval of the Board, by subscribing to the capital stock of the Federal Reserve Banks the same amount in proportion to their capital and surplus as is required of national banks as members.

The role of the Board of Governors in the Federal Reserve System is largely policy making and supervisory in character. Among the major powers granted to the Board are the supervision, regulation and examination of the twelve Federal Reserve Banks and their branches; the supervision and regulation of the issue of Federal Reserve notes, which comprise the principal part of the volume of money in circulation; the admission of State banks to membership in the System, the granting of trust powers to national banks, and the examination of member banks; the determination of the amount of reserves that shall be held by member banks and the approval of the discount rates at Reserve Banks; the determination of the amounts which banks, brokers and others may lend on listed stocks; the fixing of the interest rates that member banks may pay on time and savings deposits; and the removal, upon proper citation and procedure, of any person as an officer or director of any member bank for continued violation of banking

laws or unsafe or unsound banking practices. In addition to these instances of particular regulatory authority, the Board has, in the field of national credit policy, an even more general and comprehensive responsibility for contributing to the maintenance of sound monetary and credit conditions.

The twelve Federal Reserve Banks are the functional units for accomplishing the broad objectives of the Federal Reserve Act. By virtue of their strategic location in the money markets of the United States they are in a position to exert important influences over the member banks -- indeed over all banks -- in their districts through the dissemination of information and advice on matters involving national monetary and credit policy. Particular examples of their specific responsibilities include the accommodation of the local credit needs of the district through advances and discounts for member banks. They are also empowered to lend directly to business organizations under certain conditions. In addition they are the medium for supplying the member banks of their districts with Federal Reserve notes and other currency. They act as the fiscal agent of the United States and this phase of their activities covers many phases of the Government's business. They hold the reserve deposits of their member banks, and they act as clearing houses and collecting agents in the nationwide collection of checks and other instruments.

The Federal Advisory Council is composed of a representative of each of the Federal Reserve districts, twelve in all, who are elected by the boards of directors of the Reserve Banks. The Council meets with the Board several times each year to discuss and advise with the Board on important matters of System policy.

The Federal Open Market Committee is composed of all the members of the Board and five of the presidents of the Reserve Banks. The latter, with the exception of the President of the Federal Reserve Bank of New York, are on a rotating basis. The function of the Open Market Committee is to direct the purchase and sale of Government securities held by the Federal Reserve Banks.

PURPOSES OF THE FEDERAL RESERVE SYSTEM

The principal purposes of the Federal Reserve System are:

(1) the accommodation of commerce, industry and agriculture through the exercise of the System's influence upon the general credit situation of the country; (2) the issuance and retirement of Federal Reserve notes to meet the currency needs of the country; (3) operation of an efficient system for the clearing and collection of checks; (4) a more effective supervision of banks; and (5) to act as fiscal agent of the United States. A detailed discussion of the means by which these objectives were intended to be accomplished is contained in a booklet entitled "The Federal Reserve System, Its Purposes and Functions", and a larger volume entitled "Banking

Studies", copies of which are being placed in your hands. However, it may be helpful here briefly to outline the basic System activities which underlie each of these purposes.

(1) The System's Credit Controls. The most important function which the System was designed to perform is that of helping to stabilize the economy at the highest sustainable levels of production and employment so far as that national objective may be accomplished through exercise of monetary or credit influence. The tools which Congress fashioned for System use, with respect to this objective, were powers to fix discount rates, to fix reserve requirements of member banks (within certain statutory limitations), and to make open market purchases and sales of Government bonds.

Events beyond the control of the System have done much to nullify these powers as instruments for influencing the volume of bank credit. This is due principally to the tremendous increase in the amount of Government securities outstanding, particularly those held by the banks, which resulted from the Government's financing of World War II and the need for the System to provide an orderly market and support for marketable bonds. Today, with the economy of the country threatened by dangerous postwar inflationary influences, the banks are in a position to expand credit almost at will by selling Government bonds and converting the proceeds into loans and discounts. So long as the System remains committed to the support of the Government long-term bond market -- a commitment which seems hardly likely to be withdrawn in the near future -- the banks are thus free to expand credit without restraint, since discount rates and reserve requirements under existing law are not effective deterrents.

This is one of the most important problems which face the System today. It challenges the best thinking in all of the System's units. If the Federal Reserve System is to continue as the nation's principal agency for combating economic instability, it behooves all who are connected with the System to come to grips with the problem in a realistic and objective manner in seeking solutions based on a broad conception of the national interest.

