

WHY SHOULD A BANK BELONG TO THE FEDERAL RESERVE SYSTEM?*

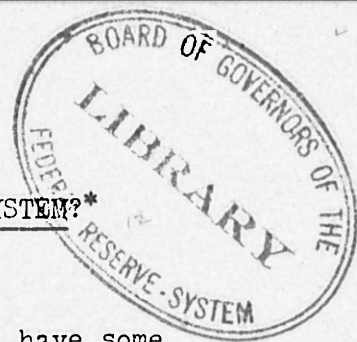
(Oliver S. Powell)

All economic societies, except the most primitive, have some form of money. In highly productive societies, such as ours, organized around personal enterprise and initiative, money will not manage itself. A productive provision for the proper exercise of the central banking function is inescapable. Every large country in the world has found it essential to establish some form of central bank. Experience has proved that central banks should be organized independently of the Executive and Treasury, just as courts of law are organized independently of the Executive and of the Department of Justice.

Our own central bank, the Federal Reserve System, is a unique creation in the history of central banking, a democratic and purely American institution. Were there no Federal Reserve System in the United States, most certainly there would be some other form of central bank to perform many of the same functions and services. If such a bank were to resemble those in other countries, it might be subject to undue centralized, political domination and might be in direct competition with private banks for loans of various types. A central bank of this type would be contrary to American concepts and tradition. For that reason alone, our present system of central banking merits the support of all banks.

The operation of the System is also free from profit motivation. Whether the Federal Reserve earns income over and above expenses has no influence on its policies. As you know, the earnings of the System in recent years have been large. Currently 90 per cent of the System's net earnings are turned over to the Treasury. The history of the Federal

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Reserve is singularly free of political bias. Although in the light of hindsight, there may not be agreement that the System has always done the right thing at the right time, there is general agreement that partisanship has no place in its operations. For this much credit must be given to the framers of the Federal Reserve Act who were militant in their efforts to safeguard the System from the pressure of public interests or partisan groups.

The Federal Reserve System includes the Board of Governors appointed by the President with the approval of the Senate, but it also includes twelve regional banks, with 24 branches, located in different parts of the Nation. Each Reserve Bank is managed by directors and officers who live in and are familiar with conditions in its District. They represent banking, business and the public. Of the nine directors, six are elected by the member banks of the District, three being active officers of member banks and three actively engaged in commerce, agriculture, or industry. Two of the six elected directors are chosen by small banks, two by medium-sized banks, and two by large banks. The remaining three directors are appointed by the Board of Governors of the Federal Reserve System and cannot be officers, directors, employees, or stockholders of any member bank, but are residents of the District.

Further provision for taking account of the views of bankers throughout the country lies in the establishment, by the law itself, of the Federal Advisory Council, and the Federal Open Market Committee. In addition, the Presidents of the Federal Reserve Banks are organized into a Conference which meets in Washington three or four times a year to discuss matters of

mutual interest and to convey the consensus of their views directly to the Board of Governors.

The benefits of Federal Reserve services and the System's stabilizing influence on our national economy accrue to the general public and to all banks, whether member or nonmember. These benefits have been tested by thirty-six years of war, peace, depression, and prosperity. From time to time improvements such as broader Federal Reserve lending powers have been added to make the System more effective.

In its more than thirty years of operation and development, the Federal Reserve System has become an integral part of American business and finance. It has contributed greatly to more efficient, less costly, and speedier handling for banks of check collections and transfers of funds. This was accomplished in part by the establishment of the Inter-district Settlement Fund which, in effect, is a daily national clearing of a large number and amount of checks and transfers that move across the country. It has provided an elastic and adequate supply of currency available on equal terms to member banks wherever located, a concentration and mobility of bank reserves for greater usefulness, and an efficient fiscal agency for the Treasury. The ability of member banks to borrow on business and agricultural paper provides a ready market for the loans of customers, tends to equalize the credit supply in all parts of the country, eliminates seasonal credit strain, and gives greater assurance that member banks can supply the credit requirements of their communities. This machinery has been set up to provide a national credit policy administered in the public interest, and to insure unified action by the banking system in carrying out

this policy. Since 85 per cent of total commercial bank deposits are lodged in banks that are members of the Federal Reserve System, there is a substantial assurance of unified action by the banking system as a whole. However, the fact that half of the commercial banks are not members of the Federal Reserve System, and that in some States member banks are greatly outnumbered by nonmember banks, militates somewhat against the effectiveness of the System.

