

Address by Hon. W. P. G. Harding, Member, Federal Reserve Board,
before the Texas Bankers' Association Convention, at Waco, Texas, May
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I shall not attempt any discussion of the Federal Reserve Act from its broadest viewpoints, but shall confine myself to certain phases of its operation that are of particular interest to member banks, and in endeavoring to stress some of the benefits of the system, I shall not seek to evade a discussion of certain features to which objection has been made, particularly by the smaller banks.

The profits arising from exchange charges have always been dear to the hearts of bankers, for the reason that transactions against which these charges are made are quickly closed up, and involve no long tying up of funds. Profits from this source, however, are constantly becoming smaller, so that in the case of many banks, in the larger towns especially, they have so diminished, that the exchange account shows a loss instead of a gain. I can remember the time when banks in Alabama charged a premium of $1/2$ of 1% for their checks upon financial centers, while they would buy at the same time sight drafts upon the same cities at the same rate of discount, thus netting a clear 1% . I presume that there was a time when rates equally as high prevailed in Texas. Some of these same banks are now glad to make a net profit of $1/10$ of 1% , and in many cases this profit is derived only from the purchase of bills drawn against cotton when that commodity is moving actively, or from the collection of, and remittance for B/L drafts drawn against shipments of goods. Theoretically, exchange may be defined as the rate at which the documentary transfer of funds is made, so that if the debits reciprocally due by two places be equal, the exchange will be at par, but when greater in one than in the other, the exchange will be against that place which has the

larger remittances to make, and in favor of the other. It is customary for the seller of goods to forward them at the expense of the purchaser, who is supposed to pay for them in funds current at the place of residence of the seller. Thirty years ago it was ~~usual~~ ^{the practice} for settlements to be made between parties living in different towns, by draft on New York or some other financial center, by post office money order, or by shipments of currency by express. In those days the rate of exchange was governed to a great extent by express rates, especially when the amount involved was large, for the remitter would not pay a bank a higher rate for its check than it would cost him to forward the actual funds by express. Merchants would go to their local bank and purchase drafts in favor of their creditors, paying the bank the agreed premium. As the business of the country developed, the local merchant gradually acquired the habit of sending his own check, drawn upon his local bank, to his creditor in New York, Chicago or St. Louis, who would deposit the check in his own bank, which would, in turn, forward it for payment. The local merchant found that by doing this he could avoid paying a premium for a bank draft drawn upon the city where his debt was due. The city dealer found that he could, in most cases, prevail upon his own bank to accept his country checks on deposit without making any deduction, so he soon became accustomed to this method of settlement. In the course of time, when ~~xxx~~ many remittances were being made in this way, the burden upon the banks in the financial centers became very great, and to protect themselves, the crediting bank would impose a charge on country checks deposited with it, so that the cost of remitting funds for settlement of goods purchased had been shifted from the local merchant to the dealer or jobber in the cities. In many cases, however, this cost is borne by neither

of the parties to the transaction, but is still absorbed by the city bank which has the dealer's account, although there seems hardly more reason for it to be taxed with the cost of transfer of funds from the buyer to the seller, than for it to pay freight upon the goods purchased. The banker in the smaller towns naturally looks with favor upon this method of settlement, as he exacts his exchange charge from the bank from which he receives the check, and his bank has enjoyed an increased deposit during the time the check has been outstanding. Many abuses have crept in, however, and it frequently happens, particularly where the drawer knows that his check will be outstanding four or five days, that he will forward it before he actually has funds in bank to meet it, relying upon his ability to make the account good by the time the check is returned for payment. The merchant in the small town, therefore, prefers to continue this method of settlement, as it frequently saves him an interest charge. It often happens also that in cases where the bank in the larger city makes a charge against its depositor more than ample to cover actual cost of collecting a country check, that it seeks to retain all or a part of this as a net profit, and is frequently enabled to do so by taking advantage of competitive conditions in an intermediate town where it has a reciprocal account, so that the expense is in many cases borne by a bank in some local center which is willing to take business at a loss to prevent a competitor from getting it. The ideal arrangement which the bank in the small town, or the real country bank, likes to make, and one which it is frequently able to make, is to charge its correspondent bank located in a financial center of its own state, exchange at the rate of 25¢ per hundred on all checks received for collection, at the same time clearing ^{the same} through ~~xxx~~ correspondent all checks payable outside of its own town