(2) The Issuance and Retirement of Federal Reserve Notes. The issuance and retirement of Federal Reserve notes is largely an automatic, although entirely elastic, process. Federal Reserve notes are paid out by the Reserve Banks to member banks on request. Any Federal Reserve Bank can obtain the notes from its Federal Reserve agent upon pledging gold certificates, eligible paper or any United States Government obligations. The only limitation is that the Reserve Banks must have in their own hands or pledged with a Federal Reserve agent gold certificates amounting to not less than 25 per cent of the Federal Reserve notes in circulation in addition to having in their own possession gold certificates amounting to not less than 25 per cent of their deposit liabilities. Under this system the currency tide of the nation simply ebbs and flows as the needs of the member banks in each district may dictate.

(3) The System's Nationwide Clearing House. The clearing house function of the Federal Reserve System is also largely a mechanical operation. Member banks send to their Reserve Banks checks which they have received for deposit and which are drawn on banks both within and without their Federal Reserve district. Each Reserve Bank in turn sends checks drawn on member banks in its district to such banks, charging their accounts for the proceeds; checks drawn on banks located out of such district are forwarded to the Federal Reserve Bank or branch in such district and a similar process is followed. Thus, the great bulk of the nation's checking business is accommodated without the physical transfer of any currency; the Federal Reserve Banks clearing with each other and the member bank accounts being charged and credited in offsetting amounts.

(4) Examination of Member Banks. Each Federal Reserve Bank is responsible for the examination of the State member banks in its district. While under the law the System is authorized to examine all member banks, in practice these examinations are conducted only of State member banks and do not include examinations of national banks. The latter are examined by the Comptroller of the Currency and his reports of examination are accepted by the System rather than having a duplication of such functions. As a rule, the State member banks are examined at least once each year by the Reserve Bank of that district.

(5) The Fiscal Service Function. The Federal Reserve Banks act as fiscal agents, custodians and depositories for the Treasury Department and certain other Government agencies such as the Reconstruction Finance and Commodity Credit corporations. For the Treasury, the principal operations performed are those in connection with the issue, exchange and redemption of Government securities and the handling of Government checks, coupons and receipts covering withheld taxes. For the RFC, CCC and other Government agencies the principal operation now performed is the acceptance, custody and release of securities and other valuable documents. About one-third of the total personnel of the Reserve Banks is engaged in fiscal agency operations.

IMPORTANT RELATIONSHIPS BETWEEN BOARD AND RESERVE BANKS

As indicated above, the function of the Board of Governors is largely supervisory and policy making in character. To the Board has been delegated the responsibility for integrating and coordinating the operations of the System as a whole to the end that the System may produce maximum results in the public interest. In order that the Board might effectively discharge this responsibility Congress has vested in it a number of general and specific powers which bring the Board and the Federal Reserve Banks into a variety of important day to day working relationships. A few examples of these powers and the manner of their exercise may assist a new director more quickly to understand the division of responsibilities as between the Board and the Reserve Banks.

Thus, the Board was granted the power to "exercise general supervision over (the) Federal Reserve Banks", to "examine at its discretion the accounts, books, and affairs of each Federal Reserve Bank", and to "require such statements and reports as it may deem necessary" from time to time. Such an examination is made at least once each year and the results are brought to the attention of the Bank's board through its chairman. In fulfilling its responsibility of "general supervision" the Board has also acted in numerous ways to protect the proprietary interest of the United States in the Reserve Banks. As you are no doubt aware, upon liquidation of a Reserve Bank the member banks in that district are entitled only to receive the par value of their shares, with accrued dividends, any surplus of such Bank being made the property of the United States Government by the Federal Reserve Act. Even now, approximately ninety per cent of the net earnings of the Reserve Banks over and above the statutory dividends payable to the member banks are channeled into the United States Treasury through an interest charge levied by the Board on the amounts of Reserve Bank notes in circulation after deducting gold certificates held as collateral security.

In addition, the Board exercises certain supervisory powers with respect to the appointment of official personnel, salaries and expenses at the Federal Reserve Banks. In this connection the Board and the Banks have recently revised the personnel classification plans for the grading of Bank personnel below the officer level, which plans also fix appropriate salary limitations within each grade. The salaries of officers are reviewed by the Board on an individual basis, with a view to maintaining such salaries on a reasonably comparable basis at all of the Federal Reserve Banks. In addition, the Board has recently reestablished the arrangement (largely discontinued during the war) under which annual budgets are submitted to it by the Federal Reserve Banks.

Other important aspects of the Board's relationships with the Federal Reserve Banks include its statutory duty to appoint three of the nine directors of each Bank; its duty to designate the chairman and deputy chairman of the board of directors at each Bank; its responsibility for approving the appointment of the president and first vice president at each Bank; its authority to remove any director, officer or employee at any Bank for cause; and its authority to suspend the operation and take possession of any Federal Reserve Bank that violates the provisions of the Federal Reserve Act. In addition, the Board is required to exercise special supervision over the foreign relationships and transactions of the Reserve Banks. The responsibility for policy with respect to the establishment, operation and discontinuance of branches of the Reserve Banks rests in the first instance with the Board. And the Board may also regulate the transfer of funds by the Federal Reserve Banks and their branches.

