

Chairman E. C. B. v.

Revised
Confidential draft

March 17, 1938

THE PATMAN BILL

The fundamental objective of H.R.7203 is to establish a mechanism that would control the volume of money with a view to maintaining a fixed price level.

Monetary objectives

The Board of Governors of the Federal Reserve System has given constant study to the problem of objectives of monetary policy. Under date of July 30, 1937, the Board issued a statement expressing the conclusion that economic stability, rather than price stability should be the general objective of public policy, because stability of the price level does not necessarily prevent serious economic maladjustment. It stated that in its judgment the Reserve System's duty, in addition to working toward the maintenance of sound banking conditions, is to exert its influence toward maintaining a flow of funds conducive to as full a use of the country's productive resources as can be continuously sustained. The Board also stated its belief that efforts of all the departments of the Government should be directed toward the achievement of this broader objective, and that neither monetary stability nor price stability can be achieved by monetary means alone.

Federal Reserve System operates in the public interest

In proposing a reorganization of the Federal Reserve System, the author of the bill contends that it has not been operated in the public interest; that it has been dominated by bankers; that it has been conducted in the

selfish interests of a small group, and that it has made large profits at the expense of the community. The Board of Governors does not believe that any of these assertions can be sustained by the record.

Ownership of stock by member banks does not enable the bankers to control the Federal Reserve System. It is more nearly in the nature of a compulsory capital contribution than stock ownership. Although the member banks elect two-thirds of the directors of the Reserve banks, the large banks elect only two out of nine directors. The small banks elect two, the medium-sized banks elect two and the Board of Governors in Washington appoints three. Only a third of the directors can be bankers and all directors and officers are subject to removal by the Board of Governors. The appointment of all Presidents and First Vice Presidents and the salaries of all officers and employees are subject to approval by the Board in Washington.

Complete authority over all matters of major national policy, such as the determination of discount rates, reserve requirements, margin requirements on security loans, and maximum rates of interest to be paid on time deposits is vested in the Board of Governors. Authority over open market operations is vested in an open market committee consisting of seven members of the Board of Governors and five members elected by the Reserve banks. Not only has the Board a majority of the committee, but the other members are subject to the Board's approval in their positions as presidents of the Reserve banks.

It is clear, therefore, that in matters with which the bill is primarily concerned the System is dominated, not by banks, but by the Board of Governors, a governmental body whose members are appointed by the President and confirmed by the Senate.

Federal Reserve banks not operated for profit

During the twenty-three years of its existence the Federal Reserve System has earned approximately one and a quarter billions of dollars, of which one-half has been used for operating expenses incurred largely in performing public services, such as the clearing and collection of checks, the supplying of currency to the banks and to the public, the performance of many duties for the United States Government, and in furnishing rediscount facilities for the member banks.

Of the six hundred million dollars of earnings above expenses, approximately one-fourth has been paid to the Government as franchise tax, nearly one-fourth has been turned over to the Federal Deposit Insurance Corporation as capital, one-fourth has been paid as the statutory dividends to member banks, and the remainder is held in a surplus account which in case of liquidation becomes the property of the Government.

Member banks contribute 3 per cent of their capital and surplus to the capital of the Reserve banks and receive not more than 6 per cent annually on this amount. In addition, member banks are required to keep balances with the Reserve banks amounting on the average to 16 per cent of the member banks' deposits and receive no return on these balances. A member bank having a capital and surplus of \$100,000 contributes \$3,000 to the Reserve bank's capital and receives annual dividends of \$180, or at a rate of less than two-tenths of 1 per cent on its own capital and surplus.

The System was established and is operated in the public interest and dominated by public officials; it performs a service that saves the people of the country far more than the cost of the System, and it makes no profits for any private interest other than the amount paid annually to stockholders at a fixed rate, which has been prescribed and can be changed by Congress.

Proposals would not improve banking system

Proposals in the bill for reorganizing the Reserve System would transfer ownership of the stock in the Federal Reserve banks to the Government and would have all the directors of the Reserve banks appointed by the President and approved by the Senate. It would enlarge the membership of the Board of Governors to fifteen, including three ex-officio members -- the Secretary of the Treasury, the Comptroller of the Currency, and the Chairman of the Federal Deposit Insurance Corporation.

A Board of Governors of fifteen members proposed in the bill would be too unwieldy to function promptly and effectively. Appointment of Reserve bank directors by the President would tend to introduce party politics into the System, and would make it more difficult for it to perform its duties effectively. The proposal in the bill to offer all the privileges of membership to nonmember banks so long as they choose to keep their reserves in a Federal Reserve bank would remove all incentive to become members of the System. It would enable all banks to profit by the services of the System so long as it suited them, without contributing anything to its strength or complying with its regulations, and to withdraw their reserves when to maintain them would seem to be burdensome. It would make futile the proposed enlargement

of the power to increase reserve requirements. It would remove all incentive to membership and would make it impossible for the System to discharge its responsibility for maintaining sound credit conditions.

Distinction between monetary and fiscal authorities should be maintained

The primary function of the Treasury is to collect taxes, borrow money, and provide funds for the various agencies of the Government in accordance with Congressional appropriations. The primary function of the Federal Reserve System is to influence the flow of money and to contribute to the soundness of the banking situation. The ultimate objectives of both agencies are the same, namely, to serve the public interest, but their points of view and experience, and their approach to current problems may at times be different. The maintenance of an organization for the regulation of credit separate from the fiscal arm of the Government has been found advantageous in most countries of the world, and its abandonment, which is proposed in the bill, would, in this Board's opinion, be a backward step.

Local autonomy in local matters should be preserved

Since its establishment in 1914, the Federal Reserve System has undergone many changes in the direction of increased control by the Board of Governors. With the passage of the Banking Act of 1935 this control has been greatly strengthened in so far as national policies are concerned. In regard to local matters, the maintenance of local autonomy under general supervision and close Government regulation is advantageous in a country like the United States, consisting of various regions with diverse economic interests. The

maintenance of locally elected directors on Federal Reserve bank boards is of great advantage in creating local pride and local interest in the System and in inspiring the business community with confidence in its management. This would be largely destroyed if the appointments of local directors were handled entirely from Washington. There would also be the danger that partisan political considerations would enter into the appointments and the directors and through them the personnel of the banks might become subject to political patronage. There is nothing that would be more destructive than this of the ability of the System to render a disinterested public service to all classes of the community.

To sum up, the Board is convinced that improvement in our banking system is urgently needed but sees nothing in this bill that would tend in this direction. The Board believes that the main objective of the bill is not practicable; and is convinced that the evils which the bill proposes to correct do not exist; that the organization which it proposes to establish would result in less satisfactory service to the country, and that its enactment would be a retrogression and not a forward step in the development of the banking system in the public interest.

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 divi-

dends 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, depository 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 cur-
rency, the cost of issuing such currency at the
Reserve banks, and the cost of redeeming Fed-
eral 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 work-
ing 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 Depository

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 Corpora-
tion, Federal Land Banks, Federal Inter-
mediate 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
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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
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Total	\$4,143,834

Bank examination

The cost of examining state member banks and incidental work in connection therewith was

	\$1,101,800
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Expenses of the Board of Governors

Assessments for expenses of the Board of Governors of the Federal Reserve System ...

	\$1,748,379
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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, tele-
phone service, filing, mailing, etc., cost \$2,294,234

Protection

The salaries of special officers and watch-
men, 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