Speech of B. S. Strong - Jr
Atlantic City - 6/14

President Haines: We will now proceed with the program as arranged, and the next is an address on "The Federal Reserve System," by Mr. Benjamin Strong, Jr., Governor of the Federal Reserve Bank of New York.

THE FEDERAL RESERVE SYSTEM.

Mr. Benjamin Strong, Jr., Governor of the Federal Reserve Bank of New York.

Mr. President and Gentlemen: I am sure that Congressman Fowler will not object to my calling your attention to an error in the printing of the program. It seems that I am called upon to address you in regard to some features of an economic monstrosity. (Laughter.)

Now, unfortunately the gentlemen who were charged with the duty of engaging officers for the Reserve Bank failed to take into consideration that certain qualifications not usually required for bankers apparently were required for these positions. They should have selected men with some talent for speechmaking. Our duties at the office in New York have been rather arduous, and rather than devote considerable time to careful preparation of addresses in regard to the Reserve Bank, we have thought best to ask the bankers who are good enough to invite us to address them to let us make very informal talks in regard to the work that is being done, and I will therefore ask your indulgence if the matters that I want to talk about this afternoon are very informally dealt with. Congressman Fowler, I am sure, will not object to my referring to one or two words only of his remarks. Discussion of banking legislation in this country, as I recall, has been pretty active for the last eight or ten years. If we are to have the real discussion that Congressman Fowler suggests, I am afraid we will now have no time for anything but banking discussion, judging, at least, by the activity that has prevailed since 1907 in efforts to get better banking law. He refers to a remark, possibly unfortunate, that this new law is 70 per cent. good. My memory of one such remark was that it was 80 per cent. good. And Congressman Fowler considers it 170 per cent. bad. I think he is mistaken.

These last seven years of discussion, in which Congressman Fowler himself participated very actively and himself contributed toward a better understanding of the problem, if it did nothing else, convinced the people of this country that our problem was a very different one from any that existed in Europe. We have in the United States over 25,000 banking institutions. The are scattered over an area equal to pretty much all of Europe. Conditions are different in the different parts of the country and at least two-thirds or three-fourths of those institutions are governed by the laws of forty-eight different States. I think at least we owe a great deal of thanks to those men who devoted themselves, with tangible results, not reduced to percentages, however,

to bringing about the law that has been passed. In fact, except some divine inspiration had operated in the preparation of this law, I do not believe the American people could expect one that was 100 per cent. perfect.

Now, my own view of the law has somewhat changed since taking a position in this system. Before the law was passed, with many other bankers who I think were devoting themselves to serious thought on this subject, I felt that one bank was what this country wanted, as Congressman Fowler has suggested. We have twelve banks. With these we can well be satisfied. Our problem just now is to assist in the development of the system that we have, so that it will serve your needs, and some of the work along that line I would like to talk about.

I must not, however, pass the opportunity to express the satisfaction that some of us feel at the apparent success of the major surgical operation that was just referred to. Those 131 banks of northern New Jersey that are shortly to become members of the Second District will receive a very warm welcome. (Applause.)

You will recall that shortly after the banks were organized, a circular, No. 13, was issued by the Federal Reserve Board in regard to commercial paper. That circular was later withdrawn and a new circular, No. 4, was issued in its place, the effect of which was to leave it very much to the discretion of the member banks and the discretion of the officers of the Reserve Bank as to what paper was eligible for rediscount by the member bank. Since that time there has been issued a new circular and regulation which is to take effect on July 15th. So many inquiries are being made as to the exact procedure under that circular and just what will be required after July 15 that we have had in course of preparation a statement or letter which will express as briefly as seems possible the views that are entertained by the officers of our bank on this matter so that the member banks can readily observe its provisions. I would like to read some portions of this circular, which may, however, be changed at a later date.

Circular No. 3, the one which takes effect July 15th, defines eligible paper and provides that member banks will be expected to keep credit files showing the condition of their larger borrowers in order to certify the eligibility of paper offered for rediscount after July 15, 1915. Until July 15th, Circular No. 4 shows how such eligibility shall be certified, but thereafter Circular No. 4 will no longer apply. The judgment to be exercised, in other words, will be controlled by Circular No. 3, and I would like to call your attention to the fact that that circular distinguishes between paper taken by members banks from their customers and paper which they purchase from brokers or through their bank correspondents.

