INTEREST RATES, EARNINGS, DIVIDENDS AND TAXATION

AN ADDRESS

DELIVERED BEFORE THE

AMERICAN

BANKERS ASSOCIATION

AT NEW ORLEANS

NOVEMBER 21, 1911

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¶ The purposes to be accomplished by monetary legislation are stated by Senator Aldrich in his letter of January 16th to be the "unification of our banking institutions into one comprehensive system," the establishment of a "scientific basis for bank note circulation," and the "creation of a discount market similar to the discount markets in Europe." The keystone of the proposed plan is the assembling of a large part of the scattered bank reserves into the custody of the Reserve Association, thus making them actively useful.

¶ As the reservoir of the country's reserves, the Association must be able so to control its note and deposit liabilities that its reserve will at all times be adequate to permit extensions of credit, both ordinary and extraordinary. At the same time it must be able to exert a sufficient influence upon the exchange and money markets to contract its credit extensions and increase its reserves when necessary and without harmful influence upon business.

¶ The provisions of the plan as to taxes, earnings and dividends, and the possible relation of the Association to rates of interest throughout the country all co-ordinate with the broad design of the organization.

¶ Having no precedent in banking history for the radical readjustment of the relations and methods of a class of institutions controlling such vast resources as do the banks of this country, that is contemplated in the National Reserve Association, it was essential that its limitations and powers be reasonably safe, clearly defined and liberal enough to insure the accomplishment of the objects for which it is created. As will be seen, the safeguards provided in the plan operate generally as restrictions upon expansion of the Association's liabilities, and reduction of its reserves, while most of the powers vested in the management may be directed toward strengthening the Association's reserves. The proposed methods of taxation govern every possible form of expansion, and the limitation of the distribution of profits to shareholders and to surplus should cause the management to seek a record for conservatism rather than for money making. As it is intended that the Reserve Association shall maintain the surplus reserve of the whole country, such provisions are most important.

¶ The powers conferred upon the management in the exercise of which it may strengthen its reserves are: The power to borrow gold; authority to fix an uniform discount rate, and authority to purchase and sell foreign bills of exchange and foreign government obligations.

¶ An analysis of the disposition of earnings, the methods of taxation and the probable relation of the Association to the domestic and foreign money markets all lead to the belief that the Reserve Association will be a conservative and trustworthy custodian of the country's lawful money reserves.

¶ As to the earnings of the Association and their distribution, I suggest the following assumed statement of the possible condition of the Reserve Association at the end of say one year, as stated by one of our noted financiers in an address delivered at Nashville last May:

ASSETS

Lawful money received for capital	$100,000,000
Lawful money received for government deposits	100,000,000
Lawful money received for bank deposits	500,000,000
Government bonds taken over	500,000,000
	$1,200,000,000

LIABILITIES

Capital	$100,000,000
Government deposits	100,000,000
Bank deposits	500,000,000
Circulating notes	500,000,000
	$1,200,000,000

¶ No amount has been allowed for capital subscribed by State institutions. The capital stock of the State institutions which would be eligible for membership could not exceed $803,000,000, the present combined capital of such institutions, but would be very much less owing to the fact that of the 12,000 odd State banks and trust companies whose capital is included in these figures, nearly 7,000 have not the requisite capital of $25,000.

¶ Solely for the purpose of illustration we will assume a condition for the Association, after some years of operation, as follows:

Assets

Lawful money received for capital	$125,000,000
Lawful money received for government deposits	100,000,000
Lawful money received for bank deposits	625,000,000
Government bonds taken over	700,000,000
Investments and discounts	300,000,000
	$1,850,000,000

Liabilities

Capital	$125,000,000
Government deposits	100,000,000
Bank deposits	625,000,000
Circulating notes	700,000,000
Deposit and note liabilities arising from investments and discounts	300,000,000
	$1,850,000,000

¶ In this estimate is included an increase in capital and deposit liabilities, as well as circulation to cover a possible admission of State institutions, and a larger discount and investment account is indicated than may arise for many years. Based upon this assumed condition the earnings should work out in round figures about as follows:

Earnings

3%	on 700,000,000	U. S. 3's	$21,000,000
4½%	" 100,000,000	discounts	4,500,000
3½%	" 200,000,000	investments	7,000,000
			$32,500,000

Deductions

1½% on 700,000,000 U. S. 3's	$10,500,000
Expenses, Main Office and 15 branches	6,000,000
Expenses, note issues (about double present cost)	2,000,000
	$18,500,000

¶ This result, although allowing for changes in the monetary plan since the estimate heretofore referred to was made, is substantially the same. The stockholders might receive a dividend of $5,000,000, and there would be left for surplus $4,500,000, and for the government $4,500,000, total $14,000,000. It is quite apparent, therefore, that the disposition of the earnings of the Association may become an important question immediately upon its organization.