without any expense whatever. I believe, however, that arrangements of this kind are becoming harder to make, and that the greater part of exchange charges now being made in this country are borne by the sellers of goods. It may be that their profits are sufficient to admit of their bearing this expense, and I have always been impressed with the logic of a contention made by a country merchant when I was a bank clerk in ~~xxxxxxx~~ Alabama more than thirty years ago. It seems that on one occasion he sent his own check on the local bank to a New Orleans merchant in payment of some sugar, instead of following what was then the prevailing custom of going to the bank and buying its draft on New Orleans. This check was deposited in a New Orleans bank, who sent it for collection to the rival bank in ~~xxxxxxx~~, so that the bank on which the check was drawn made no profit out of the transaction. The cashier asked this merchant what he meant by sending his local check as far away as New Orleans, and suggested that he come in as usual and buy a bank draft. The merchant replied, that whenever the New Orleans merchants would pay the freight on their goods shipped to him, that he would be willing to pay the freight on their money. Sellers of goods all over the country have for several years past been paying freight on the money paid them for their goods, and the volume of local checks that are transmitted in the mails every day now reaches enormous proportions; - certainly \$200,000,000 would not be a high estimate. When the Federal Reserve Act was being debated in Congress, representatives of those who have been paying exchange charges on checks sent them in payment of goods sold, exerted their influence in favor of free check collections, and shortly afterwards representatives of more than 2,000 country banks went to Washington and appeared before the committee having the bill in

charge, and entered a vigorous protest against being deprived of what they regarded as a legitimate profit. The result was, that this paragraph was included in Section 16 of the bill as enacted, and is now part of the law:

"Every Federal reserve bank shall receive on deposit at par from member banks or from Federal reserve banks checks and drafts drawn upon any of its depositors, and when remitted by a Federal reserve bank, checks and drafts drawn by any depositor in any other Federal reserve bank or member bank upon funds to the credit of said depositor in said reserve bank or member bank. Nothing herein contained shall be construed as prohibiting a member bank from charging its actual expense incurred in collecting and remitting funds, or for exchange sold to its patrons. The Federal Reserve Board shall, by rule, fix the charges to be collected by the member banks from its patrons whose checks are cleared through the Federal reserve bank, and the charge which may be imposed for the service of clearing or collection rendered by the Federal reserve bank."

It seems to have been the idea in Congress that country banks would be appeased by the provision that they might make a charge against those of their patrons whose checks were cleared through the Federal reserve bank. In other words, if Mr. Brown of Abilene should draw his check upon the Citizens National Bank of Abilene, in favor of Smith & Co. of Chicago, for \$100., and that check should be returned to the Abilene bank for payment through the Federal Reserve Bank of Dallas, it was thought that the Abilene bank could charge Mr. Brown 15¢ for having paid his check in Chicago funds. The fact, however, was evidently overlooked that Mr. Brown would not look with favor upon this charge, which if persisted in, would result in the loss by the Citizens National Bank of Mr. Brown's account. Neither is the permission given "to charge for exchange sold to patrons" any more satisfactory to the small bank, for the reason that their patrons have long since gotten out of the habit of buying bank drafts and make a practice of remitting their own checks. It seems, therefore, in actual practice that the only charge allowed is for "the actual expense incurred in collecting and re-

mitting funds", which must seem a mere pittance to banks that have been charging 25¢ per hundred. Yet the Federal reserve banks are required to "receive on deposit at par from member banks or from Federal reserve banks checks and drafts drawn upon any of its depositors", and the Federal Reserve Board is charged with the duty of carrying out the law.

