HOW STATE BANKS MAY BECOME MEMBERS OF THE FEDERAL RESERVE SYSTEM

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In discussing this question it is going to be my effort to be as practical as possible. Some banks have determined to join the System and wish to know the next step. Other banks are considering how they should go about determining whether or not they should join. It is my hope that this discussion will enable both classes of banks to clear up certain points about which they are in doubt. To begin with, a State bank to become a member of the Federal Reserve System should be something more than solvent, it should be in good condition. It stands to reason that the System will not take in some bank that weakens it. It would not be fair to those banks that are already members of the System. The System gives a great deal of strength to the bank that joins it and in turn does not expect to take in any bank that contributes an element of weakness rather than strength. A good bank, however small it is, contributes an element of strength to the Federal Reserve System.

Capital Necessary for Membership.

In addition to being a good bank, a State bank must have sufficient capital to enable it to join. That is, if it is located in a city or town not exceeding 3,000 inhabitants it must have a capital of $25,000. If in a city or town exceeding 3,000 but not exceeding 6,000, it must have a capital of $50,000. If in a city or town exceeding

6,000 but not exceeding 50,000 inhabitants it must have a capital of $100,000 and if in a city exceeding 50,000 inhabitants, $200,000.

Perhaps the most helpful way to treat this subject is to consider a hypothetical case, using the smallest capital which makes a State bank eligible for membership, that is, a bank with $25,000 capital.

Let us say that this bank has a surplus equal to 20 per cent of its capital, or $5,000. A good bank will want at least this much surplus, and if a bank having a less surplus should make application, while this would not be something to criticise, one of the conditions of membership would be that the bank shall, twice each year, carry to surplus account one-tenth part of its net profits for the preceding half year until its surplus fund shall amount to twenty per cent of its capital stock.

The capital and surplus of an applying bank is the basis for its subscription to stock of the Federal Reserve Bank. Therefore, our bank would subscribe for 6 per cent of $30,000, or 18 shares of stock of the par value of $100 each, but would pay in only one-half of this amount, or $900, the remaining $900 being subject to call. On this $900 paid in, the bank would receive a 6 per cent dividend annually. It is certain of this much return on the money, for the dividend is cumulative.

Reserves.

Let us suppose now that our bank has total deposits of $300,000, of which $200,000 are demand deposits and $100,000 time deposits. It is necessary that a reserve be kept against these deposits. Under the Arkansas law, if not a member of the Federal Reserve System, it must keep a reserve against all of its deposits of 15 per cent. This means that our bank would have to keep at all times a reserve of $45,000. It is true that part of this reserve may be kept on deposit with correspondents, on which the bank would probably receive 2 per cent interest, but the balance must be cash in the bank's vault.

The Arkansas law, however, provides that when a State bank becomes a member of the Federal Reserve System, if it keeps the reserve required by the Federal Reserve Act, it complies with the Arkansas law. The Federal Reserve Act then would require of the bank under consideration, it being in a non-reserve city, 7 per cent of the $200,000 demand deposits, or $14,000, and 3 per cent of the $100,000 time deposits, or $3,000, making a total reserve of $17,000 that it will have to carry with the Federal Reserve Bank. Our bank will receive no interest on this $17,000, but it is required to keep only $17,000 as a reserve, whereas before it became a member of the System it had to keep a reserve of $45,000. It therefore has released for loaning purposes in its community $28,000. If our bank had kept all of this $45,000 reserve required before it became a member of the System with correspondents, which, of course, it could not have done as the law requires part to be kept as cash in vault, and had received 2 per cent on this amount, its return would have been $900. However, it does not lose anything by becoming a member of the System, since by becoming a member of the System it releases the difference between $45,000, the old reserve, and $17,000, the System reserve, or $28,000. In the majority of instances the bank could loan this $28.000 at home at 6 per cent, which would give it a return of $1,680 a year. Assuming that the interest it obtained through its old reserve method is $900, it is apparent that as a member of the System, by investing the released reserve at home, the bank in reality would make $780. Or putting it another way, the bank would suffer no loss if it invested this $28,000 released reserve at just a little in excess of 3 per cent. This, remember, is figured on the theory that our bank, under its old reserve method, had kept all of its reserve with correspondents, drawing interest, and none in its vaults.

We therefore see that our bank, on becoming a member of the Federal Reserve System, would have to make only two payments, one for its capital stock of $900, on which it is sure to receive a 6 per cent dividend, or $54 a year, and the other a payment of reserve into the Federal Reserve Bank of $17,000, on which balance it will receive no interest from the Federal Reserve Bank, but, if the proceedings as outlined above are followed, the released reserve should make for the bank, over its old reserve method, $780 a year.

Member Bank Must Par Checks.

