Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 14, 1938.

To Chairman Eccles

From Mr. Smead

Subject:

In accordance with the request of Governor Ransom, there is attached for your information a copy of comments with respect to Section 2 (c) of the Patman Bill, H.R. 7230, prepared in compliance with his request at the Board meeting on Friday, March 4.

Attachment.

COMMENTS WITH RESPECT TO SECTION 2(c) OF THE PATMAN BILL, HR 7230

Section 2(c) of the Patman Bill provides that "After all necessary expenses have been paid or provided for, the net earnings of the Federal Reserve banks shall be covered into the Treasury as miscellaneous receipts". Section 7 of the present Act requires that all net earnings of the Federal Reserve banks after the payment of dividends shall be transferred to surplus.

The reasons for the proposed change in the Law, it is assumed, are based on the assumption that

(1) the net earnings of the Federal Reserve banks, after the payment of dividends, are substantial,

(2) the United States Government will have no claim on such net earnings if they are not paid to the Government currently each year, and

(3) the surplus of the Federal Reserve banks is adequate in relation to their liabilities.

No one of the above assumptions is valid.

During the period of the world war and for a few years thereafter member banks were borrowing very large amounts from the Federal Reserve banks, and as a consequence the earnings of the Federal Reserve banks were exceptionally large. At that time Federal Reserve banks paid a franchise tax, the franchise tax payments amounting to over $120,000,000 for the calendar years 1920 and 1921, as compared with total franchise taxes of $149,138,300, for the period from the organization of the Federal Reserve banks to the end of 1932 after which the requirement for the payment of a franchise tax was repealed. It was also during this period that the Federal Reserve banks added substantial amounts to their surplus accounts. The Federal Reserve Act, as amended on March 3, 1919, provided that all of the net earnings of a Federal Reserve bank remaining after the payment of dividends, including those for the calendar year 1918, should be paid into a surplus fund until it amounts to 100 percent of subscribed capital and that thereafter 10 percent of such net earnings should be paid into the surplus and the remainder paid to the United States as a franchise tax. This provision of the Law was again modified by the Banking Act of 1933, to provide that all of the net earnings of a Federal Reserve bank, after payment of the 6% dividend provided by law, shall be paid into its surplus fund. At the same time, however, Congress required the Federal Reserve banks to use one-half of their surplus to purchase stock in the Federal Deposit Insurance Corporation, on which they receive no dividends. In other words, one-half of the surplus of the Federal Reserve banks was appropriated by Congress for the purpose of furnishing the Federal Deposit Insurance Corporation with a part of its capital funds.

The net earnings of the Federal Reserve banks available for transfer to surplus during recent years have been relatively small, amounting to $2,616,352 in 1937, to $352,524 in 1936, and to $607,422 in 1935. In some years the Federal Reserve banks have had deficits in net earnings after payment of dividends which were charged to surplus.

With respect to the second assumption mentioned above, Congress has the right at any time to legislate with respect to the surplus funds of the Federal Reserve banks. If at any time Congress should consider the surplus of the Federal Reserve banks more than adequate, in the light of their liabilities and responsibilities, it could appropriate a portion thereof for such purposes as it saw fit. As stated above, Congress did in 1933 appropriate one-half of the surplus of the Federal Reserve banks to be used as a part of the capital funds of the Federal Deposit Insurance Corporation. While the Federal Reserve banks technically own stock in the Federal Deposit Insurance Corporation, they are not permitted under the Law to receive any dividends on such stock.

Under present law member banks are entitled to a 6 percent cumulative dividend on their paid-in subscription to capital stock of the Federal Reserve banks. No further distribution to member banks of the net earnings of the Federal Reserve banks is possible under existing law. In case of liquidation of a Federal Reserve bank the Law provides that its surplus shall be paid to and become the property of the United States.

The acquisition by the Government of the capital stock of the Federal Reserve banks, as provided in Section 2(a) of the Patman Bill, would necessitate an initial expenditure of Government funds in the amount of approximately $133,000,000 for the cost of such stock, and, in view of the fact that the public indebtedness of the Government presumably would be increased by a corresponding amount, the net income derived by the Government from the ownership of such stock would be limited to the difference between the interest cost to the Government of money borrowed by it and the annual dividends of the Federal Reserve banks. The annual 6 percent dividend payable to member banks in accordance with Section 7 of the Federal Reserve Act amounts to about $7,800,000, and if the cost to the Government of borrowed money be considered to be say 2-1/2 percent per annum on the basis of long term bonds the net profit which would accrue to the Government from its investment of $133,000,000 in the capital stock of the Federal Reserve banks would be less than $5,000,000 per annum

With respect to the adequacy of the surplus, the Federal Reserve banks now have deposit and note liabilities of about $11,960,000,000 and surplus accounts aggregating $148,739,000, the surplus accounts amounting to about 1.2 percent of deposit and note liabilities.

