

Speech of Benj. Strong  
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You will recall the case of the man who stated in his will, that he had led a very unhappy life, worrying about things, 90% of which, however, never happened. This statement, unfortunately, would equally apply to the attitude of many bankers toward the Federal Reserve System. It is, also, true that these same bankers have in the past had many unhappy moments worrying about things which frequently did happen, but which are not now likely to happen again. Frank discussion of these matters with the member bankers would dispel some of the misconceptions of the effect of this legislation and make clearer some of the advantages which may not yet have become distinctly apparent.

It has frequently been stated to me that the Federal Reserve banks will not earn their expenses, much less their dividends, and that the member banks, either directly or indirectly, must stand some loss. This surmise is unfounded. The Federal Reserve Bank of New York in the past six months, has earned all of its current expenses and a considerable sum to be applied towards liquidating the expenses of organization, and while it may take some months to extinguish the latter item, it would, if that were necessary, be quite proper to apportion it over a period of years, as the greater part of the organization expense consisted of the cost of preparing an initial supply, and a very large one, of Federal Reserve notes. The Federal Reserve Bank of New York has total resources of \$140,000,000. With but 10% of these resources invested and loaned at the present very low rates of interest, the bank is to-day making earnings at the rate of about \$200,000. a year, after paying its running expenses. If from 20% to 25% of its resources were invested at present rates, it

would earn its expenses and dividends and have something in excess to add to surplus, and its reserves would still exceed 75% of its liabilities.

It has not, however, been the policy of the bank to force its funds into use at a time when huge excess reserves are held by the banks throughout the country. Had the Reserve banks been in operation a few years, and accumulated a considerable loan and investment account, their policy under present conditions should be to withdraw funds from the money market for the purpose of correcting undue ease of money rates, which is only too frequently accompanied by unsound expansion and speculation. In fact, the policy of the reserve banks in using their funds, should be influenced by the desire to stabilize rates, rather than to employ their funds at any rate obtainable, for the sole purpose of earning dividends, without regard to the effect of such a policy.

The statement has also been made by some bankers of our district that very little, if any, of the paper held by their banks is eligible for rediscount with the Federal Reserve Bank. Those bankers who make this statement are liable to create the impression that this opinion is held generally by member banks; but an examination of statements filed with us disclosed that only about 80 banks, out of 480 members, reported that they had very little, if any, paper eligible for rediscount. With these, we have communicated, in order to ascertain upon what theory their reports were based. By correspondence and personal interview with many of them, we have satisfied them, as well as ourselves, that one-half or more of the paper they hold is eligible for rediscount.

The reports, also, disclosed that the banks outside of the City of New York, which carry about \$10,000,000. of reserve deposits in our bank, claim to hold no less than \$79,000,000. of eligible paper, and the banks of New York City which have on deposit with us \$120,000,000. report \$248,000,000. of eligible paper.

Up to the present time, and until July 15th, considerable latitude has been allowed as to the method by which the eligibility of notes offered for rediscount, shall be determined. The judgment of the officers of the member banks and of the Reserve bank has been exercised broadly, and I may say, without undue regard to technicalities, few notes have been rejected on account of failure of eligibility; some having been returned owing to carelessness in drawing or indorsing; and it has been our practice - which we shall continue - to act upon the application on the day of receipt, and advise credit if so requested by telegraph. There is, in fact, no red tape to be untied, nor is there any disposition to use it. On July 15th next, however, Regulation B becomes effective, and to the terms of that regulation your attention should be particularly directed. After July 15th, member banks will be expected to furnish more specific evidence of eligibility of notes when applying for rediscounts. As to smaller borrowers whose notes are offered for rediscount, considerable latitude will still be permitted in determining the question of eligibility; as to larger borrowers, the member banks are asked to adopt standards of credit information which will enable them to promptly determine for themselves the eligibility of the paper which they desire to rediscount. The regulation is based upon three important general rules:

First: That the member bank should have in its files an original

or certified copy of a signed statement disclosing the financial condition of the borrower in the case of all commercial paper purchased from brokers or through correspondents.

Second: That it should have similar statements on file as to the financial condition of customers whose notes are offered for rediscount for a total amount of \$5,000 or over, or for an amount exceeding 10% of the capital stock of the member bank making the application; that is to say, financial statements must be held as to all purchased paper, and as to paper made by the bank's customers where the amount of the customer's obligation rediscounted exceeds \$5,000 or 10% of the bank's capital. On the other hand, no such statement is required by this regulation as to customers whose paper is offered for rediscount in smaller amounts than those named, in order that they should be eligible.

