Form F.R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 30, 1938.

To Chairman Eccles

Subject:

From Mr. Smead

ERS

At the Board meeting on Tuesday, March 22, Governor Ransom asked that our memorandum with respect to Section 2(c) of the Patman Bill be revised so that it could, if the Board chose, be used in connection with the hearings on the Bill, and that as revised it include a statement with respect to Federal Reserve notes. A copy of the memorandum, as revised, is attached.

Attachment.

March 29, 1938

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 Federal Reserve Act as amended requires that all net earnings of the Federal Reserve banks after the payment of dividends shall be paid into the surplus funds of the banks.

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.

Net earnings of Federal Reserve banks. 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 for the calendar years 1920 and 1921 amounted to over $120,000,000. For the eighteen year period from the organization of the Federal Reserve banks in 1914 to the end of 1932 total franchise tax payments amounted to $149,138,300, or only $30,000,000 more than the amounts paid for the two years 1920 and 1921.

Revised

The requirement for the payment of a franchise tax was repealed by the Banking Act of 1933. The surplus accounts of the Federal Reserve banks were built up in large part during the World War and early post World War periods when the earnings of the Reserve banks were relatively large.

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 amounted 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 percent dividend provided by law, should 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, after payment of dividends, have had deficits in net earnings which were charged to surplus.

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

Of the net earnings 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.

Government's right 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 the 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 received from 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 $8,000,000, 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. Should Congress decide to reduce the dividend on Federal Reserve bank stock this profit would be largely eliminated.

Adequacy of surplus of Federal Reserve banks. The Federal Reserve banks now have deposit and note liabilities of about $11,960,000,000 and surplus accounts aggregating $147,739,000, the surplus accounts amounting to about 1.2 percent of deposit and note liabilities.

Operations of the Federal Reserve banks must under the law be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country. If the Federal Reserve banks are to serve the productive enterprises of the country adequately they must at times take unusual risks. Furthermore, the Federal Reserve banks should be in a position, if necessary in the public interest, to operate over substantial periods with income insufficient to cover expenses. In the circumstances, it is important that the Federal Reserve banks have adequate surplus out of which to defray such expenses and losses. The present surplus of 1.2 percent of liabilities may prove inadequate for these purposes and should be increased from time to time as the earnings of the Federal Reserve banks permit.

Federal Reserve notes. It is frequently stated that the Federal Reserve banks obtain Federal Reserve notes from the United States Treasury for the cost of printing, and that they place large volumes of such notes in circulation and thus obtain substantial profits which should belong to the Government. It is important, therefore, to review the factors that determine the volume of Federal Reserve notes in circulation, what the Federal Reserve banks have to do to get them and the costs connected with the supplying of currency to the public.

The amount of money in circulation at a given time represents what the public collectively wants, since currency always moves out of the Federal Reserve banks when the demand for it increases and returns to them when the demand subsides. This is what is meant by an elastic currency. When currency is needed, the public obtains it from the local banks, and the latter obtain it from the Federal Reserve banks. When it is not needed, the public deposits it in the local banks, and the local banks in turn redeposit it in the Federal Reserve banks. The Federal Reserve banks may be regarded as reservoirs from which additional currency is drawn when the public requires it and to which currency not required by the public is returned. The Federal Reserve banks have no way of keeping in circulation a larger amount of currency than the public requires, or reducing the amount of currency that the public needs to finance its current operations.

The demand for currency is determined by various conditions. A certain minimum is required for day-to-day cash expenditures of individuals; a certain minimum is required for payrolls. There are times when personal expenditures rise, as during holidays, and there are times when payrolls rise, as during harvest. Certain individuals, businesses, and communities have their own periods when they need more or need less cash than ordinarily. The net effect of all of these factors is a normal and regularly repeated cycle of demand for currency year after year -- slack after the first of January, when retail trade falls off following the holidays, larger during the succeeding spring months, when payrolls increase and outdoor industries become active, slack again in mid-summer, and steadily increasing during autumn and early winter to the regular peak in December.