¶ Credit institutions are influenced in their operations by two considerations—profit and safety. In this plan the ability to make profits is subordinated to the necessity for safety. Very wisely a limit has been placed both upon the amount of dividends to be paid to the subscribers and the amount of profits to be added to surplus. By limiting the amount of dividends and surplus, incentive to large profits is removed, and no pressure of opinion either from the public or stockholders should induce the management of the institution to allow undue inflation or extend its operations for profit beyond the point of conservative action.

¶ The attention of the country will be focused upon the condition of the Reserve Association, and its earnings will be a subordinate consideration, as is the case in Germany, France and England.

¶ Were the surplus to be increased beyond a moderate maximum fixed amount, subscribers to the stock, in later years, at a greater book value, would realize an increasingly reduced interest return as compared with older stockholders, unless adjustments in the dividends were made which plan would seem impracticable.

¶ The Bank of England has established by long precedent, a fixed rest or reserve of approximately 3,000,000 Pounds, in excess of which amount profits are distributed to the shareholders. The dividends paid by the Bank since 1844 have been from 7% to 11¾%, in recent years 9%. Eliminating its own notes held in its Banking Department, the Bank of England shows roughly a net earning power of 1.3% on all of its assets and 2.2% on the assets which are earning interest, assuming that all of its earnings have been distributed. This compares with the assumed earnings as above suggested of $\frac{3}{4}$ of 1% on all of the assets of the Reserve Association, and 1.4% on the assets which are earning interest.

¶ The Bank of England earns roughly \$6,500,000 to \$7,000,000 on \$500,000,000 assets, against a forecast of earnings for the Reserve Association of \$14,000,000 on \$1,850,000,000 of assets.

¶ No more difficult problem could have been presented to the Monetary Commission than that of devising a suitable check, by means of taxation, upon expansion of the note and other liabilities of the Association. The banking business of this country has about doubled in the last decade, and an arbitrary tax, based upon a fixed excess of circulation, would be almost certain in time to cause distress and embarrassment, if, as seems probable, our growing commerce results in a continued growth in our banking requirements. It has, in fact, been calculated that had a tax upon the basis proposed in the first plan submitted by Senator Aldrich been applied to our bank note circulation about seven years ago, a portion of the normal note issues in circulation to-day would be paying a tax of 6%. There are three taxes proposed by the plan: The first is based upon percentages of deficiency in the amount of the Association's reserves. For each 2½% that the reserve falls below 50% of net demand liabilities, a tax at the rate of 1½% per annum is to be paid to the government upon the amount of such deficiency. Further consideration may develop necessity for increasing the amount of such tax, or possibly starting the tax at a smaller rate and increasing it as the amount of deficiency increases. While there is no precedent in Europe for the imposition of a tax based upon the *percentage* of reserves held, the plan is so simple and appears to be so scientific in its effect that it should meet with approval. It must be borne in mind that emergency measures are generally applied to bank crises after the worst injury has been done. This was true in the three instances when the Bank Act was suspended in England. The suggested form of taxation should enable this country to meet a crisis without the necessity of an emergency measure, as Germany has done recently through the power vested in the Imperial Bank to expand its circulation. To meet the demand upon it the Imperial Bank has issued 500,000,000 Marks in excess notes upon which it has had to pay a tax of 5%, but by doing so in the ordinary course of business a crisis never developed. When the pressure was over the excess issue immediately began to be reduced; and the same phenomena should occur under the Association plan, provided the amount of the tax is reflected in a higher bank rate.

¶ The second tax provided in the plan is applied directly upon such amount of circulation in excess of $900,000,000, as is not covered by 100% lawful money, until the circulation reaches $1,200,000,000, after which the tax is 5%. This is possibly a wise limitation, necessitated by inability at this time to forecast conditions which may arise in future years. It may, however, prove to be burdensome. There is certainly difference of opinion among bankers in this country as to the wisdom of an absolute limitation upon circulation either by fixing the maximum amount permitted, or by applying a tax upon a circulation in excess of a fixed amount. This tax, however, does not interfere with the further extension of note issues, if fully covered by gold, and the Association would still be able to receive gold and issue its notes against it to an unlimited amount.