Third: That the proceeds of the loan must have been used or be intended for use in some industrial, commercial or agricultural transaction, but not for the purchase of land, buildings or machinery, or other fixed or permanent assets or investments, or for the purchase of goods carried for speculative purposes. Most bank officers are sufficiently well-acquainted with those who borrow small amounts, to readily ascertain the purpose for which the loan was made. In the case of larger borrowers, this can be best determined by an examination of a statement of the borrower's financial condition. His statement should be made in such form as to disclose whether the amount of his current assets, that is to say, cash, bills and accounts receivable, stock of goods, or raw and partly manufactured material, is reasonably in excess of his current debts. Should the borrower's statement disclose that his short loans and bills and accounts payable, in other words, his current liabilities,

are greater in amount than his quickly convertible assets, it would necessarily indicate that some portion of the proceeds of his short loans has been invested in more permanent form in his business. Such a condition would, in most cases, render the credit doubtful unless strengthened by an indorsement. Notes made by borrowers of that character are therefore, not eligible for rediscount but if the loan is made to a good indorser and his statement conforms to the same test of eligibility that is required of a maker of an unindorsed note, it then becomes eligible for rediscount.

Firms and corporations engaged in mercantile or manufacturing business as a rule can make statements which can be readily analyzed to determine this question of eligibility. With an individual, and particularly the agricultural borrower, this seems more difficult. If the loan is made for a commercial purpose, or its proceeds are used in agriculture, its eligibility can usually be ascertained by inquiry of the borrower at the time the loan is made. Encouragement of the practice of requiring financial statements will in itself tend to establish higher standards of banking. Eligibility and goodness, however, should not be confused. It is assumed that every loan made by a member bank is good, but only those made for commercial purposes and having the self-liquidating characteristics referred to, are eligible. There will now be incentive for bank officers to use greater energy in obtaining definite knowledge of the financial condition of their customers in order that their banks may have considerable percentage of paper eligible for rediscount. Customers of a member bank will likewise be benefited by the additional assurance afforded to the bank that at times of seasonal demand

and in time of crisis, their bank has an assured means of converting a large percentage of its paper into credits for the benefit of its own customers. Officers of member banks have frequently stated that they felt obliged to keep a portion of their resources invested in bonds in order that they might have collateral readily available at any time for borrowing purposes. With standards of commercial borrowings so established that a large portion of the paper held by the banks is readily convertible at the Federal Reserve Banks, the necessity for carrying a bond account, simply for borrowing purposes, should no longer exist.

It must not be assumed that these changes can be brought about at once, nor would the development of the system be promoted by attempting to force new methods upon member banks, without allowing ample time for study and preparation. But the mere establishment of a standard for commercial paper which may be rediscounted, will gradually exert an influence towards the creation of that class of paper, that will be more effective in bringing about the desired result than will the establishment of restriction rules. Such paper will in time command better rates. The influence of discrimination will ultimately be irresistible. The experience of the past six months has given much evidence of the desire of member banks to gain a better understanding of what is required in order to make as large an amount of their assets as possible available for rediscount with the Federal Reserve Banks.

The Reserve banks are at present engaged in the establishment of a system for collecting checks, the details of which plan are so well known as to require no particular comment. Discussion of the plan, how-

ever, discloses two strong objections in the minds of the officers of member banks, - one being the possible loss of revenue from exchange charges now made by the country banks, and the other the possible loss of interest on balances at present carried with Reserve Agents, through whom collections are made, and which now count as reserves.

As to the first objection: Experience must demonstrate whether economies resulting from a more prompt and scientific system for collecting country checks, together with earnings growing out of the enjoyment of other advantages afforded by the Federal Reserve system, may not entirely make up the loss of exchange charges to the extent that such charges are reasonable and legitimate.

As to the second objection: Some of us feel that in many cases, the present system of check collection necessitates carrying larger compensating balances than should be required or will be necessary when the Federal Reserve collection system is in full operation. To the extent that balances maintained solely for collection purposes can be withdrawn and used locally, additional revenues will accrue to the member banks.

The statement is, also, frequently made that the member banks that join the system, are liable to suffer unexpected depletion of their reserve balances, and on that account, they will find it necessary to carry unaccustomed excess balances in order to anticipate such depletion. This, we hope, will not be the case. As stated in our circular to member banks and as indicated in a more recent circular letter, it is our intention to cooperate in every way possible with the banks for whom we are collecting checks, so as to enable them to maintain the reserve

required by law without unnecessary depletion or unnecessary excess. If a member bank finds, after experience, that the charges against its account exceed the amount of the offset which they are able to remit, it should be possible by arrangement with its Reserve Agent to make regular transfers for its credit by a simple transfer entry on the books of the reserve bank. On the other hand, the Federal reserve bank will enter into such arrangement as may be desired to make regular transfers from the accounts of member banks to the credit of the member banks' Reserve Agent, so that excess balances should not unduly accumulate. This plan should prevent unexpected impairment of reserves, as well as unnecessary loss of interest on balances.

It is also urged that, as a considerable percentage of the checks handled by country banks are drawn on state institutions, and cannot be collected through the Reserve Bank, country banks must continue existing collection arrangements, carrying collection accounts with their correspondents, and that after two years such balances will not count as reserve. On this account, the claim is made that reserve requirements are, in fact, increased by reason of the Act, rather than decreased and that further losses of interest will result from this cause. This conclusion anticipates a possible loss to arise a year or two hence. The balances will count as reserve wholly or in part for the next two years. It also assumes that no progress will be made in the next two years in finding a satisfactory method of dealing with the situation. It also assumes that state banks will not take membership in the Federal Reserve System, and such assumption is far from being justified. To the extent that the

member banks employ the facilities of the reserve bank for collecting checks on member banks, the necessity for carrying outside balances will be reduced, and to the extent that state banks take membership, the necessity for carrying outside balances will be further reduced. In order to minimize the necessity for carrying additional balances that two years hence will not count as reserve, member banks should employ the Reserve Bank collection facilities to the fullest extent possible, rather than to reduce the effectiveness of this collection facility by withholding their consent to the plan.