In addition to this regular annual cycle, the amount of currency also responds to increases and decreases in the volume of retail trade and of payrolls as the amount of business done by the country increases or decreases. There have been times also when the demand for currency was greatly increased as in the period preceding the banking holiday in 1933. In the course of a few weeks at that critical time the Federal Reserve banks furnished the public with as much as $2,000,000,000 of additional currency.

For more than twenty years the Federal Reserve banks have fully met the normal demands of the country for currency; they have also fully met peak demands both in times of prosperity and in times of depression, and they have made it possible for the volume of currency to decline automatically when the public demand for it declined.

Machinery of note issue. Before a Federal Reserve bank can obtain Federal Reserve notes it must deposit as security with the local representative of the Government, known as the Federal Reserve agent, collateral at least equal in amount to the notes to be issued. This collateral, as provided by law, may consist of the following assets only: (1) promissory notes, drafts, bills of exchange, or acceptances, usually referred to as "eligible paper"; (2) gold certificates on hand or due from the United States Treasury; and (3) until June 30, 1939, United States Government securities bought in the open market. In addition to being secured by the pledge of specific collateral, Federal Reserve notes are a first lien on all the assets of the issuing Federal Reserve bank, and a 40 percent reserve in gold certificates must be maintained against them.

As of March 16, 1938, the Federal Reserve banks had obtained $4,440,000,000 of Federal Reserve notes from the Federal Reserve agents, of which $4,125,000,000 were in circulation, constituting about two-thirds of the total of $6,330,000,000 of money in circulation, and $315,000,000 were held in the vaults of the Federal Reserve banks. The collateral held against these notes was as follows:

Gold certificates on hand and due from U.S. Treasury	$4,533,000,000
United States Government securities	10,000,000
Eligible paper	7,000,000
Total	$4,550,000,000

Gold certificates are receipts which are issued to the Federal Reserve banks by the United States Treasury for gold deposited with it by the Federal Reserve banks in compliance with the Gold Reserve Act of 1934, which required all monetary gold in the United States to be delivered to the Treasury. The Federal Reserve banks do not have the right to pay out these gold certificates. As indicated, the Federal Reserve banks have pledged $4,533,000,000 of these certificates against $4,440,000,000 of their own notes in circulation. Federal Reserve notes, therefore, at present are virtually substitutes for gold held by the United States Treasury. So long as the Federal Reserve banks pledge one dollar in gold certificates against each dollar of Federal Reserve notes in circulation they cannot obtain a profit by issuing Federal Reserve notes. Moreover, all costs connected with the printing, shipping and redemption of Federal Reserve notes are borne by the Federal Reserve banks. As will be noted from page 10 of this memorandum, it cost the Federal Reserve banks nearly $6,000,000 during 1937 to obtain currency from the Treasury and supply it to member banks and through them to the general public.

<u>Expenses of Federal Reserve banks.</u> The expenses of the Federal Reserve banks were incurred in rendering the services and performing the functions required by the Federal Reserve Act. As stated above, they furnish the public with an adequate, safe and elastic currency; 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, custodianship, and depositary services for the Treasury and other 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. The Board of Governors 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 reviewed and summaries thereof are furnished the Federal Reserve banks in order that their costs may be compared.

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 the compensation of the Chairmen 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 principally to improved methods of procedure.

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	
Assessments 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 and Safekeeping

Making discounts and advances to member banks; handling applications for advances to industry for working capital under Section 13b of the Federal Reserve Act; maintaining credit information, 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 127,823,053 Government checks and coupons, including work relief checks, and 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 3,892,004 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 cost	$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.	$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

Cost of examining state member banks and of analyzing condition and examination reports of National and State member banks, etc.. amounted to	$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 nonmember banks, conferences, etc. cost ...	$195,004

Personnel and Service

Maintenance of filing, mailing and personnel departments; vaults and telephone service; purchasing supplies and equipment; equipment repairs; page service, etc., cost $2,294,234

Protection

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

Postage and Insurance

Postage on ordinary mail; insurance on equipment and supplies; premiums on employees' fidelity bonds, bankers blanket bonds, etc., cost $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 other miscellaneous expenses, amounted to $1,685,101

Total Net Expenses $28,263,800