It has been the earnest desire of the Board to cause as little hardship as possible in making these changes, and after a careful study of the whole subject, and after many conferences with representatives of all Federal reserve banks and officers of member banks, a plan has been agreed upon which will be gradual in its operation, and which will, it is thought, in the course of time prove effective. Each Federal reserve bank, in accordance with this plan, has notified its member banks that a check clearing system will be established, but that for the present the system will be a voluntary one, and no bank will be required to be a party to it except of its own free will and accord. In order best to describe the workings of this plan, I will assume that the member banks in Dallas, Ft. Worth, Waco, Austin, Houston, San Antonio, Paris, Galveston, Sherman and El Paso assent, and agree to permit the Federal Reserve Bank of Dallas to charge against their respective accounts as soon as received checks upon each bank which may come into the hands of the reserve bank. Such checks will be immediately forwarded to banks upon which drawn, for credit, and any checks not good are to be returned to the Federal Reserve Bank and re-credited by it. Each of the banks agreeing to the plan must carry with the Federal Reserve Bank, in addition to its required reserve, an amount sufficient to provide for the debiting against its account of these checks. We will assume that there are 40 banks which agree to this plan at the start. Any one of these 40 banks having checks upon the other

39 banks, will forward them all to the Federal Reserve Bank of Dallas, and receive immediate credit. It will, of course, have to stand an immediate debit on the books of the Federal Reserve Bank of all checks drawn upon itself received by the reserve bank from the other 39 banks, so that the net result to any one bank is merely a balance, and it will at the same time have been inconvenienced by having to write only one remittance letter instead of a great many, and by receiving only one incoming letter from the Federal Reserve Bank, instead of perhaps 39. Parties receiving checks upon any of these 40 banks will soon appreciate the fact that they are collectible at once without charge, and, therefore, are as desirable as checks on New York, Chicago or St. Louis have been hitherto. There will thus be established a preference for checks drawn on these banks, and parties remitting in payment of bills checks on banks not connect with this clearing plan, will soon be brought to realize that checks drawn on banks in the clearing system are preferred. If a merchant in Sherman finds that by reason of his bank being a member of the clearing system that his checks are received without question, he will appreciate the facility given him, but if a merchant in Texarkana, for instance, finds that by reason of his bank not being a member of the clearing system he is charged exchange upon the checks that he sends out, while his competitor in Sherman or Waco is exempt from such charge, he will soon, no doubt, exert enough pressure upon his own bank to induce it to become a member of the clearing system. If Galveston, Austin and Ft. Worth, as well as Dallas, should all be members of the clearing system, merchants in all these towns would enjoy the same advantage, and in the course of

time the banks in ~~San Antonio~~ Alarillo, for instance, would find that they would lose business by remaining out, and would, I think, as a matter of business necessity, finally become members of the clearing system. The Federal Reserve Act does not, of course, become entirely effective as far as its reserve requirements are concerned until three years from November 16, 1914, or until November 16, 1917, after which time the entire reserve of a member bank must be partly in its own vaults and partly with the Federal reserve bank of its district. It is thought that during this time there will be a gradual accession to the number of banks assenting to the new clearing plan, and after the fall of 1917 it is not believed that many banks who have customers sending their checks to distant points, will fail to become members of the clearing section. As balances with other member banks will then no longer count as reserve, surplus funds will be loaned, rather than kept with other banks to control collections.

We ought to look this matter squarely in the face, and should realize that we must give and take, that we could not in any event have expected permanently to be able to make a charge of from 15¢ to 25¢ per hundred on checks sent us for collection, at the same time collecting all of our out of town checks without any cost whatever. The banks in the smaller towns will learn, as the city banks have already learned, to make up losses in ~~xxxx~~ exchange by adding to their volume of business, and while at first thought many of you may feel that there is little chance of increasing the volume of business in your own towns, I am sure that as the workings of the Federal Reserve System become better known, and the safeguards it offers are more fully appreciated, that any ~~much~~ money now being hoarded in your communities will come into sight

and be deposited with you, and with the development of your section, your business will expand in a healthy way. You have been given facilities, whether you borrow your money from the Federal reserve bank or not, of getting all the rediscounts to which you are entitled at lower rates than ever before. You will soon realize that there is no longer occasion for you to hoard money by carrying abnormally large reserves, and before the new reserve requirements under the Act are fully effective, I am sure that you will all have found that you can more than recoup your losses in the way of exchange profits by the gains derived through a greater volume of business.