¶ The provisions of law as to the taxation of unusual note issues by the principal banks of Europe are briefly as follows:

¶ The Bank of England has a fiduciary circulation limited to the exact amount of 18,450,000 Pounds. Beyond that, notes must be covered in full by gold or silver coin or bullion. Three times since 1844 the Bank Act has been suspended, although it was only necessary in one instance to issue additional fiduciary notes. The tax imposed by the government has simply been the amount of net profits realized upon such issues. The Bank of France is limited to a maximum note issue of 5,800,000,000 Francs. It may not exceed this amount even with 100% cover in gold, and there is no provision for an emergency circulation subject to an emergency tax. The Imperial Bank of Germany may issue its notes to an unlimited amount, free of tax, if fully covered by bullion, coin or lawful money. It may also issue, free of tax, up to an amount of M.750,000,000 in excess of the bullion, gold coin and lawful money held by it, or an unlimited further amount subject to a governmental tax of 5%, provided such excess is covered by government securities and short notes and bills, but at no time may the total note issues of the Bank exceed three times the amount of lawful money held.

¶ The first two plans of taxation should, as designed, provide an effective check upon expansion by causing a higher rate and its resultant curtailment of loans. Actual contraction of liabilities should soon follow, as the paper carried by the Association would not be subject to renewal. As soon, therefore, as the decrease in new loans exceeded the amount of maturing bills, a contraction in liabilities would commence.

¶ The third tax provided by the Monetary Plan consists of a "franchise" tax of 1½ per cent. annually upon an amount equal to the par value of the 2 per cent. government bonds transferred to the Reserve Association by the subscribing banks. The government is asked to increase the rate on its 2 per cent. bonds to 3 per cent., thus giving the Association an investment of a market value about equal to the price at which it takes the bonds over. At the present time the government pays 2 per cent. interest on its bonds and receives from the banks one-half of one per cent. upon the amount of their circulation. Approximately the same result is realized to the government by this plan. Were it not for such an adjustment the bonds taken over by the Reserve Association would have a market value upon an investment basis estimated at 70 per cent. of their par value. The shrinkage in the value of this asset would be possibly $200,000,000, or nearly double the assumed paid-in capital of the Association. This tax, of course, has no relation to the reserves of the Association, and its effect is simply to reduce a large part of the government debt to an annual net interest charge of 1½ per cent.

¶ Of more importance to the country as a whole will be the relations of the Reserve Association to the money markets, and the effect of its operations upon interest rates. The magnitude of the plan will be realized when we consider the possible loan contraction resulting from the payment of $100,000,000 lawful money to the Reserve Association for its paid-in capital. For instance, if every subscribing bank were loaned up to its limit, figured upon the 14 per cent. average of lawful money reserves now held throughout the whole country, this would theoretically call for a contraction of about $700,000,000 in loans unless offset by other provisions of the plan, or by the operations of the Reserve Association itself. As partly offsetting the effect of such payment, there will doubtless be released a considerable amount of lawful money now held as reserve for savings and time deposits, upon all of which reduced reserves are permitted by the revised plan. Any further net contraction caused by payments for the Reserve Association's capital stock would probably be offset by the discounts of the Association soon after its organization, and no disturbance of rates should result.

¶ The plan provides that "The rates of discount which the National Reserve Association shall have authority to fix from time to time shall be published, when fixed, and shall be uniform throughout the United States." It further provides that the Association shall have power to "contract for loans of gold, coin or bullion," also that the Reserve Association shall have power to purchase from its subscribers, and to sell with or without its endorsement checks or bills of exchange, payable in foreign countries. These are powers, in the exercise of which the Reserve Association may, in time, be expected to exert an important influence upon interest rates. A uniformly low rate of interest cannot be expected in this country for a long time to come, but greater stability in interest rates, particularly in our money centers, might result as soon as the Reserve Association becomes active. This would enable those engaged in commerce to anticipate, with greater certainty, the cost of their credit requirements and should make normal business safer to carry on. French economists, commenting upon the unique record of the Bank of France, contend that the welfare of the commerce of France has been conserved and protected by the maintenance of a low and uniform rate of interest.