Every banker wants to be on the first team. All banks want to carry their fair share of responsibility for a sound and effective banking system. This is especially true these days when the banking system is taking the lead in attempting to fight inflation and to preserve the purchasing power of the dollar. The Federal Reserve, through its statutory powers, is exerting all possible pressure in this direction, and the best way for State banks to support this objective is to join the Federal Reserve System. To quote a State member banker:

"There is one intangible value which I think is greater than all the specific values. . . and it is a little hard to describe. The strength of the Federal Reserve System is of incalculable good for business and industry, and it is only because a large part of the banks in America are members of the System that we have strength. America needs a large, well-supported, strong banking system, and the Federal Reserve gives us just that."

It might even be appropriate to ask, "Is it proper for a banking institution to withhold itself from membership in a system which is known to be essential to the economic welfare of the country?" or "Should a bank not thus contribute its share to the support of the financial machinery so necessary to the country's welfare?" A banker may adopt the attitude, "My bank is small, and it makes little or no difference in the effectiveness of

the central bank whether we belong to the System or not." This is suggestive of the parallel attitude, "It makes no difference whether I vote or not - it is just one vote." Thinking Americans everywhere deplore the lassitude and complacency of the citizens who do not vote, for they realize what this may mean to the country.

Importance of the Correspondent Banking System

The State bank contemplating membership in the Federal Reserve System should clearly understand that such membership does not remove the desirability of his maintaining correspondent bank connections. The correspondent banking system is an important part of the independent competitive banking system in the United States. Without the services of correspondent banks, the banking system of the United States would lack cohesion, flexibility and leadership. State member banks should expect to carry correspondent balances large enough to provide those banks with revenues sufficient to pay for the correspondent services rendered. In addition to check collections, these services include:

- Purchase and sale of Government and municipal securities and commercial paper;
- Investment advice;
- Advice on loans and types of lending operations;
- Participation in loans;
- Assistance in solving bank operating problems;
- Many contact services which make use of the wide acquaintance and sources of information of the correspondent bank;
- Credit information;
- A great variety of personal services;

Loans to bank officers and directors; and
An innumerable variety of other services.

Concrete Advantages of Federal Reserve Membership

There are many important, concrete advantages in Federal Reserve membership.

1. The System's lending facilities. A member bank which finds either that its deposits have fallen away or that its loan or cash requirements are unduly heavy or that it needs more reserves may borrow either from its correspondent banks or from the Federal Reserve Bank of its District. Since practically all member banks have Government securities lodged in safekeeping at their Federal Reserve Bank, it is a very simple and natural procedure to pledge these securities to obtain a loan at the Federal Reserve Bank. If other assets are pledged to secure a loan, the intimate knowledge of the member bank's assets which the Federal Reserve Bank has as a result of its bank examination operations enables the Federal Reserve Bank to lend on the member bank's sound assets with a minimum of deliberation.

A country member bank knows that it can obtain any warranted credit from its Federal Reserve Bank, a fact which is significant for its city correspondent as well. The correspondent relationship imposes upon the city bank a responsibility for taking care of the country bank's borrowing needs. In times of economic stress and strain, country bank balances have shown a tendency to reach their ebb at the same time their borrowing needs are greatest. It is a common experience for a country bank's borrowing requirements to rise at a time when the correspondent bank itself may be fully loaned up. It should be a matter of comfort to both the country bank and its city

correspondent, in cases where the country bank is a member of the Federal Reserve System, to know that the discount facilities of the Reserve Bank are available and adequate to take care of the country bank's needs.