What I have just said relates to the clearing of checks between banks in the same Federal reserve district, but the broader question of exchanges between the respective Federal reserve banks has also been considered by the Federal Reserve Board. It is proposed to obviate as far as possible the necessity for an actual transfer of currency from one Federal reserve district to another, and I think we have seen for the last time the stringency which has been recurring every fall during the active crop moving period. Member banks will no longer be obliged to undergo the expense of, nor to suffer the inconvenience due to delays attached to shipping in currency from the old reserve cities, but their currency requirements will instead be abundantly and quickly supplied at a minimum cost by their Federal reserve bank. The money that you will use in handling the crop next fall will consist largely of Federal Reserve Notes, which will stay in circulation as long as needed, and when the crop movement is over, and the notes become redundant, they will find their way back to the Federal reserve bank, where they will be retired. The abnormally high rates to which we have become accustomed dur-

ing the closing months of the year will no longer obtain, nor will there be the usual demoralization of rates in the early spring, due to the heavy flow of redundant currency into the great financial centers. Your cotton drafts can, if you wish, still continue to take their usual course, and I presume that you will prefer to send them direct in order to avoid delays in transit. You can, however, instruct your correspondent bank to make deposit with the nearest Federal reserve bank for the credit of your Federal reserve bank for your use, and you can order Federal Reserve Notes from your own Federal reserve bank against such deposits as made. Many years will doubtless elapse before uniform ^{interest} rates prevail throughout the country. Under present conditions money will continue to command higher rates in ~~xxxxxxx~~ ^{Houston, Dallas and Waco} ~~xxxxxxx~~ than it will in New York, Chicago or Boston, but the rates will certainly be stabilized and extreme fluctuations will cease.

Section 16 of the Federal Reserve Act provides that,-

"The Federal Reserve Board shall make and promulgate from time to time regulations governing the transfer of funds and charges therefor among Federal reserve banks and their branches, and may at its discretion exercise the functions of a clearing house for such Federal reserve banks, or may designate a Federal reserve bank to exercise such functions, and may also require each such bank to exercise the functions of a clearing house for its member banks."

The Board has accordingly, after conferences with the Federal Reserve Agents and the Governors of the several Federal reserve banks, decided to establish a Gold Settlement Fund, to be carried in the Treasury at Washington, and to which each Federal reserve bank shall contribute \$1,000,000 in gold, gold certificates or gold order certificates, in addition to an amount at least equal to the net indebtedness due to all Federal reserve banks as of May 24th. Each Federal reserve bank will be required to keep at all times in this fund, a balance of not less than

\$1,000,000, and this balance will count as a part of its lawful reserve. At the close of business each Wednesday night (or when Wednesday is a holiday, Tuesday night) each Federal reserve bank will telegraph to the Federal Reserve Board the amounts in even thousands due to the other Federal reserve banks as of that date, and on each Thursday the Settling Agent of the Federal Reserve Board will make the proper debits and credits in the accounts of each Federal reserve bank with the fund, telegraphing each bank the amounts, in even thousands, of credits to its settlement account, giving the names of each bank from whom received, and also giving the net debit or credit balance in the weekly settlement. Proper debits and credits will then be made upon the books of each Federal reserve bank. In case the debit settlement balance of any Federal reserve bank should be in excess of the amount to its credit in the Gold Settlement Fund, such deficiency must be immediately covered either by the deposit of gold, gold certificates or gold order certificates in the Treasury or any Sub-Treasury, or by credit operations, which term includes rediscounts with other Federal reserve banks which have an excess balance in the Gold Settlement Fund. Excess balances may remain in the fund to the credit of the banks to whom they are due, or they may, if desired, be refunded by the return to the reserve bank of gold order certificates, properly endorsed, or of gold certificates payable to bearer, and whenever practicable payments will be made by the nearest Sub-Treasury.