As to all purchased paper, the Board has seen fit to require that each member bank shall be able to certify to its reserve bank that it has a signed statement or a copy of a signed statement of the borrower. As to the paper which they take from their customers, no such certificate is required in the case of a note of any one customer or the obligation of any one customer which does not exceed five thousand dollars in amount or does not exceed 10 per cent. of the capital stock of the member bank. That is to say, a bank of twenty-five thousand dollars capital can apply for a rediscount of notes of any one of its borrowers not exceeding twenty-five hundred dollars in amount without making a certificate or stating that they have in their files a statement of the borrower's financial condition. For larger amounts credit bills will be required.

The Federal Reserve Banks must be prepared to make their resources available when needed, to the commerce, industry and agriculture of the country, to facilitate production, manufacture or distribution. That is the language that is employed in the regulation itself. Their resources must, however, be kept liquid. Therefore, except for a limited amount of agricultural paper, all notes rediscounted must mature within ninety days and must be taken up by the banks which indorse them, whether they are paid by the makers or not. But the act and the regulation require that the original borrower's financial condition shall also reasonably evidence his ability to meet his current liabilities promptly. Stated negatively, this means

that a Federal Reserve Bank may not discount a member bank's paper which represents or is based on lands, buildings, machinery or other fixed or permanent assets or on investment securities or on goods carried merely for speculative purposes. Such paper does not contain the element of self-liquidation, as it does not represent goods in any of the stages of production, manufacture and distribution. The paper which in form evidences most satisfactorily that it is self-liquidating is a note, bill or accepted draft, representing the obligation of the purchaser to the seller for goods sold.

Let me say that there seems to be a good deal of misunderstanding as to what might be called trade paper. Too many of the member banks are under the impression that they must in applying for discounts submit only paper on which there are two obligations to pay, a maker and an endorser. That is not a fact. The test of the eligibility of a note, which I will refer to later, is not of that character.

This paper represents, in fact, an actual commercial transaction, and its payment is directly related to the sale of the goods. But the development in this country of the open credit granted by merchants and manufacturers, and of the system of cash discounts, offering advantages to purchasers with ample capital, has reduced the volume of self-liquidating paper and substituted for it the promissory note on which working capital is obtained in order to carry indebtedness due by customers on open accounts, as well as for the purchase of material. The provisions of the act and the regulation contemplate the rediscount of the latter class of paper at Federal Reserve Banks and it has so far constituted the vast majority in volume of the paper which our bank has thus far discounted.

In the case of the ordinary promissory note with or without endorsements, how shall the member bank determine whether it is eligible for rediscount with its Federal Reserve Bank? This is most difficult in the case of notes discounted by individuals. In such cases it would be advantageous to ascertain first the business of the discounter. If he is engaged in commerce, industry or agriculture, it may be eligible. If he is not so engaged, it is not eligible unless he uses the proceeds of the note for commercial, industrial or agricultural purposes. Smith may be a practicing lawyer or physician, but he may also own a farm and his notes may be issued to purchase feed, fertilizer or stock, or pay wages or other regular costs of operating a farm, just as in the case of any farmer. Likewise Smith may also have an interest in the local newspaper or other industry. A note issued by Smith for money to advance to the newspaper would be eligible for rediscount, provided it was not to go into fixed assets, such as land, buildings or machinery.

But if Smith should offer a note issued by the person, firm or corporation running the newspaper or other concern, it would be evidence on its face that it had been used for industrial or commercial purposes. In this case eligibility would be determined by examining the statement of the concern to see if it has a reasonable excess of quick assets over current liabilities. But if Smith, a lawyer or physician, merely borrows for household expenses or for any purpose not commercial, industrial or agricultural, his note is not eligible.

Accommodation makers or endorsers do not affect the eligibility of the note. The eligibility depends primarily upon the purpose for which its proceeds are used.

In the case of notes discounted by firms or corporations, if such firms or corporations are engaged in commerce, industry or agriculture, their notes are eligible, provided they show by statement or otherwise that they have a reasonable excess of quick assets over current liabilities.

It is quite apparent that if a large borrower in making a statement shows that his short borrowings, current liabilities, current indebtedness, are in excess of his quickly available assets, some part of his borrowings must have gone into plant or machinery or fixed assets. And that, in fact, is the principal test of the eligibility of paper, based, as I have stated, upon the character of the statement that the borrower makes.