A bank which becomes a member of the Federal Reserve System must remit at par for checks cleared on it through a Federal Reserve Bank. For a time the Federal Reserve Bank made a small service charge for the collection of checks, but you of course know that this has not been its practice for quite a while. If the bank under consideration has been charging exchange on checks, membership in the System will mean that it will receive no income from exchange, or at least a smaller income from exchange as a large number of the checks which it now receives from other sources will be routed through the Federal Reserve Bank. This is what it is coming to whether it joins the Federal Reserve System or not, for in two of the districts all of the banks are on the par list and over 50 per cent of all the banks in the Eighth District, both those that are eligible and those that are not eligible on account of insufficient capital, are remitting at par and others are being added to this number every month. In time, competition will bring about the loss of exchange even though a bank should not become a member of the System. If it continues to stay out of the System this may be a real loss, but if it comes into the System it would seem that there are ways to offset this loss. It certainly can be offset in the way mentioned to the extent of $780, being profit on released reserve under the Federal Reserve System, and it would seem that any loss of exchange would be more than offset by the lower rate at which our bank can borrow from its Federal Reserve Bank as compared with the rate charged it by its correspondents.

Rediscount Rates.

For instance, at the present time, as a member of the Federal Reserve System it could borrow on its collateral note secured by Liberty Loan Bonds or U. S. Treasury Certificates for 15 days at 4 per cent, or it could rediscount a note of a customer secured by Liberty Loan Bonds or Treasury Certificates of Indebtedness for 15 days at 4 per cent, and for a longer time up to 90 days at 4¼ per cent. If it wishes to use bills receivable as collateral, it could borrow on its collateral note secured by eligible bills for 15 days at 4 per cent. It could rediscount its customers' eligible paper for as long as 90 days at 4¾ per cent. At present the highest rate the Federal Reserve Bank charges is 5½ per cent, this being charged when a bank rediscounts a note of a customer based on agriculture or livestock for 91 days to six months. You gentlemen know the rates that you have charged banks that have borrowed from you, and you know the rates that you have had to pay when you borrowed from your correspondents. I believe it is safe to say that on all of the borrowings you have had to make recently, if you had made them from the Federal Reserve Bank, you would have saved in interest from one to two per cent. It would seem that this lower rate would more than offset any loss on exchange, provided you ever have to borrow at all.

This brings us to the privilege you have as a member of the Federal Reserve System of borrowing money and rediscounting through your Federal Reserve Bank. The Federal Reserve Bank of St. Louis mobilizes the reserves of District No. 8. That is, it takes the reserves of the bank under consideration, $17,000, a small amount when used by itself, and adds it to reserves which it holds of all the other banks in District No. 8 in such a way that each bank has behind it the combined reserve of all member banks. As has so often been said, these reserves are, as it were, in a reservoir and are made available for use by a bank through the process of rediscount.

Greater Part of Notes Eligible for Rediscount.

It used to be quite a usual thing for a State bank, especially one of the smaller ones, to say that it had no paper that was eligible for rediscount with the Federal Reserve Bank. When such a statement was made, in nine cases out of ten, for some unknown reason the bank had jumped to this conclusion without having investigated the facts. If a bank is a real bank, doing a banking business, it is safe to say that from 80 per cent to 90 per cent of all the notes in its bill case are eligible for rediscount with the Federal Reserve Bank. This is not true if a bank has been in the habit of allowing all of its customers to give demand notes, for a note to be eligible with the Federal Reserve Bank must have a fixed future maturity. I believe the bankers, however, will agree with me that the demand note habit is not a good banking habit. The customer is better off when he realizes that he must pay his note at a fixed time, and the bank is better off when it knows when its notes will mature. It is just as easy to grant an extension, in fact much easier, than to keep all of the demand notes under constant vigilance, as they should be kept. Experience has shown that it is not difficult for a bank to get its customers in the habit of borrowing money for the length of time they think they will need it.

Statements.

Then again, if the Federal Reserve Bank is to rediscount a note it is natural that it should want to know at least what the bank knows that made the original loan. Where the amount is less than $1,000, the Federal Reserve Bank of St. Louis will accept the statement of the banker as to the condition of the borrower. Where the note is for more than $1,000, a statement of the borrower is required. Some will say that we can not get statements from our customers. Still if a man expects you to loan him in excess of $1,000 it is nothing more than fair that he give you a statement of his affairs. The belief that it is impossible to get a statement experience has shown to be a mistake. In fact, there are a number of our banks, and I am speaking of the smaller ones now, which instead of having the difficulty they anticipated in getting statements, with the use of a little tact, have really had no trouble and say that it is one of the best things that the Federal Reserve System has helped to make a common practice. Further than this, it stands to reason that if National banks and the State banks that have joined the System can get statements, the other banks could also get them.

