"THE FEDERAL RESERVE SYSTEM AND THE BANKING ACT OF 1935."

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I am glad of this opportunity to be with you this evening, for most of you I understand are students of banking, and that is what I am myself. No matter what our positions in the banking world, we are still students of banking if we are sincere. For banking is not a simple thing, and its principles cannot be understood without experience and patient study.

Speaking personally, I have always found that in the process of studying any institution, or function, or problem, it is important to keep referring back to fundamentals. Otherwise it is easy to go wandering off into details without knowing what they are all about. For that reason, I should like to review a few basic things in spite of the fact that we are all familiar with them. I should like to brush away the great mass of details for a little while and discuss some of the elementary facts about the Federal Reserve System and the functions it performs for the country. I believe it is particularly worth while to do this before considering the new and important legislation in the Banking Act of 1935.

The Federal Reserve Act, which in 1913 established the Federal Reserve System, is one of the most important pieces of financial legislation ever passed in this country. It represented the decision reached after many years of dissatisfaction with our banking and currency facilities, brought to a head by the panic of 1907; after a thorough study of banking here and abroad by a National Monetary Commission established by Congress in 1908; and after long and earnest public discussions of banking reform over a period of twenty years or more.

Since 1913, on the basis of actual experience and in response to new developments, numerous amendments have been made to the original Federal Reserve Act. During the depression changes were made by the Glass-Steagall Act of 1932, the Emergency Banking Act, the Banking Act of 1933, the Gold Reserve Act of 1934, and other acts. The most recent as well as the most important of these is the Act approved August 23, 1935.

Federal Reserve banks

The work of the System may be considered first from the point of view of the Federal Reserve banks in their relations with the banking institutions of the country, and then from the point of view of the broader responsibilities for credit policy which come under the central organization in Washington, now known, under the Banking Act of 1935, as the Board of Governors of the Federal Reserve System.

The location of the Federal Reserve banks was not determined by Congress, but by the Secretary of the Treasury, the Secretary of Agriculture, and the Comptroller of the Currency acting as the Reserve Bank Organization Committee. To this Committee Congress delegated the authority to designate not less than eight nor more than twelve reserve cities and to divide the continental United States into a corresponding number of reserve districts. These districts, according to the law, were to be apportioned with due regard to the convenience and customary course of business. They may be readjusted by the Board of Governors of the Federal Reserve System. In addition to the twelve reserve banks there are now in all twenty-five branches and two agencies. The Federal Reserve Bank of Cleveland has a branch in Cincinnati and one in Pittsburgh.

All National banks were required to become members of the System, subscribing to the capital stock of the Reserve banks, and depositing their reserves therein. State banks were permitted to become members on similar terms, provided they fulfilled certain requirements as to capital structure and as to the general nature of their business. This division of the banks of the country into National and State banks, with different laws, powers, and supervisory authorities, was a basic condition upon which the Federal Reserve System was superimposed, and it is a basic condition to which its operations have always had to be adjusted.

About forty percent of the banks in the country now belong to the Federal Reserve System and these banks account for about seventy percent of the country's banking resources. The member banks include 5,425 national banks and 985 State banks and trust companies. The State banking institutions which are still outside the System are for the most part small. There are about 9,000 non-members; about 1,400 of them have deposits of less than $100,000, and about 2,600 have deposits of less than $250,000.

Under provisions of the Banking Act of 1935 State non-member banks, with certain exceptions, having average deposits of $1,000,000 or over, must become members of the System after July 1, 1942 or lose the right of having their deposits insured with the Federal Deposit Insurance Corporation.