If the operations of the Federal Reserve banks are to be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country as required by statute, the Federal Reserve banks cannot function with a profit motive in view. Moreover, if they are to discharge effectively their statutory responsibilities, they must have adequate surplus funds to permit them to operate at a loss, if necessary, over substantial periods. Present surplus funds, amounting to 1.2 percent of liabilities are certainly not excessive and could easily prove inadequate particularly as there are no present prospects for substantial increases therein.

Since the Federal Reserve banks were organized in 1914 their total earnings have amounted to $1,241,000,000. Of this amount $610,000,000 has been utilized to cover costs of operation, $33,000,000 has been set aside as reserves for contingencies and the balance of $598,000,000 has been used as follows:

Payment of 6 percent dividend on capital stock, as required by Section 7 of the Act	$162,000,000
Payment of franchise tax to the United States Government	149,000,000
Contribution to the capital stock of the Federal Deposit Insurance Corp.	139,000,000
Balance in surplus accounts	148,000,000

It will be noted from the above that of the net earnings of $598,000,000 of the Federal Reserve banks since their organization, 48 percent has gone to the Treasury as franchise taxes and to the Federal Deposit Insurance Corporation as a contribution to its capital funds, 27 percent has gone to member banks in payment of the 6 percent dividend required by statute, and 25 percent remains as surplus.

The expenses of the Federal Reserve banks were incurred in rendering the services and performing the functions required by the Federal Reserve Act. One of the purposes of the Federal Reserve System, as stated in the preamble of the Act, is to furnish an elastic currency, and in order to do so Section 16 of the Act authorizes the Federal Reserve banks to issue Federal Reserve notes. In accordance with the provisions of the Act the Federal Reserve banks furnish member banks and through them the public with the currency needed for carrying on the country's business; they collect large volumes of checks and other items payable upon presentation for member banks; they provide rediscount facilities for member banks; and perform fiscal agency, depositary and custodianship services for the Treasury and a large number of Government agencies. In carrying out these and other important functions the Federal Reserve banks have endeavored to be of as much service to their member banks, and through them to commerce, industry, agriculture, and the public in general, and to the United States Government, as is consistent with the efficient and economical operation of the System.

All compensation provided by the boards of directors of the Federal Reserve banks for directors, officers or employees is subject to the approval of the Board of Governors. In discharging this responsibility the Board gives individual consideration to the salary of each officer in every Federal Reserve bank, and has provided a classification plan whereby all of the non-official positions in each Federal Reserve bank are classified and a maximum salary provided for each. The Board of Governors also requires each Federal Reserve bank to submit periodically detailed reports of its expenses and of salaries paid each officer and employee. The reports of expenses are tabulated by the Board's staff and summaries thereof are furnished each Federal Reserve bank in order that it may compare its costs with similar costs at other Federal Reserve banks.

Shortly after the present Board took office on February 1, 1936, it instituted a survey of the organization at each Federal Reserve bank and as a result thereof many economies were effected, among which were the placing of the chairmanships at the Federal Reserve banks on an honorary basis and the fixing of their compensation on the same basis as that of any other director in lieu of annual salaries of from $20,000 to $50,000, as had been the previous practice. Wherever it is found that certain operations can be handled more economically without sacrificing efficiency prompt steps are taken to effect the economies.