Bank deposits are currently high and may continue so, but there is no guarantee that deposits in the next few years will stay in the same localities or in the same banks. Banks may have unforeseen or sudden need for additional cash and reserves. Following World War I more than three-fourths of the member banks in one Federal Reserve District found it necessary to discount paper with the Federal Reserve Bank. Both city and country member banks were borrowing heavily at that time. At the present time, February 15, 1951, the Federal Reserve discount rate on eligible paper and Government securities is $1\frac{3}{4}$ per cent. The rate on advances on other sound assets is $\frac{1}{2}$ per cent above the current rediscount rate (now $2\frac{1}{4}$ per cent).

As a STATE member banker recently stated:

"A member is permitted to borrow funds from the Federal Reserve Bank on any of its sound assets and, therefore, facilitates quick conversion into cash if any unusual requirement arises....we regard the availability of this service of real potential value and are able to operate our bank in a more fully invested position than we would otherwise be able to do."

2. Savings through reduced loss of interest on funds in transit, greater convenience and less expense. The Federal Reserve System has always had as major objectives the shortening of time required for the movement of funds, including currency, checks, and bank balances, around the country and a better equalization of access to such funds between city and country banks. A member bank can participate directly in the benefits devised by the Federal Reserve System to meet these objectives.

(a) Federal Reserve Banks ship currency to member banks and receive currency from member banks, assuming all transportation expense and risk of loss incident to these shipments. Thus, it is no more expensive for a member bank in an outlying town to obtain currency from a Federal Reserve Bank than it is for a member bank across the street from a Reserve Bank. Moreover, most of the Federal Reserve Banks make credit allowances for currency in transit to or from a member bank in analyzing the bank's reserve account.

Most Federal Reserve Banks are now furnishing wrapped coin to member banks at the cost of wrapping. With high-speed machines now being developed, it is expected that handling the coin-wrapping operation on a wholesale basis will prove an important saving to the banking system.

(b) A member bank may make direct use of Federal Reserve check collection service and other collection facilities. Most country member banks send their out-of-town checks to their city correspondent banks as a matter of convenience and most correspondent banks send checks so received, plus checks received in other ways, to the Federal Reserve Bank for collection. In some cases correspondent banks suggest to country banks that they send checks to the Federal Reserve Bank directly to save double handling of the checks. (First, by the correspondent bank and, then, by the Federal Reserve Bank.) The Federal Reserve Bank will perform this service for any member bank without asking for an additional reserve balance. Any excess balance which a member bank may have over and above its required reserve account may be shifted to a correspondent bank freely and without pressure or influence from the Reserve Bank to keep the excess balance in that institution.

When a member bank regularly handles a quantity of checks drawn on banks in other Federal Reserve Districts, it may arrange with its Federal Reserve Bank to send those items directly to the other Federal Reserve Banks or Branches for collection. Since this procedure saves double handling within the Federal Reserve Bank system and reduces float by cutting off one day of collection time, the Federal Reserve Banks encourage this direct-sending practice by reimbursing member banks for postage and other transportation costs on such sendings.

(c) The private wire network maintained by the Federal Reserve Banks and the mechanism of the Inter-District Settlement Fund are indispensable parts of the banking machinery in the United States. Through these facilities it is possible for member banks to transfer balances or other funds in a matter of minutes to banks in any part of the country. This elimination of the time element affords a tremendous saving to the banks of the country in avoiding interest loss on the \$400 billion transferred in a normal year. The Federal Reserve Banks perform this service free of charge where a member bank's own funds are being transferred. Only the cost of the telegram is charged when funds of a customer are transferred.