The Federal Reserve banks differ from ordinary commercial banks in both their organization and their functions. Generally speaking, as you know, they do not deal directly with the public. Their customers are the member banks who make deposits with them and secure credit or currency just as the public does with the local banks. The capital stock of the Federal Reserve bank is owned by the member banks, which are required by law to subscribe to capital stock equal to six percent of their capital and surplus. One-half of such subscription is paid in cash and the other half is subject to call. The management of the reserve bank is in the hands of a board of directors which represents not only the member banks but other business interests of the community. Of the nine directors of each Federal Reserve bank, three known as Class C directors are selected by the Board of Governors of the Federal Reserve System and six are selected by the member banks, three known as Class A directors representing the stock holding member banks, and three known as Class B directors representing commerce, agriculture, or industry in the district. The chief executive officer of the bank, designated as president under the new banking act, is appointed by the board of directors of the bank subject to the approval by the Board of Governors of the System. The legal requirements for ownership and management of the Reserve banks, therefore, recognize that their functions must be performed in the public interest and that their management must take account of both the banking and the general business interests of the region.

Holding member bank reserves

One of the purposes of the Federal Reserve Act was to provide institutions which would hold the reserves of the nation's banking system. It is necessary for all banks to keep a certain proportion of their deposits available to meet the current demands of their customers. Before the establishment of the Federal Reserve System, National banks were required to keep part of their reserves in their own vaults and part on deposit in other banks, usually metropolitan banks. Banks in the central reserve cities, however, of which there were then three, New York, Chicago and St. Louis, had to hold all their reserves in cash. When there was a general and heavy demand for funds, especially at crop moving times, for example, and country banks everywhere drew down their balances with their city correspondents, a situation was developed in which a currency and credit crisis of greater or less magnitude might readily occur. Country banks then had difficulty in getting money from the city banks, and the public in turn had difficulty in getting money from the country banks and from the city banks as well.

Now all member banks are required by law to keep their reserves on deposit in the Federal Reserve bank of their district and it is the business of the Reserve banks to supply member banks with credit or cash in such emergencies.

The required reserves vary with the type of deposit and the class of bank. Banks in central reserve cities, which now are only New York and Chicago, are required by law to maintain reserves equal to thirteen percent of demand deposits, that is, deposits which can be withdrawn without advance notice. For example, if a customer of a Chicago bank borrows $1,000, his deposit balance is credited with $1,000 and the bank in turn must provide for $130 of reserve deposit at the Federal Reserve Bank of Chicago, unless prior to the loan it already had excess reserves of that amount or more. Banks in so-called reserve cities, of which there are about sixty, are required to maintain reserves of ten percent against demand deposits, and all other banks are required to maintain reserves of seven percent. Reserves of three percent against time deposits are required to be maintained by all banks. Member bank reserve balances on deposit with the twelve Reserve banks amount today to over $5,600,000,000. Because of unusual conditions, the total of these balances is about twice as much as the banks are required to have.

The Reserve banks serve as the credit reservoirs of our banking system. Local banks no longer need have any fear that they will be unable to draw on their reserves when needed, as used to be the case before the Reserve System was established. Accordingly, one important risk has been eliminated from commercial banking.

Loans to member banks

Equally important with their function of holding member bank reserves is the power of the Reserve banks to make loans to member banks. Through these loans the member banks are able to increase their deposit balances and thus provide the reserves necessary for the expansion of credit. The Reserve banks may supply funds to member banks by rediscounting paper or by making advances to member banks, as provided by law and Board regulations, or by purchasing bills and securities, and entering corresponding credits to the account of the member banks, thus increasing their reserve balances. Member banks in turn can increase their loans to the public in the aggregate by an amount several times the amount of the additional reserves.

The Federal Reserve Act, however, places limitations on the character of paper on which loans may be obtained from the Reserve banks. For many years Reserve banks have had the power to discount only short-term self-liquidating commercial paper, that is notes, drafts, bills of exchange and bankers' acceptances arising out of commercial, industrial and agricultural transactions, and to make advances to member banks on their promissory notes backed by paper eligible for discount or purchase or by United States Government obligations. They were not authorized to make advances on a wide range of other assets which made up an important part of the total earning assets of banks. These included real estate loans, securities other than those of the United States Government, and loans to business men which did not meet the requirements of the narrowly-defined eligible commercial paper.

