

For release in morning newspapers
Thursday, August 29, 1957

THE MEANING OF MEMBERSHIP
IN THE FEDERAL RESERVE SYSTEM

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August 28, 1957

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In drafting the Constitution of the United States, the Founding Fathers were influenced profoundly by those political philosophers who held that democratic republican government should exist for the good of the people at large and only with the consent of the governed. This philosophy of government also assumes a sort of contract between government and those governed by virtue of which the governed surrender a measure of their individual freedom to the authority of government in return for the advantages of its protective might over their persons and property and a reservation, above all, of the right to retain a decisive voice in the formulation and conduct of governmental policies.

The Federal Reserve Act contains much of the same kind of political philosophy that is to be found in the Constitution. Where the Constitution recognized the prior existence of a federation of independent states, the Federal Reserve Act created a system of twelve regional and autonomous Federal Reserve Banks, each of which is governed by a board of directors, a majority of whom are elected by the member banks of each Federal Reserve district. In turn, the Federal Reserve Banks are subject to the general authority of the Federal Reserve Board much in the same way that the forty-eight states in the Union yield authority to the Federal Government. Finally, the member banks of the Federal Reserve System are the foundation of the scheme of regional and central banking organization that was established by the Federal Reserve Act, their position being akin to that of the nation's electorate.

In keeping with the concept of a contract between governor and those governed, membership in the Federal Reserve System is contracted as a free expression of the will of the individual member bank, except as to banks that have chosen to operate under national bank charters that automatically prescribe for such membership. The terms of the membership "contract" between a district Federal Reserve Bank and a member bank involve a grant of specified privileges to the member bank in return for an obligation to yield a considerable degree of supervisory authority to the Federal Reserve System. The true meaning of membership in the Federal Reserve System is to be found in these privileges and obligations of membership.

The shares of capital stock in its district Federal Reserve Bank that an entering bank purchases are the initial evidence of its membership in the Federal Reserve System. This stock ownership entitles the member bank to participate in the election of six out of the nine members of the Federal Reserve Bank's board of directors and to receive dividends on its holdings at the rate of 6 per cent per annum. Inasmuch as the earnings of the Federal Reserve Banks derive largely from their special position as central banks of issue, and due to the Federal Government's enveloping role of responsibility for the Federal Reserve System as the nation's central banking system, all earnings above 6 per cent, as well as the surplus accounts of the Federal Reserve Banks, are subject to the residual claim of the Federal Treasury. Through these financial arrangements, the member banks share with the Federal Government in the total capitalization of the Federal Reserve Banks.

Moreover, as the remaining three directors of a Federal Reserve Bank, including its Chairman and Deputy Chairman, are appointed by the Federal Reserve Board, which is an agency of the Federal Government, a distant connection can be traced between the Federal Government and the managements of the Federal Reserve Banks.

Membership in the Federal Reserve System has a moral and legal significance that transcends in importance the purely financial ties that have been referred to. This is because acceptance of membership signifies admission into a legally constituted fellowship of banking institutions entailing an obligation on each member bank to conform to appropriate standards for invested capital and to operate in accordance with broad rules of conduct prescribed by regulation. In line with these principles, when considering the admission of a bank to membership in the System, the Federal Reserve Board is required to pass judgment on the adequacy of the applicant's capital funds in relation to the character and condition of its assets and to its existing and prospective deposit liabilities, and to refuse admission if the requirements for capital funds are not met. By the same token, the Federal Reserve Board is empowered to require a member bank to forfeit its membership in the System if the conditions set for its membership or the regulations governing its operations under the provisions of the Federal Reserve Act are not complied with.

Furthermore, the Federal Reserve Board is empowered to remove from office any director or officer of a member bank who is found to violate any law relating to the operation of the bank in which he holds office, or who is party to continued unsafe or unsound banking practices

after having received timely warning.

The conditions for holding membership in the Federal Reserve System mean, in effect, that this particular kind of fellowship demands the subordination of the individual member bank's choice of banking conduct to the superior right of group determination of what are appropriate standards for banking practice. As the member banks have an important voice in the framing of banking legislation, including amendments to the Federal Reserve Act, their thinking rightly has a marked influence on legislated standards for banking conduct.

The time honored concept that banking is vested with a public interest and, therefore, subject to public regulation and supervision is the backdrop to the supervisory authority administered by the Federal Reserve Board, and is exemplified in the periodic examinations made of the condition of each member bank to ascertain that the quality of its assets affords adequate protection to its depositors and that its operating practices conform to the conditions prescribed for membership in the System.

What has been said up to this point has dwelt on the obligations of membership in the Federal Reserve System and the principle that either personal or corporate existence in a free society demands the sacrifice of some individual rights to the welfare of society as a whole. It is now time to examine the compensating advantages and privileges that go with membership in the System.

The incomparable check collection services offered by Federal Reserve Banks are by themselves a persuasive reason for accepting member-

ship in the System because they have endowed American banks and businessmen with the benefits of the most modern mechanical means for promptly making financial settlements. In effecting these settlements, member banks are required to pay checks drawn on themselves at their par value. This requirement accepts the thesis that the payee of a check should be paid its face amount and that the drawee bank's cost of making payment should be borne by the depositor for whom that service was rendered.

The Federal Reserve Banks perform a legion of other valuable services for their member banks, including the telegraphic transfer of funds and U. S. Government securities, and the safekeeping of securities. However, the value of Federal Reserve Bank services reaches full flower through their loan and discount facilities.