(d) Federal Reserve Banks will hold in safekeeping for country member banks without charge their own securities, pledged and unpledged. This is especially convenient in the matter of Government securities. When the member bank purchases new issues, the securities are immediately placed in safekeeping and there is no necessity for the bank thereafter to move the securities from one place to another, incurring postage and other costs. When the securities are redeemed, they are cancelled and paid for without

being moved. If the member bank sells Government securities, the transfer of the securities can be made by telegram over the Federal Reserve private wire system. Such transfers are made without charge in the case of short-term Government securities and at a nominal charge for longer term securities. It is estimated that this service saves member banks several million dollars annually as compared with the old method of shipping Government securities by registered mail. (Since this service is a Fiscal Agency operation authorized by the Treasury, it is available also to nonmember banks, but obviously member banks are in a better position to take advantage of it.)

3. Dividends. A bank coming into the System subscribes for Federal Reserve Bank stock to the extent of 6 per cent of its capital and surplus, but pays for and is allotted only half of that amount. The Reserve Banks are not operated for profit and the dividends are limited by law to 6 per cent, but according to one STATE member banker, this stock is:

" . . .one of the best and most profitable investments
a bank has. . ."

4. Prestige. Many STATE member banks contend that they have gained considerable prestige through membership. The use of the emblem MEMBER OF THE FEDERAL RESERVE SYSTEM prominently displayed is good advertising. A STATE member banker puts it this way:

"We feel that being a member of the Federal Reserve System adds prestige to our bank, for it declares that the bank has qualified, and we believe United States citizens have come to have faith in the Federal Reserve System as a stabilizing foundation of American banking."

Or in the words of the cashier of a STATE bank:

"If the only service rendered by the Federal Reserve Bank to the small rural bank was that of furnishing currency and coin without cost to the member bank for shipment, insurance, etc., and the added prestige afforded by advertising membership, these alone would make membership desirable and profitable."

Member banks are PAR banks and are so recognized throughout the nation by banks and business.

5. Examinations. A STATE bank, after coming into the System is examined by the Federal Reserve Bank. In some States the Federal Reserve examiners join the State Banking Department in its examination, which eliminates duplications. No charge is made by the Reserve Bank. The principal purpose in examining STATE members is to determine the soundness of assets, so that in case of an emergency, credit can readily be extended. The vice president of a STATE member bank states:

"The Federal Reserve Bank and its examiners take a very practical viewpoint in determining the soundness and value of our assets. They look at the bank and its assets as a going concern and appraise it on that basis, rather than on a liquidating basis. Because of this approach, they are of great assistance to us in making a true and accurate appraisal of the soundness of our loans and we, in turn, are most willing to furnish them with all the information that we have at our disposal to assist in their examination."

6. STATE bank loan limits retained. A STATE member bank enjoys the same privileges as a national bank so far as the facilities of the Federal Reserve Bank are concerned, yet the STATE bank continues to operate under its State charter subject to State supervision and has the State loan limit both as to chattel and real estate loans. The president of a STATE member summarizes this advantage as follows:

"Being a State Federal Reserve member gives us all the privileges which a State institution enjoys plus all the advantages any other bank has as a member of the Federal Reserve System."

7. General satisfaction. According to law, all national banks are required to belong to the System, but with STATE banks, membership is a matter of choice. The opinion of these voluntary members, therefore, reflects the attitude of member banks toward the System. From the foregoing statements and those which appear below, it is evident that STATE banks which have aligned themselves with the Federal Reserve System are well satisfied.

"Our membership has made our bank stronger for protection to the depositors and more efficiently operated for the benefit of our stockholders."

"Our association with the Fed. . . has its compensation in dollars and cents which must be apparent to every banker who cares to investigate."

". . . our customers are entitled to the best of protection and service, and surely it must be a recognized fact that, only by the obligations and restrictions of membership voluntarily assumed in the System around which the financial structure of our country is built, can they be offered."

"In effect, the System makes the country bank proportionately as strong as the larger city bank and equally well equipped to serve its trade area."

"It is my definite opinion that there are many good reasons for membership being desirable and profitable, especially for the small rural bank. . ."