As a result of many developments in our financial organization, paper which qualified for borrowing from the Reserve banks has constituted a constantly decreasing proportion of the total assets of member banks ever since the System was established. In 1929 it was only about twelve percent of total loans and investments of such banks, and in 1934 it was but eight percent. Consequently, in 1931 and 1932 when the great liquidation occurred, many banks with assets which were good but technically ineligible for borrowing at Reserve banks, were obliged either to dump them on a falling market, suffer severe loss and contribute to the deflation in values or to close their doors.

The new banking act corrects this situation. It authorizes the Reserve banks to make advances to member banks for periods not exceeding four months on any security satisfactory to the Reserve bank, at a rate of interest at least one-half of one percent above the highest discount rate in effect at the particular Reserve bank. This amendment modifies and makes permanent the emergency legislation which it was necessary to pass in 1932.

In addition to the foregoing general powers of discount and purchase the Federal Reserve banks have special powers with respect to loans to commerce and industry for working capital purposes. These powers are granted by Section 13b of the Act. Under this section the Reserve banks are authorized to discount loans made by member banks and other financing institutions to established industrial and commercial businesses for the purpose of supplying working capital. Such loans are to have maturities of not to exceed five years. The Reserve banks are authorized to discount these loans without recourse for as much as 80 percent of any loss thereon. The Reserve banks also have authority to grant commitments to discount such loans. This makes it possible for a member bank to hold in its portfolio loans which the Reserve bank is under obligation to take over upon request, and upon which the Reserve bank assumes 80 percent of any loss. In other words the member bank has an earning asset which is insured 100 percent as to liquidity and 80 percent as to loss. This arrangement is not restricted to member banks; it is open to non-members as well.

Under the same section the Reserve banks are authorized in exceptional cases, and when credit is not available from the usual sources, to make such loans for working capital purposes direct to the borrower.

As of October 23, the Federal Reserve Bank of Cleveland had received 553 applications for working capital loans aggregating $17,000,000. Of these, 141, aggregating $6,300,000, had been approved. The Reserve bank's outstanding advances on that date were $1,800,000 and at the same time it had commitments outstanding for another $1,800,000.

These loans have been made to all kinds of enterprises, industrial and commercial. In many cases they have been loans which bankers have not been accustomed to making, and which would not be made were it not for the fact that the Reserve bank stands behind the bank which makes them. But as it is, they constitute secure and liquid assets, yielding a good rate of interest.

Currency issued by Reserve banks

Another activity of the Reserve banks is the issuance of Federal Reserve notes. These constitute the paper money authorized by the Reserve Act for the purpose of supplying the country an elastic currency - that is, a currency whose volume can be readily increased or decreased according to the public demand for it.

Federal Reserve notes are obligations of the United States and are secured by specific collateral pledged by the Reserve bank. The bank is required to keep reserves in gold certificates at least equal to forty percent of the notes in actual circulation. The Federal Reserve banks, of course, do not supply the entire currency of the country. The Government issues silver dollars, minor coin and some paper money and, until July of this year, the National banks continued to have the privilege of issuing National bank notes. The larger part of money in circulation, however, consists of Federal Reserve notes.

A member bank that has satisfactory assets can always secure all the currency that it needs. If it has a demand for more cash than it has in its vault, it can readily obtain Federal Reserve notes at its Reserve bank. It can borrow and take the proceeds in notes or it can draw against its account and, if necessary, restore the account to the required level by borrowing. If it receives on deposit from its customers more currency than it needs to keep on hand for current requirements, it can send the excess to the Reserve bank to be added to its reserve balance.

The function of supplying elastic currency is important, but it is less important than the lending power, because, as you know, currency does not play a major role in present-day business transactions. About ninety percent of our business is conducted by the use of checks. Currency is used, for example, for purchases at retail stores and filling stations, for car fare, and for payrolls, but such uses account for only about ten percent of the total monetary transactions in the country. Such fluctuations in the demand for currency as appear regularly on pay days, during the period of Christmas shopping, and near holidays, are met completely by the machinery provided by the Federal Reserve Act.