In the case of purchased paper, eligibility will be determined by the statement of the person, firm or corporation on the strength of whose credit the paper is bought. If a reasonable excess of quick assets over current liabilities is shown, the paper is eligible.

In the case of paper discounted by farmers, unless the farmer makes a statement (in which case the same test of quick assets over liabilities will apply), and if the proceeds are to be used for seed, fertilizer, feed, stock or current operating expenses, it is eligible, but it is not eligible if they are to be used for lands, buildings or machinery of a permanent nature.

Eligibility and credit, of course, are not to be confused. All notes discounted by member banks are presumably good; some are eligible and some are not, according to the purpose for which their proceeds are to be used.

A renewal is an indication that the debt is not self-liquidating. But the regulation makes the statement of the concern the test of eligibility. Whenever the statement shows a reasonable excess of quick assets over current liabilities, a note, even if renewed, may be considered eligible. What is a reasonable excess varies with different industries. Packers maintain high credit if they have say $1.50 of quick assets for $1 of current liabilities. A manufacturer of jewelry possibly might make a statement showing a large stock of gold where the margin of quick assets would be very small and yet the statement be a perfect test of the eligibility of his borrowings. The more special the line the higher the ratio expected, unless there is a sufficiently strong endorser to permit the ratio to be reduced. But the excess should always be reasonable considering all the circumstances in the case.

Many member banks in our district carry bonds on which, as occasion required, they have been accustomed to borrow from their reserve agents. The law does not permit member banks to borrow from the reserve banks on the se of bonds; conversely, it is no longer a necessary for member banks to carry bonds simply for the purpose of occasional borrowing, because the law permits the rediscount of their commercial paper when they are in need of funds.

In examining the statements furnished us in New York by the member banks of our district I think there were something like seventy-five or eighty banks that reported that they had little or no paper that was eligible to rediscount. We wrote each of those banks a letter asking them to either send an officer of the bank to see us or to write us and give a description of the character of the paper which they had in their portfolios. We found on examination and in conversation with the officers that we saw, that hardly any of those that replied had less than 50 per cent. of eligible paper in their portfolios; but their reports were based upon a conception of what the regulation meant that was not accurate.

Many banks have been accustomed to borrow on demand. The law does not permit the use of commercial paper as security to demand loans, but banks desiring short loans may select from their portfolio paper having about the required time to run.

The Federal Reserve Bank of New York has as members several of the largest as well as many of the smallest national banks of the country. Its facilities are open on equal terms to all and it is prepared to discount small as well as large notes. You may be interested in a few figures as to exactly what discounting we have done.

Thirty-three banks have applied for rediscount of paper, the total amount aggregating $8,061,919.93. Only four of those banks were located in New York City; the other twenty-nine outside of the City of New York. The largest amount rediscounted on a single application has been $2,182,500 and the smallest $1,700. The largest single note rediscounted has been $300,000 and the smallest $25.40. (Laughter.) Most of our applications come from member banks up the State and largely in farming communities. I can say that the paper that is offered for rediscount, which is manifestly paper made by farmers, and very largely issued to buy fertilizer, stock, to some extent feed and other supplies in the spring season, has almost without exception been discounted, and much of it was single name paper. It becomes double name paper, of course, in our hands, with the endorsement of the member bank.

Applications for rediscount are almost invariably acted upon when accepted, and the proceeds credited on the day of receipt. There again is a delusion that in some way or other there is a great deal of red tape to uncut in connection with the operation of discounting paper at the Reserve banks. It is quite simple. A number of banks have admitted to me that they sent in some notes for discount just to see how it worked, and they did not really want the money. (Laughter.)

It is our practice to return paper for collection to the bank which rediscounted it about five or ten days before its

maturity. We charge it to the bank's account on our books the day it matures. It is not our practice to permit a member bank to take up paper before the date of maturity except in special cases where the maker of the note has been permitted by the member bank to anticipate his note. In such cases we have generally allowed a rebate of interest at one per cent. below the current rate for such maturity at the date the note is taken up. Member banks offering notes for rediscount should examine them carefully to see that they are in good order. One of the most difficult matters to deal with in the bank has been the large around of paper that appears with various technical irregularities. Too many of them altogether indicate that carelessness prevails in observing prudent rules as to the way notes are drawn, dated and filled in. And such little irritation as has developed from those discounting transactions that we have had with the member banks has been almost entirely due to the existence of this carelessness in the way paper is permitted to be drawn by the customers of the member bank.