Red Tape.

There was time when a great deal was said about red tape, and here again those who talked did not do so from experience, or if they did make a statement, saying it was based on some experience of their own, it was on the theory that if the Federal Reserve Bank did not do business as loosely as they, then it was red tape. The fact is that a member bank can do business with the Federal Reserve Bank of St. Louis as easily as it can with any bank in the world, and I believe that our member banks that have used us most will all bear testimony to this effect.

Attitude of Federal Reserve Bank.

The chief purpose of the Federal Reserve Bank is to aid member banks to be of more assistance to the communities which they serve. It is true that members of the Federal Reserve System have to keep accounts with the Federal Reserve Bank, but that very fact makes it all the more necessary that the Federal Reserve Bank do everything in its power to have pleased customers. There can be no bank more desirious of holding its correspondents than the Federal Reserve Bank is of giving real service to its members. To this end it always welcomes suggestions and is glad to be so aided by its member banks.

Facilities Given by Membership.

When a bank becomes a member of the Federal Reserve System that bank by the very act of joining can enjoy banking facilities in all of the cities in which Federal Reserve Banks or branches are established. For instance, if it desires to transfer money to a bank in New York all it has to do is to write or wire the Federal Reserve Bank or a branch, if it is located in branch territory, and ask that so many thousand dollars be transferred to such and such a bank in New York.

This the Federal Reserve Bank will do by wire free of charge, and it has cost the member bank nothing. If the member bank desires, it does not have to have a New York, San Francisco, or other large city correspondent, since as a member of the System it can issue exchange drafts available in the Federal Reserve cities and cities having branches.

A member of the Federal Reserve System no longer has to assort currency. It sends it to the Federal Reserve Bank or the branch and this work is done for it. In addition to this, the Federal Reserve Bank will pay the postage, expressage and insurance on shipments of paper currency from it or any of its branches to member banks and also on shipments of paper currency or coin from the member banks to the Federal Reserve Bank or any of its branches.

The Federal Reserve Bank will also pay the charges on all telegrams received from or sent to member banks in connection with such money shipments, wire or mail transfers, or deposit transactions.

These are some of the facilities given to the member banks, not all. In fact a member bank will not be able to appreciate in how many ways it can get advantages from the System unless it carefully studies it with a view to its own requirements. The Federal Reserve Bank of St. Louis on its part is always trying to see how it can be of some additional service to its members. For instance, in order to assist banks in handling the large number of Government securities issued during the past two years, the Federal Reserve Bank has, when requested, accepted such securities from member and non-member banks for safe-keeping, and will in the future be glad to render this service, in keeping with its facilities, free of charge to such member banks as request it and will give to such securities as are left in its custody by the member banks the same care that it gives to its own property.

Charter Rights.

Perhaps someone says, under our charter we have a right to make real estate loans in a much more liberal way than can National banks, even country National banks under the amended laws, and we do not wish to give up this right by becoming members of the System. The answer is, you do not have to give up these rights, for when a State bank joins the Federal Reserve System it comes in with all of its charter powers. The Federal Reserve Bank, however, just as your State Banking Department, desires that sound banking principles be followed and that, having in view the volume of commercial business, the amount loaned on real estate be not so large as to impair the liquidity of the bank. This, however, is just good banking and has nothing to do with the Federal Reserve System.

Loan Limit of the State Law.

Someone else says, the bank we have under consideration is an Arkansas State bank and the Arkansas law allows it to loan to any one person, firm or corporation, up to 30 per cent of its capital and surplus. Could we continue to loan to this limit as a member of the Federal Reserve System? The answer is you would come in under your charter rights and if the Arkansas law allows you to loan up to 30 per cent, then you could continue to so loan as a member of the System. However, you could not rediscount with the Federal Reserve Bank any part of a loan of a person, firm, or corporation which is liable to you for borrowed money in excess of 10 per cent of your capital and surplus.

The Application.

If at this point it looks like it would be well for our bank to join the Federal Reserve System, and it would be if the testimony of the 54 State banks that have already joined in District No. 8 can be believed, what is the next step? The thing to do is to write to the Federal Reserve Bank for forms. It will send you an application, in which is emboidied a form of resolution to be passed by your board of directors. One form calls.for a statement of your resources and liabilities, really a transcript of your daily statement, and then there is a supplement to this form which asks other questions in regard to officers and directors, general information in regard to loans, list of the bonds and securities, and some other information. In addition to these forms, a copy of your charter and articles of incorporation and also two copies of the last report of examination made by your State Bank Commissioner would be needed. If you will request him to send the reports to the Federal Reserve agent he will do so.

Examinations.

