THE FEDERAL RESERVE SYSTEM UNDER THE NEW BANKING ACT

ADDRESS

by

WILLIAM MC CHESNEY MARTIN

Governor Federal Reserve Bank of St. Louis

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Up to the time of the passage of the original Federal Reserve Act, which was approved December 23, 1913, there was no means for the coordinated action of banks except the clearing house associations that were established in the larger cities. There was no means whatever for the cooperation of the banks located throughout the rural districts and in the smaller centers. The fact that banks scattered throughout forty-eight different states had no means of combined action resulted in the country, so far as banking is concerned, being very much handicapped in a time of business crisis. The principle of cooperation which proved effective through the clearing houses was broadened and used in the formation of the Federal Reserve System. All National banks were compelled to subscribe for stock in the Federal Reserve Bank of their district and to keep their reserves in their Federal Reserve Bank. In this way a joint ownership was created and there was also a pooling of reserves which enabled any member bank, when it desired, through the medium of rediscount, to draw on those reserves. In this way the reserve of all banks was put behind each individual bank to the extent of its eligible and acceptable assets for use when the necessity developed.

It was provided that State banks could use their discretion about membership in the System, though none were eligible unless they measured up to certain minimum requirements.

Member banks pooled their reserves in the Federal Reserve Bank of the district and could have access to them through the medium of rediscount, and in addition the twelve Federal Reserve Banks could rediscount with each other and upon the affirmative vote of at least five members of the Federal Reserve Board one Federal Reserve Bank could be compelled to rediscount for another.

In this way the machinery for a country-wide cooperative mechanism was set up, and in 1920 the fact that the St. Louis Federal Reserve Bank could borrow from other Federal Reserve Banks helped it to cushion the deflation in such a way that there were comparatively few either business or bank failures. Because we could borrow from other Federal Reserve Banks we were not compelled to insist that our member banks pay loans at maturity, but we enabled them to carry such loans until they could be cared for in an orderly way.

Over the twelve Federal Reserve Banks there was a Federal Reserve Board in Washington which had a general supervision and served as a means of unification of the twelve districts.

The banking situation was further brought together as a unit by the establishment of the gold settlement fund. To set up this country-wide clearing system, each Federal Reserve Bank deposited a million dollars in gold with the Treasurer of the United States for transfer to the Federal Reserve Board in Washington so that by a daily telegram to the Federal Reserve Board balances between districts could be adjusted, with a result that credits against which money can be paid can be practically instantaneously transferred from San Francisco to New York or from Dallas to St. Louis; in fact, can be sent from one center in this country to another center through the agency of the Federal Reserve Banks with their twenty-five branches. I some times think that the influence of the gold settlement fund is not fully appreciated.

The purpose underlying the establishment of the Federal Reserve System was to enable member banks more effectively to meet the money and credit conditions of their respective communities. It was not set up to deal directly with the public.

The Banking Act of 1935, approved August 23, 1935, was designed to meet the banking and credit conditions of the country as they have developed in the twenty-two years since the passage of the original Federal Reserve Act.

While, whether we like it or not, there has been a decided trend towards having all banks, both National and State, members of the Federal Reserve System, the new banking law makes little change in the existing requirements of membership until 1941, when it is provided that "all State banks with deposits insured by the Federal Deposit Insurance Corporation which have average deposits of a million dollars for the calendar year 1941 or any succeeding calendar year, shall by the next July 1 become a member of the Federal Reserve System". It also gives the Board of Governors (as the Federal Reserve Board is to be called under the new banking act) of the Federal Reserve System the right to waive the requirements of membership in order not to work a hardship on such a bank. There is nothing in the new law that changes the status of State banks with average deposits of less than a million dollars. If they have the necessary capital for the towns in which located they can join or not as to them seems best.

As to National banks, which must be members of the Federal Reserve System, the double liability of stockholders is changed. Under the Banking Act of 1933, National Bank stock issued after June 16, 1933, is not subject to double liability, and it is now provided that a National bank may terminate double liability on its stock on or after July 1, 1937 by publishing a single newspaper notice six months prior to termination. This means in effect that there will be no double liability on National bank stock after July 1, 1937. However, to strengthen the banks, in place of the double liability they must carry not less than one-tenth of their net profits of the preceding half year to surplus before the declaration of a dividend, until the surplus equals the common capital.