There has been a gradual reduction in the unit costs reported for the principal operating units of the Federal Reserve banks. For example, in the Country Checks-Outgoing unit, which is the largest single operating unit in the Federal Reserve banks, the average cost of handling a thousand items was $3.65 ten years ago as compared with $2.59 in 1936 and $2.64 in 1937. With a few exceptions, the unit cost in the Country Checks-Outgoing unit for each of the past ten years has been lower than that reported in the immediately preceding year as may be noted from the following tabulation:

Cost per thousand items in the Country Checks-Outgoing unit

1928	$3.65	1933	$3.47
1929	3.35	1934	3.05
1930	3.35	1935	2.88
1931	3.23	1936	2.59
1932	3.30	1937	2.64

The reductions in operating costs reported for the Country Checks-Outgoing unit are due to improved methods of procedure. A survey of the Country Checks unit at all Federal Reserve banks has recently been completed by members of the Board's staff. Since the new Board took office members of its staff have also made field surveys of the Bank Examination, Auditing and Legal Departments at the Federal Reserve banks. On occasions when the unit costs of some particular bank appear to be out of line special field surveys are made. For example, last month a special survey was made of a certain operating unit at two banks where there was a substantial variation in unit costs and suggestions were made to the bank reporting the higher cost.

The costs of performing the various services rendered by the Federal Reserve banks during 1937 are set forth below in summary form.

EXPENSES OF FEDERAL RESERVE SYSTEM, YEAR 1937

Currency and Coin

The cost of receiving and handling 2,257,889,000 pieces of currency and 2,730,387,000 pieces of coin, including shipping charges to and from member banks was $4,149,671

Assessment by the Treasury Dept. to cover the cost of printing new Federal Reserve currency, the cost of issuing such currency at the Reserve banks, and the cost of redeeming Federal Reserve currency unfit for circulation, including shipping charges, amounted to $1,787,036

Total $5,936,707

Check Clearing and Collection

Handling and collecting 926,792,000 checks and 6,705,413 maturing notes, drafts, coupons, etc. cost $3,802,889

Loans, Rediscounts and Investments

The cost of making 13,571 discounts and advances to member banks; of handling 388 applications for advances to industry for working capital under Section 13b of the Federal Reserve Act; of maintaining credit information, of holding in safekeeping and servicing about $4,000,000,000 of securities for member banks and purchasing and selling Government securities for member banks cost $1,366,258

Fiscal Agency, Custodianship and Depositary

Receiving, proving, and paying 127,823,063 Government checks and coupons, including work relief checks; maintaining the general account of the Treasury of the United States, etc. cost	$1,125,402	
Fiscal Agency work for the U. S. Treasury Dept. comprising principally the issue, redemption, and exchange of 3,982,751 pieces of securities cost	$1,380,352	
Total	$2,505,754	
Reimbursed by Treasury Dept.	$1,634,363	
Net cost		$871,391
Services performed for various Government agencies such as the Reconstruction Finance Corporation, Federal Farm Mortgage Corporation, Federal Land Banks, Federal Intermediate Credit Banks, Federal Emergency Administration of Public Works, and the Federal Home Loan Banks and Home Owners' Loan Corporation amounted to	$2,231,142	
Reimbursed by Government Agencies	2,204,426	
Net cost		$26,716

Accounting

This function, which includes the maintenance of the general books, member and Federal Reserve bank accounts, etc., and the making of transfers of funds for the account of member banks, cost		$1,579,520

Banking House and Furniture and Equipment

Cost of operation of banking houses, including payment of taxes, the salaries of janitors, elevator operators, etc., less deductions for income received from rented space, etc., was	$2,612,685	
Reserves set aside for depreciation on banking houses	1,297,859	
Furniture and equipment, net cost	233,290	
Total		$4,143,834

Bank examination

The cost of examining state member banks and incidental work in connection therewith was		$1,101,800

Expenses of the Board of Governors

Assessments for expenses of the Board of Governors of the Federal Reserve System ...		$1,748,379

Statistical and Analytical

Preparing and publishing monthly reviews of credit, business and agricultural conditions; and obtaining and assembling various statistical data, etc. cost $480,028

Bank Relations

Bank relations work; visiting member and non-member banks, conferences, etc. cost $195,004

Personnel and Service

The maintenance of personnel records, the purchasing of supplies and equipment, telephone service, filing, mailing, etc., cost $2,294,234

Protection

The salaries of special officers and watchmen, and the cost of other protective services amounted to $964,932

Postage and Insurance

The cost of postage on ordinary mail; insurance on equipment and supplies, etc.; the cost of employees' fidelity bonds, bankers blanket bond, etc., amounted to $1,324,298

Auditing

Maintaining general audits of the Federal Reserve banks and branches cost	$552,623

Legal

The employment of counsel and other legal expenses cost	$190,086

General Overhead

General overhead and supervisory expenses, including directors' fees and expenses amounted to	$1,685,101
Total Net Expenses	$28,263,800