We also frequently hear the claim made by the country banker that he will be unable to conduct his business and make his collections economically on the 12% reserve now permitted by the law, and that he is, therefore, unable to take advantage of the reduced reserve requirements. This claim is based upon a lack of appreciation of the present flexibility of his position.

If 50% or more of the commercial paper in the portfolios of the member banks may be promptly converted into reserve balances by rediscounts with reserve banks, the country banker should certainly be able to take advantage of the reduced reserve requirements without undue apprehension as to his ability to meet unexpected demands by his customers. We appreciate very thoroughly that he is obliged to make every available dollar earn something. Appreciating, also, the fears that have been expressed as to the possible effect of the new system of check collection upon the earnings of member banks, we have arranged with competent experts to make careful examinations of typical banks in this district in

order to ascertain in what respect economies may be effected and earnings augmented as a result of the changes to be undertaken, and its results will be made known to the member banks.

The experience of the St. Louis district throws some light on this matter. The Federal Reserve Bank of that district undertook to clear checks for its 459 members some months ago. No assent was asked or obtained. The adoption of the general collection plan has recently afforded all the member banks of that district opportunity to withdraw if they so desired. I am advised that only 99 out of the 459 have withdrawn. Presumably, the other 360 are satisfied to continue the service. It will be a great aid to the officers of the bank, if the member banks will give patient consideration to the work now being done and give the new collection system a fair trial.

One other unfortunate aspect of the attitude of member banks toward the system should be referred to. They have not yet developed a proper sense of proprietorship and responsibility as to the reserve bank itself. They are too much disposed to regard it as a government office or department and overlook the fact that the bank was created by law for the purpose of performing a service to its stockholders and depositors and not to impose upon them expense and hardship. This cannot be too strongly emphasized. All the stock of the reserve banks is owned by member banks and all the deposits are the property of the member banks; two-thirds of the directors are elected by the member banks; the primary responsibility for the management of the reserve banks rests upon the member bankers themselves. It is their duty

and responsibility to see that competent directors are elected and that efficient and reliable officers are appointed. They should regard their ownership and interest as a privilege, and they should likewise feel free to suggest and criticize - certainly, to a greater extent than they would feel warranted in making suggestions and criticisms to their Reserve Agent.

The matters I have so far referred to are rather those which have been a cause of anxiety or criticism in the minds of bankers as to the future. Your attention should be directed to one important thing which has been a cause of anxiety in the past and which may now safely be forgotten. At no time since our Civil War and the financial disturbances which followed it, has the world faced so many uncertainties regarding future financial developments as at the present time. Uncertainty, doubt, timidity, under old American banking methods have frequently given rise to occurrences which have been a menace to our whole credit system and even to the solvency of some of our banks. The underlying cause has been doubt in the minds of the banker as to his ability on short notice to convert his assets, even the most available, into a circulating medium of undoubted goodness and acceptability to the people.

The occurrences of last Fall, when the fear of what might happen, gave rise to instant demand for currency, demonstrated that the ability to promptly satisfy that demand would promptly and effectively allay apprehension. The issue of \$388,000,000. of Aldrich-Vreeland currency served on the one hand to protect bank reserves, and on the other hand to meet the demands of depositors. The machinery then in existence for the issue of this currency was necessarily slow in starting

motion and not completely effective until **after** the lapse of some weeks. We have now in existence most complete machinery with which to meet any normal or exceptional demand for currency, and it can be put in motion without previous notice or preparation. The currency to be issued, that is, the Federal reserve notes, while at present largely secured by the deposit of gold, may be issued, if required, against deposit of commercial paper eligible for rediscount and indorsed by member banks, it will be additionally protected by large gold reserves and it is the direct obligation of the United States government. The Federal reserve banks to-day hold over \$250,000,000. of cash resources, principally gold, and there is no longer need for anxiety by the member bankers as to their ability to meet the requirements of their customers and depositors.

The last six months have been occupied by the members of the Federal Reserve Board and by the directors and officers of the reserve banks in painstaking efforts to gradually develop this great organization, so that it may demonstrate in actual operation what it was designed to accomplish..

The reserve system was created to perform a service and provide protection directly to the banks of this country and indirectly to the customers of the banks. However much was accomplished by the passage of the Act, it cannot serve its true purpose except by efficient administration; such an administration depends for its success upon the cooperation and loyalty of the banks on the one hand and intelligent work by the manager of the system on the other. Of one thing you may be assured: this statute is on the books to stay, in fact, the bankers

of the country would not themselves permit its repeal.