Due to what I personally regard as an unfortunate provision of the act it is also necessary to require a special endorsement on the paper discounted, which includes a waiver of demand, notice and protest. I may say that the Governors of the twelve Reserve Banks have already recommended that that provision be eliminated from the statute if possible, but the practice now followed, of sending notes well in advance of maturity to the member bank for collection, will dispel any doubt as to whether endorsers will be held by presentation and demand at the proper time.

Now I would like to say a few words generally about the attitude of the member banks towards the Federal Reserve system. There is some danger that the work of organizing and developing the banks will be retarded by two classes of bankers; on the one hand those that are liable to make extravagant claims for what the banks can do and express possibly oversanguine expectations, and on the other hand, those who are prone to express unfounded fears and criticisms. It takes time to do the work that is now being undertaken by the Federal Reserve Board and by the officers of these banks, and according to my view the development of the system will not be as successful as it should be if unwarranted expectations of immediate completion of the work are developed or an attempt is made to progress too rapidly without due regard to the real interests of the member banks, both those who are present members and those state institutions which are in fact potential members of the future.

There is also some danger in the development of unenlightened and uninformed criticism. I do not want to go into that particularly just now. You have all heard it. I would like to feel that those who are affected by the development of these banks are at least patient enough and loyal enough to give those men who are doing the work an opportunity to demonstrate by experience with the system what it can do rather than condemn it before any experience at all can be had with it. (Applause.)

Another feature of the attitude of the member banks that personally I deplore —it is a natural one, possibly—is a tendency to regard the Federal Reserve banks as departments of the government. I am sure you will not consider that I am dealing with this matter in a trifling way when I say that some of the bankers who have called at our office have evidenced considerable uneasiness when they came in to talk to Mr. Jay or myself, such, for instance, as they might display in calling upon some high officer of the government. Now that is all wrong. Member bankers must bear in mind that they own these banks. Every dollar of their assets belongs to the member banks. Two-thirds of the directors they have elected themselves; and the officers of the banks are appointed by those directors; and speaking for our bank I have no hesitation in saying that if that bank is not properly managed it is largely the fault

of the member banks of that district for not electing proper directors or seeing that proper officers were elected. The disposition to regard the banks as a department of the government is, however, fairly natural owing to a feature of the Federal Reserve Act that is quite unique in legislation in this country. Banking legislation in this country, as Congressman Fowler suggested, has been discussed and passed somewhat upon the theory that the banks needed regulating, just as the railroads needed regulating. In the case of the railroads, statutes and regulations were passed and adopted and a special body was created by Congress to administer this law. Unfortunately the American people are altogether too prone to point out evils existing in our economic life, cry for the passage of some law, rejoice over its enactment, and then subside into a happy lethargy, thinking that the passage of the law has accomplished everything, that it will work some revolution. As a matter of fact the accomplishment of the purpose of such legislation depends upon its administration and in the case of the Federal Reserve Act quite a new plan of administration has been introduced. The government has in fact loaned its credit in a very important way to these banks. They are the instruments through which notes bearing the obligation of the government are to be issued. The security for those notes remains in the office of the bank by which they are issued. The government has therefore placed three directors in the board of the bank and appointed two of those directors officers of the bank to make them in fact not only partners in the management of the reserve bank but to recognize the responsibility resting upon the government for its management.

Directing and supervising the management of the Reserve banks is a Government-appointed Board, with broad and necessary powers by which the system may be co-ordinated and safeguarded.

Just the experience of the last six months has indicated many of the advantages of that arrangement. In the case of the regulation of the railroads it is common knowledge to everybody that for many years past there has been a species of antagonism, you may call it, at any rate a distinct line of cleavage, between the body that is administering the Interstate Commerce law and the railroads that are affected by it. Now that line of cleavage has resulted in much of the constructive progress being wrung from one or the other body as the result of bitter litigation carried to the court of last resort.

Apparently in the reserve banks quite a different condition exists. Instead of developing a distinct line of cleavage between the regulating body and the banks these government directors and elected directors meet weekly or monthly in the banks, and the contact there resulting becomes rather a point of fusion. I can see many cases where difficulties that might develop at those points of contact are very easily dealt with, and I feel especially hopeful of the success of that feature of the Federal Reserve system.