I am violating no confidence when I say that the Federal Reserve Board desires earnestly to have the state banks become members of the Federal Reserve System. The Board feels that the membership of the state institutions is essential to the coordinated banking system that it wishes to establish, and realizes that there can be but one credit

system of nation-wide extent. It fully appreciates that the strength of the Federal Reserve System must be gauged by the quality of its members, rather than by number, and it will use all the broad discretionary powers vested in it by the Federal Reserve Act to bring about this coordination. It seeks to establish only such reasonable standards of admission as will be generally recognized as necessary to protect the Federal Reserve System against the admission of banks which would be a source of weakness rather than of strength, and it intends to prescribe only such regulations governing their conduct as members, as will insure a reasonable conformity to the fundamental principles deemed essential to the success of the new banking system. The banks of this country are beginning to realize that membership in the Federal Reserve System carries with it privileges and guaranties of great value, not only to themselves, but to their customers as well. It is believed that membership in the system will come to be regarded as a test of banking solidity, and that membership, giving as it does full access to the facilities and resources of the system, will add to the prestige of even the strongest institutions, so that in the course of time the public will, instead of drawing a distinction as heretofore between national banks and state banks, will distinguish rather between banks which belong to the Federal Reserve System and the banks which do not belong, so that ultimately little importance will attach to the terms NATIONAL BANKS and STATE BANKS, and banks will be classified as MEMBER BANKS or NON-MEMBER BANKS.

Section 9 of the Federal Reserve Act requires that state banks becoming members of the Federal Reserve System must comply with certain general requirements which now apply to national banks. The minimum capital permitted is \$25,000, and this requirement as to capital is raised

according to the population of the town in which the bank is located, so that in cities of more than 50,000 inhabitants the minimum capital allowed will be \$200,000. State banks becoming members must also conform to the provisions of law governing national banks regarding the limitation of liability which may be incurred by any person, firm or corporation to such banks, the prohibition of purchases of, or loans upon their own stock, the withdrawal or impairment of capital, and the payment of unearned dividends. The Board is not disposed to make any hard and fast rules respecting loans upon real estate or mortgages by state banks who wish to become members. It will seek rather to provide reasonable limitations, so that loans or investments of this character will not be so excessive in amount as to endanger the bank's liquid condition.

The important question of examinations has been fully considered by the Board. As admission to the system will be regarded as evidence of a bank's strength, the Board must necessarily have accurate and reliable information regarding the condition of an applying bank and the character of its management. Examinations must, therefore, be under the direction of the Board, but it will as far as possible avoid imposing additional expense upon a bank by adopting a method of joint or supplementary examination in cooperation with state banking authorities. It will use examiners and auditors in the employ of the respective Federal reserve banks in supplementing the examinations conducted by the banking departments of the several states, and in passing upon applications for membership the Board will appreciate the cooperation of the state banking authorities.

The membership of state banking institutions in the Federal

Reserve System differs from that of national banks in being optional, and the Board has felt from the start that the directors of state banks should be given the right to terminate their banks' membership in case they should deem it advantageous to do so. The Board does not believe that state banks after becoming members will wish to withdraw from ^a the system which offers so many advantages, but at the same time it recognizes the responsibilities attached to the management of the state banks, and having received ample assurances from high legal authorities as to its powers, it will, I think, reach the conclusion that the state bank members may, with reasonable limitations as to the maximum withdrawal of capital and reserves during any one year, surrender their membership should they elect to do so. I am sure that the Board will define its position in this matter clearly within a very short time.

Permit me, in closing, to impress upon you all, the fact that we are living in a critical period of the world's history. The sun never sets upon the lands that are sending troops to engage in the most stupendous conflict of all the ages, and the toll in human lives and in destruction of property is enormous. The money cost of this war, and the indebtedness of the nations party to it, are beyond the comprehension of the average mind. No one can predict the duration of this titanic struggle, nor its ultimate outcome, nor can we foretell what readjustments of capital must be made between the nations after the restoration of peace. We were able last summer, to withstand the shock occasioned by the outbreak of war, by putting into circulation over \$300,000,000 of emergency currency, now practically all retired or in process of retirement. After June 30th, however, the law will no longer permit such issues, and such currency expansion as may be necessary in future will be in the form of

Federal Reserve Notes. The Federal reserve banks can ultimately provide, even without the state banks as members, an emergency issue more than three times as large as the maximum outstanding last year, but it can extend direct aid to member banks only. Those of you who control the destinies of state banks are earnestly invited to bring your institutions under the protecting aegis of the Federal Reserve System, and I confidently believe that in doing so, not only will you promote your own interests, but that you will perform at the same time a patriotic act by adding to the power of the world's strongest banking system.