There is a most cordial co-operation between the Bank Commissioner of Arkansas and the Federal Reserve System, and the System is glad to act on the Arkansas examiner's reports. Every State bank that is a member of the Federal Reserve

System must be examined at least once a year, but it is not the object of the System to multiply examinations, nor cause undue expense, so the examinations of the State of Arkansas are accepted. The Arkansas Bank Commissioner very kindly allows a representative of our examination department to accompany his examiners, and this is without additional expense to the member bank. Even where a representative of the Federal Reserve Bank does not accompany the State Department examiners the examination is accepted. Of course, the Federal Reserve Act provides that "Every Federal Reserve Bank may, with the approval of the Federal Reserve agent or the Federal Reserve Board, provide for special examination of member banks within its district." This provision is a natural one and for the protection of all banks. In brief, the examination of a State bank that is a member are conducted about as they were before it became a member of the System. This question of examination seems to be a thing very much misunderstood, and I have even heard it given as a reason for not joining the System. Such a reason, however, was given by someone who had not taken the trouble to inform himself as to the facts.

Condition of Applying Bank Must be Good.

As has been stated before, the condition of the applying bank must be good or it will not be taken into the System, because it is not fair to those banks that are members of the System to take in a weak bank. I am speaking to bankers and you gentlemen know what is a satisfactory banking condition and what is not. You do not want too many doubtful loans in your bank. There should be no excessive loans. The practice of granting overdrafts should not be habitual. The banking house and real estate should be carried at a reasonable figure, and it is not a bad idea to have provided an annual charge-off on such things as furniture and fixtures. If there are any matters of this kind, the bank has undoubtedly had its attention called to them perhaps more than once by the Bank Commissioner. I am certain that no one is more interested in having an applying bank in good condition than the officers and directors themselves. It is well, however, to bear this in mind that these reports of condition come before reasonable and practical men. Nothing will be asked of any bank in regard to condition that is not asked of all banks.

Summarizing what I have said, we see that:

"First. Our bank must present itself in good condition.

"Second. It must pay into the Federal Reserve Bank one-half of 6 per cent of its capital and surplus, or $900 for certificate of stock, the remainder of the subscription being liable to call, but which in all probability will never be called.

"It must also pay into the Federal Reserve Bank 7 per cent of its demand deposits and 3 per cent of its time deposits, upon which it receives no interest on daily balances, but as its reserve takes the place of that required under the Arkansas State law, releases some of the reserve it now must carry, which can be loaned locally at a good rate of interest.

"Third. It gets out of the Federal Reserve Bank a 6 per cent cumulative dividend on its paid-in stock, also it can rediscount its eligible paper with the Federal Reserve Bank at rates which at the present time are certainly lower than can be procured from any other correspondent. This discount privilege can be exercised with certainty, as your Federal Reserve Bank correspondent has sufficient resources to grant any legitimate request as soon as it is made. It can transfer money throughout the United States, and issue exchange drafts in place of New York, San Francisco, Chicago, St. Louis, or any other large city exchange. It can send in its currency without the cost of shipping charges and without the trouble of assorting it, and also receive currency without the cost of shipping charges. In fact, it can do many things which will add to its efficiency as a bank and thus add to the efficiency of the help which it can render its community.

Fourth. A State bank can try the System, and if then it prefers the old method of doing business can return to that method. The law allows it to withdraw upon giving six months' notice of its desire.

Eligible State Bank Should Investigate Carefully.

"It would seem that an eligible State bank that does not join the System is standing in its own light, but an eligible State bank should not take the word of anyone for this, but should carefully investigate and decide the question for itself. This investigation will make the bank familiar with the possibilities of the System as applied to its local needs, will show it how to use the System, and for this reason it will find its membership satisfactory and remunerative. We do not want a bank in the System that does not know how to use it, because that bank may be disappointed, and it is not the object of the System to have any member which does not receive a real benefit from its association. There are at present 1,009 State banks that are members of the System, and I believe I am safe in saying that they are all enthusiastic about it. One reason for this I believe to lie in the fact that when they came into the System the investigation which convinced them of the necessity taught them how to use it. There may be here and there a National bank which, under the law, had to come into the System that complains or else speaks of it with a faint praise that damns. I think I am safe in saying that in every case where such a complaint is made the bank has failed to learn how to use the System. It is a pity that such a National bank was forced by the law to join, for it prefers to travel in an ox-cart instead of a high-powered automobile and complains because the dust of the passing machine gets on its clothes, and the pity is that the member bank owns an automobile that will travel over any kind of a financial road and will not take the trouble to get out of the ox-cart long enough to learn how to shift the gears so as to run it.

"Membership in the Federal Reserve Bank offers the opportunity for increased business. I know of one State bank which by advertising its membership increased its deposits in a phenomenal way. It also offers a sense of security not only to depositors but to stockholders, directors and officers."