I would like also to refer to one rather important matter that is peculiar to the present time. It is undoubtedly a fact that some bankers in this country feel that the expiration of the Aldrich-Vreeland law, its operation expiring by limitation on June 30th, possibly weakens our situation. They look back with satisfaction at what was accomplished in August, September and October of last year in that great crisis by the ability of the banks to promptly furnish currency through the operation of that law, in fact, to convert their assets into a circulating medium. Some inquiry has been made as to how well prepared the Reserve Banks might be in case some emergency arose that required a similar treatment of the situation. I would like to read some figures to indicate in a measure what has been and what I think can be confidently counted upon to take place if any such occurrence did develop.

In 1907 the reports made by the national banks to the Comptroller of the Currency as of August 22nd showed that the national banks of the three central reserve cities held $14,000,000 of excess cash reserve in their vaults and that all the other national banks in the United States held $77,000,000 excess cash reserve. No call was made until after the worst effects of the panic of the fall of 1907 had passed; that is, until December 3rd. The call of December 3rd showed that the national banks in the three central reserve cities were deficient $32,000,000 in cash reserve, and that all the other national banks of the United States held an excess cash reserve of $123,000,000. Now the effect upon our banking system of this sudden withdrawal or shifting of bank reserve, in addition to the withdrawal of money which was undoubtedly hoarded at that time, can hardly be estimated.

I would like to contrast those figures with the reserve situation of last summer and fall. The call of June 30, 1914, showed that the national banks of the three central reserve cities were deficient $6,000,000 in their cash reserve and that all the other banks of the country had excess cash reserves of $56,000,000. The call of September 12th, 1914, disclosed that the cash reserves of national banks in the central reserve cities were $45,000,000 deficient, and all the other national banks of the country were $60,000,000 excessive. Contrast these figures with 1907. It means that in 1907 the country national banks and the national banks in the reserve cities accumulated about $50,000,000 of reserve money that they did not need, and last fall, in the face of a possible calamity far worse, from our point of view, for the gold reserves of Europe were closed to us, the country banks actually accumulated only $4,000,000 of additional excess reserve. Undoubtedly that was largely due to the influence of the existence of the Aldrich-Vreeland Act and to its prompt operation. Now what can the Reserve banks do after the expiration of the Aldrich-Vreeland Act?

In the first place the Aldrich-Vreeland associations were admittedly barely organized last fall. They had a paper organization only. They had no clerks, they had no offices, they had no machinery, they had no credit information except what could be gathered from the banks that participated in the management of the affair. These twelve Reserve banks have complete organizations, they have credit information; they have stored in Washington already $300,000,000 of notes, and on July 1st they will have $500,000,000, and the supply will be kept at about $500,000,000 or over. And I think sight has been lost of the fact that these Reserve banks have over $250,000,000 of untouched cash assets. Sometimes it is a little difficult to be patient with criticism that compares the facilities that existed last August, say, with those that exist today with these twelve banks in full operation.

Now just one word in conclusion of a more personal character. The men who are managing these twelve banks—and I am now well acquainted with nearly all of them—believe that they are performing a public duty. It may be that they are mistaken in that idea, but I do not think so. And they feel that they are entitled to have the support of the banks for whom they are really working; and that support today will be best evidenced by patience in waiting for results. It may also be expressed by a statement of my personal views as to what should be done in regard to facilities for the admission of State banks to membership. No reform of our banking methods in this country will be complete and satisfactory to the country until it includes all banks, at least all banks that do commercial banking in one comprehensive system. I firmly believe that if a regulation can be issued which will appeal to the State bankers of the country as fair, not as evidencing an intention to buy their allegiance, and, on the other hand, not evidencing an intention to bar their admission, that we can then afford to let them work out that particular feature of the problem themselves. Our duty will be to make the system attractive to them and wait for them to come in if they want to.

Gentlemen, I am sorry to have taken so much of your time. You have listened very patiently. Permit me to thank the bankers of this State for extending to us an invitation to address them on this very important matter.

The Chair desires to announce the names of the members of the Nominating Committee—Charles H. Laird, Jr., J. W. Lushear and Wessels Van Blarcom.

And the Resolutions Committee—W. H. Taylor, F. A. Phillips and F. M. Riley.

We will proceed with the program with an address on "Bank Publicity," by Fred W. Ellsworth, of the Guaranty Trust Company of New York.