Then, too, the Board exercises certain authority over the credit functions of the Federal Reserve Banks. For example, the discounts,

advancements and accommodations extended to member banks are subject to the orders and regulations of the Board. The discount rates charged by the banks are subject to the Board's approval. And the Board may also require a Reserve Bank to rediscount at rates fixed by the Board paper acquired by other Reserve Banks and to write off doubtful or worthless assets. The issuance and retirement of Federal Reserve notes are also under the supervision and regulation of the Board.

These are some, but not all, of the Board's statutory responsibilities for the conduct of System affairs. Merely to enumerate them is to emphasize the basic need for the constant interchange of intelligence and ideas between the Board and the Federal Reserve Banks. Fortunately, however, this need is being met in a satisfactory and practical manner. For example, the presidents of the Federal Reserve Banks meet with the Board several times each year, both in their Presidents' Conference and as rotating members of the Federal Open Market Committee. These meetings are devoted to full discussions of matters affecting monetary and credit policy as well as of various problems affecting the operations of the Reserve Banks themselves. There are also a number of committees of the Presidents' Conference, in some of whose discussions members of the Board's staff participate, which are devoted largely to discussions of operating problems. In addition, the chairmen of the Federal Reserve Banks meet with the Board twice each year to discuss similar topics. Then there are the various conferences which are held at the Board between certain of the operating staffs of the Banks and the members of the Board's staff. These include periodic conferences relating to member bank examinations, auditing, legal matters, research programs, and such other special topics as from time to time may require special discussion.

DIRECTORS OF THE FEDERAL RESERVE BANKS

Each director of a Federal Reserve Bank has a position of vital public responsibility, and each is chosen especially for his ability to fulfill that responsibility. Although the term of all the directors is three years and although their responsibilities are alike, the manner of their selection, which is provided by law, is based on their being divided into three classes. The purpose of this arrangement is to obtain a wide representation of public, banking, agricultural, commercial, and industrial interests. Class A and B directors are chosen by member banks; the three Class A directors are usually member bank officers, and the three Class B directors, who may not be officers and employees of any bank, must be actively engaged in their district in commerce, agriculture or some other industrial pursuit. The three Class C directors are selected by the Board of Governors. Each Class C director must have been for at least two years a resident of his district, and he may not be an officer or employee of any bank.

The primary responsibility of a Reserve Bank director is, of course, to the Reserve Bank itself. By making available to the Bank his

seasoned experience in business and public affairs, and with his broad knowledge of regional conditions he can help guide the Bank wisely. His board prescribes the bylaws under which the Bank's general business is conducted and the privileges granted to it by law are exercised. It is responsible for the general conduct of the Bank's affairs, including the election of officers, being required to administer these affairs "fairly and impartially and without discrimination in favor of or against any member bank or banks".

But a Reserve Bank director has an even broader responsibility. Because of the breadth of his experience he is in a position to make valuable contributions to the formulation of System policies and their effective application in his district. Furthermore, when System policy decisions have been made, the directors are able to explain and thereby bring about an understanding and acceptance of them in their various communities. There is a widespread feeling that fiscal and monetary programs and procedure are difficult, if not impossible, for the average individual to understand. However, actions taken by the Government and its central bank in this field are of the utmost importance to the public generally, and it is desirable that an understanding of them be as widespread as possible. And this will be particularly true in future years, which will be characterized by a large national debt, a large federal budget, and increased importance of fiscal and monetary policies in the economic life of the country. Although the System has no direct responsibility for fiscal policy, that problem is so closely related to the System and its responsibilities that the directors, through the information developed by the System, should keep in touch with it as it affects the System and the Federal Reserve Banks and be prepared to advise regarding the policies that might be followed.

Much has been said in recent years about the Federal Reserve Banks as centers of information and leadership and it is believed that the directors can play a most effective part in bringing this about. In this connection the following is a summary of a statement made by the chairmen at their conference in April 1941:

"There should be no limit to the work of the Federal Reserve Banks in the field of cooperation, education, and leadership. The good that the Banks can do is limited only by the intelligence, courage, and leadership of their directors and officers. On the other hand, we must not underestimate the routine or operating functions and responsibilities of central banking as they form a vital part of the System. On the assumption that there will be further centralization with respect to fiscal and monetary policy and that the objectives of that policy will be different and novel involving measures which will take on an increasing explicit regional differentiation, it seems desirable that the Reserve Banks be firmly established as centers of information, enlightenment, and leadership. They must be able to submit

comprehensive information wisely interpreted on economic problems and regional trends. They must be able to act as centers for interpretation in their districts of national policy and methods in the fiscal and monetary area. They must be able to assume leadership in times of emergency and to exert proper influence on national policy especially from the point of view of regional considerations."

This assignment is one to challenge the abilities of the best qualified men to serve as directors of Federal Reserve Banks.