Before the Federal Reserve System was established in 1913, and prior to the 1933-1935 amendments to the Federal Reserve Act, sad experience had demonstrated that periods of financial stress had been aggravated by the inability of banks quickly to raise cash against the occurrence of sudden and abnormal deposit withdrawals. That sort of difficulty, by forcing banks to liquidate assets at salvage values in order to get cash, often endangered their solvency and led on to a spiraling destruction of values if and when a succession of banks became similarly involved. Any recurrence of these former difficulties is most unlikely because member banks are now in a position to meet the pressure of unforeseen deposit withdrawals by obtaining cash through borrowing at their Federal Reserve Banks on the collateral of any qualified asset. This right of emergency borrowing from the Federal Reserve Banks is an

advantage of almost incalculable value that goes with membership in the Federal Reserve System. Furthermore, as this borrowing facility relieves a member bank of the necessity of forcing the liquidation of assets in order to meet abnormal deposit withdrawals, the possibility is greatly reduced that any circumstances adversely affecting its affairs will spread contagiously to other banks.

Under normal conditions, Federal Reserve Bank loans are usually made for the purpose of permitting a member bank to make good a deficiency in the amount of reserves that it is required to keep on deposit with its district Federal Reserve Bank. Properly, however, use of this borrowing privilege is intended to provide only a temporary source for replenishing a member bank's reserves pending its resort to other means for working out a final adjustment in its reserve position. The continuous employment of funds borrowed from a Federal Reserve Bank is undesirable as it can lead the borrowing member bank into expanding its resources beyond the limit of the deposits at its disposal and, in that way, to extend its position and the fundamental protection that is otherwise afforded its depositors by an unobligated control of its assets.

Moreover, too frequent member bank recourse to borrowing at the Federal Reserve Banks can run counter to the effective conduct of Federal Reserve System monetary and credit policy. This is because the reserve funds borrowed from Federal Reserve Banks have the same credit-creating expansibility as the reserves that the Federal Reserve System can supply on its own initiative by operating in the open market.

The possibility of this kind of a conflict between Federal Reserve System monetary and credit policy and member bank borrowing at the Federal Reserve Banks is more apt to occur at a time when the broad objective of System policy is to restrain an expansion of commercial bank credit in the interest of sustaining a stable level of economic activity, and it has become advisable to limit the volume of reserves available to the commercial banking system.

As primary purveyors of credit and the most dynamic and crucial force in the array of credit-granting institutions, commercial banks are conscious of the compelling influence of bank credit on all economic activity, and that the tempo of their credit-granting actions can stimulate or restrain the entire range of economic undertakings that depend for their consummation on the use of credit. They also realize that whereas Federal Reserve System credit policy exercises a general form of credit control over the lending activities of all commercial banks, each separate bank exercises a species of individual credit control that allies itself naturally with the Federal Reserve System's general policies of credit control. This alliance derives from the simple fact that in deciding what types of loans or investments are suitable to the particular position of his bank, a banker is practicing a form of selective credit control that has been shaped partially by the influence of the scheme of general credit control currently in use by the Federal Reserve System.

Looking further into the credit policy relationship between an individual bank and the Federal Reserve System, it is obvious that

in deciding on the merits of a loan application, a banker is influenced by the economic climate of the times and the over-all loan position of his bank. If the period is one of general optimism, the paying performance of the bank's borrowers good, and the total of its assets anchored satisfactorily to an acceptable degree of liquidity, he proverbially feels free and willing to lend in volume. On the other hand, if opposite conditions prevail and the economic climate is bleak, he is naturally more cautious in reaching his loan decisions.

The Federal Reserve System indirectly is in a position to give bankers helpful guidance in making their loan and investment decisions. The source of this guidance lies partly in the System's supervisory responsibilities for the operations of its member banks, and partly in its overriding national responsibility to employ monetary and credit policies that will be conducive to the maintenance of a sound commercial banking system. In this latter connection, by observing the direction and economic intentions of Federal Reserve policy, and by also studying the wealth of published economic material that is the foundation on which that policy is built, banks have at hand an invaluable guide for framing their own lending and investment policies that is reinforced by combining their intimate knowledge of local conditions with an insight into the prospective local effects of the national business trends reported by the Federal Reserve System.

This form of indirect Federal Reserve guidance in a real sense supplements the compelling influence of the System's general credit

controls over the credit-granting activities of the commercial banking system. Along that line, it should be mentioned that general credit controls also serve the purposes of bank supervision and examination through the sort of credit climate induced by such credit controls and its effects on commercial bank credit activities.

Harking back to what has been said of the rights and obligations that go with membership in the Federal Reserve System, it is essential to emphasize that the general credit controls operated through Federal Reserve System credit policy leave discretion to the individual banks as to how the available supply of credit shall be allocated. What this means is that the member banks are autonomous instruments for carrying out System credit policy. This right to participate in the conduct of national credit policies I regard as a high privilege of membership in the Federal Reserve System.

However, enjoyment of this right by a member bank carries with it the obligation to be conversant with the objectives of System credit policy, to the end that the total credit activities of all the member banks will fall into a pattern that is consistent with these objectives. This result is attainable through mutual understanding between the Federal Reserve System and its member banks of what are the objectives to be desired of a national credit policy, and the communication of these policy aims to the multitude of bank customers whose cooperation is necessary to their effectuation. Whether the aim of such mutual endeavor is to stimulate a flagging economy by making additional supplies

of credit available, or to restrain the expansion of credit under conditions when the overuse of credit threatens economic stability, the member banks and the Federal Reserve System are allied in the common cause of the public interest.

Let me say, in conclusion, that this alliance of the member banks in a common cause with the Federal Reserve System epitomizes the meaning of membership in the Federal Reserve System.