Other activites of Reserve banks

Beside their work in holding the banking reserves of the country, in making loans to member banks, and in supplying currency when needed, the Reserve banks have other important functions which facilitate the smoother working of our financial machinery.

The Reserve banks have greatly simplified the procedure whereby banks collect checks drawn on other banks. This has been very useful to business in general because it has permitted more prompt and cheaper settlement of monetary transactions. The Reserve banks in effect act as a nationwide clearing house, not only for checks, but for other credit items such as notes, drafts, bonds and coupons.

In order to effect the prompt transfer of funds from one part of the country to another without actual movement of currency, the System maintains an inter-district Gold Settlement Fund in Washington. The fund was established by deposits of the twelve Federal Reserve banks, and transfers from one district to another are made daily by debits and credits to the respective accounts of the Reserve banks.

The Federal Reserve System has centralized the work of the fiscal agencies of the United States Government. The Reserve banks act as fiscal agents in connection with the issue and retirement of Government debt and as depositaries of Government funds in administering deposit accounts of the Government in the Reserve banks.

Central control of credit policy

I wish to turn now from this discussion of the functions which the Federal Reserve banks perform for the local banks and consider how these activities tie in with the general responsibility of the System, through its Board of Governors, for the nation's credit policy.

When the Federal Reserve System was established it was realized that for certain activities, particularly those related to local banking conditions, a regional organization was necessary. Only in this way could the System meet local bank needs in a country as large as the United States, with economic conditions varying so much from one section to another. Each regional bank would have intimate knowledge of developments in agriculture, commerce and industry in its district and of the district's special credit needs and problems. The principle was also established by the original Federal Reserve Act that under the authority of the Act and of regulations of the Board in Washington the Reserve banks should have final responsibility in their dealings with member banks.

At the same time, it was also realized that the credit policy of the different Federal Reserve banks must be coordinated so that policies adopted in one district would not be harmful to another. More than that, there should be a credit policy for the country as a whole which would take account of general business and credit conditions. The direction of this policy is the duty of the Board of Governors of the Federal Reserve System, which is the central organization located in Washington. The Board is aided by other organizations which work closely with it, the Federal Advisory Council and the Federal Open Market Committee.

Board of Governors of the Federal Reserve System

Experience has indicated that this power of the Board to affect the expansion and contraction of the general supply of credit is of vital importance to the country, since the volume of credit is a factor in determining the course of business, and proper changes in the cost and volume of credit may tend to moderate excessive expansion or contraction of business, or, in other words may reduce the danger of inflation and deflation.

The Board's ability to influence the volume of credit rests on three important powers: the power to determine discount rates, the power to change reserve requirements, and the power, exercisable through its majority of members on the Federal Open Market Committee, to determine open-market policies.

Discount rates

Discount rates are the rates charged by the Federal Reserve banks on loans to member banks. These rates determine the cost of borrowing by member banks and consequently have a bearing on the cost at which the public can borrow from these banks. Indirectly they affect other rates in the money market. Under the Federal Reserve Act changes in discount rates are made by the various Federal Reserve banks but are subject to review and determination by the Board of Governors. This gives the Board final responsibility over the discount rates, and enables it to keep the cost of borrowing in the different sections of the country consistent with general credit conditions for the country as a whole.

The new banking act strengthens the Board's power to control these rates by making the further provision that discount rates must be submitted to the Board of Governors every fourteen days. This insures frequent review of the rates.