¶ To the forces already mentioned, which would tend toward more stable interest rates, must be added the wonderful power of expansion that the Reserve Association would possess.

¶ In the second statement of condition given it is assumed that the Reserve Association before making any discounts or investments might have total deposit liabilities of $1,425,000,000, upon which a 50 per cent. reserve, after deducting one-half of the government bond holdings, would be $537,500,000. The lawful money held was $850,000,000, or $312,500,000 in excess of 50 per cent. of its net liabilities. Were the Association to extend credits, thus expanding its deposit and note liabilities to the maximum amount possible without incurring liability for tax upon either of the two plans provided, it could at once add $200,000,000 to its circulating note issue, thereby reducing its surplus reserves $100,000,000. The balance, $212,500,000, might still serve as 100 per cent. cover for a like amount.

¶ The extent to which this vast credit would be employed would depend entirely upon the developing needs of the country as expressed in the discount rate, for, as already stated, there would be no temptation to the management to expand its liabilities for profit, and it would consequently be used only as a governor to interest charges.

¶ Under our present system (comprised of 26,000 individual units without cohesion) there is a greater divergence of interest rates in various sections of the country than can be accounted for by the difference in strictly local conditions. Credit operations between the banks are now effected through individual alliances and relationships, instead of through a broad market for commercial paper and bank acceptances. This partly accounts for the high rates that have ruled in certain sections of the country remote from financial centers, for our system is so rigid and the provisions of our present banking law so inadequate that it is now repugnant to the country banker to show an account of borrowed money in his statement. The Association plan, carrying with it a system of bank acceptances and encouraging the rediscounting of certain classes of paper will cure such objections to the employment of the credit of country banks for the purpose of making provision for the needs of their customers. The introduction of a system by which bank acceptances and short time commercial paper may be freely moved from one part of the country to another should, in time, exert an influence upon money rates largely favorable to interior institutions.

¶ The influence of bank officers will probably be exerted toward the creation and accumulation of a larger volume of short time mercantile paper, which will be susceptible of discount among banks and rediscount with the Reserve Association. Such paper will pass from the country bank to the reserve bank, and will be considered by the latter its choicest asset by reason of its convertibility through the Reserve Association. This class of paper will then become the secondary reserve of the banks of the country in place of demand Stock Exchange loans which largely constitute such reserve to-day. These loans are made with the expectation that in the early Fall they will be largely recalled, and the proceeds used for crop movement in the West and South. The same inducements which have made such loans desirable, namely, realization of interest and availability, will prevail to as great and probably a greater extent in the case of bank acceptances and short time commercial paper with the Reserve Association in operation, and it is only natural to suppose that the result will be the gradual accumulation of bills of short maturity in place of Stock Exchange loans and the building up of a new form of secondary reserve. It may be found that these changes take place slowly, and that while the Discount Account of the Reserve Association will gradually increase, yet its principal primary transactions will be the accumulation of foreign exchange. Its position, with reference to the importation of gold, as its business develops, will necessarily require the accumulation of such exchange, and its hold upon the discount market will be influenced more or less by the strength of its foreign relations. It would seem natural to expect the bank rate of the Association to follow, to a certain extent, the same position relative to open market rates in this country (open market rate would be the discount rate for commercial paper and bank acceptances) that has prevailed in France and England between bank and open market rates. It has been found in both of these countries that the rate of discount in the open market has generally been lower than the official rate of the bank. However, when it has been necessary for the Bank of England to check withdrawals of gold or to attract gold to the bank, it has assumed control of the open market rate for such time as conditions required, and it can safely be assumed that the Reserve Association, with its vast resources could, upon occasion, wield the same power over our open market and make its rate effective.

¶ The necessity for such control will be particularly felt in New York where the adjustment of our foreign exchanges and the settlement of balances in gold are principally effected.

¶ It is plain to be seen, without further discussion, that the provisions of the Association as to taxes, earnings, dividends and the probable effect of the proposed organization upon interest rates in this country are not only of the utmost importance, but that they have been given due consideration by those who prepared the plan and that they are aimed to encourage and conserve the business interests of the people of the United States.

¶ Gentlemen, this Reserve Association is a magnificent conception. If Congress permits its organization in its present form, its destiny will be in your hands, for you will own and manage it. When that time comes the highest prize to be gained by the American business man will be the privilege of participating in the management of the National Reserve Association of the United States.