Speech delivered before
Cosmos Club
Washington, D. C.
February 27, 1936

FEDERAL RESERVE SYSTEM LOANS TO INDUSTRY

WHAT IS FEDERAL RESERVE SYSTEM

The Federal Reserve System was established in 1913 by the Federal Reserve Act, one of the most important pieces of financial legislation ever passed in this country. The System was created after many years of dissatisfaction with our banking and currency facilities, brought to a head by the panic of 1907, and after a thorough study of banking here and abroad by a National Monetary Commission established by Congress in 1908. 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 recent legislation, approved August 23, 1935, makes important permanent changes so that the System can be more effective in the future in meeting the credit needs of the country.

FUNCTIONS OF FEDERAL RESERVE BANKS

There are twelve Federal Reserve banks, one in each of the twelve Federal Reserve districts into which the whole country is divided. Several of the Federal Reserve banks have branches which operate in different parts of their district. There are now in all twenty-five branches and two agencies.

Banks of the country become eligible to use the facilities offered by the Reserve banks by becoming members of the Federal Reserve System. All national banks were required by law to join and State banks are permitted to become members if they fulfill certain requirements as to capital structure and as to the general nature of their business.

Federal Reserve banks differ from ordinary commercial banks in both their organization and their functions. Generally speaking, they do not deal directly with the public. Their customers are the member banks who come to secure credit or currency just as the public goes to the local banks. The capital stock of the Federal Reserve banks is owned by the member banks, which are required by law to subscribe to capital stock equal to six per cent 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 bank is in the hands of a board of directors which represents not only the member banks but other business interests of the community.

One of the purposes of the Federal Reserve Act was to provide institutions which would hold reserves of the nation's banking system.

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.

Reserve banks are sometimes known as the central reservoirs of credit of our banking system because of this function of holding in trust the reserves of the member banks. Under the Federal Reserve System our banks no longer have any fear that they will be unable to get their reserves when needed. 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. 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.

Currency issued by Reserve Banks: Another phase of the activity of the Reserve banks is the issuance of Federal Reserve notes, which are the paper money put out by the Reserve banks under the provisions of the act for supplying the country an elastic currency; that is, 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 issuing bank. The bank is required to keep reserves in gold certificates at least equal to forty per cent of the notes in actual circulation.

Other functions: Reserve banks have greatly simplified the procedure whereby banks collect checks they receive which are drawn against other banks. This has been very useful to business men because it has permitted more prompt and cheaper settlement of many business transactions. The Reserve banks in effect act as a nation-wide clearing house. Banks merely send the checks against other banks to the Reserve bank of their district. Checks on banks in the district are cleared on the books of the Reserve bank and those on banks in other districts are cleared through the other Reserve banks. The Reserve banks perform similar services in connection with other credit items such as collection of notes, drafts, bonds and coupons, and the acceptance of exchange drafts. Machinery has also been set up for prompt payment of funds from one part of the country to another without actual movement of currency. The System maintains a fund in Washington called the Gold Settlement Fund established by deposits of the twelve Federal Reserve banks. Transfers from one district to another are made daily by adjusting the accounts of the various Reserve banks.

Reserve banks act as fiscal agents in connection with the issue and retirement of Government debt and in administering deposit accounts of the Government in the Reserve banks.

FUNCTIONS OF BOARD OF GOVERNORS

The most important duties of the Board of Governors in Washington relate to the broad credit policy for the country as a whole and are sometimes spoken of as its power to influence the volume and cost of credit. Experience has indicated that powers of the Board which affect the expansion and contraction of the general supply of credit are 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 exert an influence toward moderating excessive expansion or contraction of business, or in other words, may reduce the danger of inflation and deflation.

The Board's instruments for influencing the volume of credit are its power to change discount rates and reserve requirements, and through its majority members on the Federal Open Market Committee, to determine open-market policies.

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 affect the cost at which the public can borrow from these banks. Under the Federal Reserve Act changes in discount rates made by the various Federal Reserve banks are subject to review and determination by the Board of Governors. This gives the Board final responsibility on the discount rates so that the most of the borrowing in the different sections of the country may be kept 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 establishes as a matter of law the requirement that the discount rate policy shall be reviewed at least every two weeks.

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. Consequently the power to change reserve requirements gives the Board an important means of controlling the general volume of credit.

Another 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.

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 inter-locking 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 Gold Settlement Fund.

It is also a part of the System's problem to watch indicators of credit trends and to develop a better general understanding of the facts bearing upon credit policy. The System has pursued a policy of collecting information bearing on banking conditions throughout the country and on production, employment, trade and prices. In a monthly publication, the Federal Reserve Bulletin, and in its Annual Report, the Board has undertaken to give to 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.

LOANS TO INDUSTRY - SECTION 13-B

I want to take a few minutes now to tell you about recent special work of the Federal Reserve banks. I refer to operations under an amendment to the Federal Reserve Act approved June 19, 1934, which authorizes the Federal Reserve banks to make direct loans to industry and to guarantee for banks certain types of loans to business men which the banks might not otherwise be willing to make. The purpose of these provisions is to give both bankers and business men some added assurance in making commitments during a difficult period when they tend to feel unduly conservative.

Anyone in an established industrial or commercial business who wants a loan for working capital purposes which is reasonable and sound and has a maturity of not more than five years should now be able to get such a loan from his local bank. This applies to both member and nonmember banks. Furthermore, if the local bank cannot accommodate the borrower, he may be able to borrow from the Reserve bank itself. No business man who has assets of value to offer as security need hesitate because they do not conform to the types of collateral usually required by banks.

The local banks are given special assurance in making these loans through the privileged status which they enjoy at the Reserve banks. The loans are eligible as a basis for borrowing at the Reserve banks. More than that, if the bank wants to dispose of a loan it can procure a commitment from the Reserve bank to take it off its hands and the bank is guaranteed against loss up to 80 per cent of the loan.

The Federal Reserve banks do not seek, however, to supersede the local banks. They do not make an advance if there is a local bank willing to make it. They seek to have the local bank at least participate in the loan, and the law goes so far as to permit the Reserve bank to relieve the local bank of all but 20 per cent of any loss on the loan. Since the middle of 1934 when this program began the Federal Reserve banks have approved applications for about $126,000,000 of such credit.

The credit has been used by a wide variety of businesses. Only established commercial and industrial enterprises are eligible, the loan must be on a reasonable and sound basis, and the maturity must not exceed five years.