Reserve requirements

The Board of Governors also has the power to change the reserve requirements of member banks. The volume of credit which any member bank may extend is limited by the amount of reserves which are required by law to be maintained against its deposit liabilities. An increase in the reserve requirements reduces and a decrease increases the potential volume of member bank credit. Consequently the power to change reserve requirements gives the Board an important means of controlling the general volume of credit. Formerly this power could be exercised only in the event of an emergency arising out of credit expansion and then only with the approval of the President of the United States. Under the new act these conditions are omitted. The power is to be exercised in order to prevent injurious credit expansion or contraction, provided that reserve requirements may not be reduced below the present requirements specified in the law nor increased to more than twice the amount of these legal requirements.

Open-market operations

The third important means of control over the supply of credit are the so-called open-market operations, responsibility for which under the new banking act will be vested in a new Federal Open Market Committee. This committee will consist of the seven members of the Board of Governors and five representatives of the Reserve banks selected by the Reserve banks in different regions.

Open-market operations consist of the purchase and sale by Reserve banks of certain classes of securities, chiefly Government obligations. These operations have the effect of increasing or decreasing the supply of credit available in the market. By selling securities the Reserve banks withdraw funds from the market and there is a decrease in the supply of credit. Through a purchase of securities a Reserve bank puts funds into the market, thus tending to ease credit conditions.

Purchases and sales of securities by the Reserve banks were unimportant in the early days of the System. It was not until 1922 that they were large enough to affect the money market. At that time it became necessary to take steps to coordinate purchases and sales so that credit conditions for the country as a whole would not be adversely affected. Gradually these purchases and sales have become one of the most important means whereby the System can take the initiative in influencing credit conditions.

The responsibility for determining what security transactions should be undertaken and the authority for enforcing a program were not clearly defined by law until the new banking act. At the time this act was passed an

Open Market Committee consisting of representatives of the twelve Reserve banks was authorized to propose purchases and sales. Its proposals were then submitted to the Federal Reserve Board, which had the authority to approve or disapprove but not to initiate a policy. Even after purchases or sales by the Reserve banks had been agreed upon by the committee and the Board, the boards of directors of the twelve Federal Reserve banks throughout the country could frustrate the policy by refusing to participate in its execution.

The new act clearly places responsibility for determining open-market transactions on the new Open Market Committee and directs the Reserve banks to carry out the transactions determined by this committee. This is one of the most important changes in the Federal Reserve System which the new act introduces.

Other work of the Board

The Board of Governors has a variety of other duties which tie in with its general responsibility for supervision of the System. These include the examination of Reserve banks, passing on applications of State banks and trust companies for membership in the System, obtaining condition reports from State member banks, administration of those provisions of the Clayton Anti-trust Act which relate to interlocking bank directorates, regulation of the maximum rate of interest to be paid by member banks on time and savings deposits, regulations under the Security and Exchange Act governing the margin requirements for loans on securities listed on the stock exchanges, and maintenance and operation of the inter-district Gold Settlement Fund.

In carrying out its responsibilities it is essential that the Board keep in touch with banking developments in different parts of the country. In the organization of the System provision was made for regular contacts between the Board and the various Federal Reserve districts. One of the class C directors at each Reserve bank, designated by law as the Federal Reserve agent, represents the Board at the bank and maintains an office of the Board at the bank. The Federal Advisory Council, also provided by law, is made up of representatives of each Federal Reserve district and meets at least four times a year in Washington to confer with the Board and to make recommendations. The Board also has meetings in Washington with the chief executive officers of the Federal Reserve banks and with the Federal Reserve agents.

Information bearing on credit policy

It has always been a part of the System's work to watch credit trends and to develop a better general understanding of the facts bearing upon credit policy. Information bearing on banking conditions throughout the country and on production, employment, trade and prices, has been regularly collected. In its monthly publication, the Federal Reserve Bulletin, and in its Annual Reports, the Board has undertaken from the beginning to give the public a comprehensive view of current banking and financial developments at home and abroad and also to furnish detailed information on conditions of banks throughout the country and on the business situation. Each of the Federal Reserve banks also publishes a monthly review of the business and banking conditions in its district.

There is no central bank in the world which makes available such exhaustive information on domestic banking and business developments and on the