Under the new law, every depositor in a member bank of not more than $5,000 has his deposit guaranteed by the Federal Deposit Insurance Corporation, and whether or not we agree to the principle of the guarantee of deposits, the effect will be to do away with counter runs. Runs in the future are liable to be what we may call clearing house runs on large balances through the mail. As approximately 98% of the average bank's depositors have deposits of $5,000 or less, the bank can feel less apprehension about making loans with maturities of longer than three months. The bank should not, and, in fact, must not, if the integrity of the banking system is to be preserved, lessen in any way its striving to make sound loans.

Under the new law, the member bank has a greater latitude in the making of real estate loans and in effect by implication is encouraged to make such loans.

In this connection I think we should also set out that member banks in rediscounting at a Federal reserve bank, after an official warning of the reserve bank or of the Federal Reserve Board, cannot increase its outstanding loans secured by collateral in the way of stocks, bonds, debentures or other such obligations, or loans made to members of any organized stock exchange or investment house or dealer in securities, without having its advances from the Federal Reserve Bank deemed immediately due and payable and being denied the privilege of being a further borrower at the Federal Reserve Bank until the prohibition is lifted by the Federal Reserve Board.

The Banking Act of 1933 also provides " hereafter no National bank, without the approval of the Comptroller of the Currency, and no State member banks, without the approval of the Federal Reserve Bank, shall (1) invest in bank premises or in the stock, bonds, debentures, or other such obligations of any corporation holding the premises of such bank or (2) make loans to or upon the security of the stock of any such corporation, if the aggregate of all such investments and loans will exceed the amount of the capital stock of such bank".

In addition to the member banks' ability to rediscount with the Federal Reserve Bank commercial paper with a maturity of not to exceed 90 days, and agricultural loans with a maturity of not to exceed 9 months, under the new law under regulations of the Board of Governors of the Federal Reserve System, they may obtain advances on their demand or time notes with maturities of not more than four months which are secured to the satisfaction of the reserve bank at an interest rate not less than one-half of 1% higher than the highest discount rate of the Federal Reserve Bank. This in effect is putting into permanent form a provision that was passed as an emergency measure during our recent trying times.

This means that a member bank can obtain advances on, and thus make liquid, practically all of its sound assets. It throws an added responsibility on the officers and directors of each Federal reserve bank to see that no discounts or advances are made that are not sound, for such assets, so far as eligible paper is concerned, can be used as collateral for the issuance of Federal Reserve Notes, and the other assets, taken at one-half percent higher rate, can be used as collateral for the issuance of Federal Reserve Bank Notes.

So far as the management of banks is concerned, there are four supervisory agencies - the Comptroller of the Currency for National banks, the Federal Reserve Board for member banks, both State and National, the Federal Deposit Insurance Corporation for insured banks, both member and nonmember, and the State Banking authorities for State banks, both insured and uninsured. National banks are subject to examination by the Comptroller of the Currency and the Federal Reserve Board. State member banks are examined by the Federal Reserve examiners and the State Banking Department having supervision. A National bank or a State member bank is subject to examination by the Federal Deposit Insurance Corporation upon the written consent of the Comptroller of the Currency or the Board of Governors of the Federal Reserve System respectively. All insured nonmember banks are examined by the Federal Deposit Insurance Corporation. Provision is also made for reciprocal use of condition and examination reports by the Corporation on one hand and by the Comptroller, Federal Reserve Banks and State banking authorities on the other. Unless there are "too many cooks to spoil the broth" this should result in improved methods of banking throughout the entire country.

There is also given in the Banking Act of 1933 a right which neither the Comptroller nor the Federal Reserve Banks has had heretofore, that is, "should any director or officer continue to violate any law relating to such bank or trust company or shall have continued unsafe or unsound practices in conducting the business of such bank or trust company" after due warning and a chance to be heard, such management can be changed.

The member bank can rediscount its note secured by government bonds, FFMC bonds and HOLC bonds, just as it formerly could.

One of the principal changes under the new law is in regard to the Federal Reserve Board. Its name is changed to that of Board of Governors of the Federal

Reserve System. It is to have a chairman and a vice chairman, who are appointed from the membership of the Board by the President for a term of four years. The Secretary of the Treasury, who under the original law was chairman of the Board, has been removed entirely from its membership, and the Comptroller of the Currency is no longer a member of the Board. The present members of the Board serve until February 1, 1936, by which time a new Board of seven members will be appointed by the President by and with the advice and consent of the Senate, to serve for a period of fourteen years, at a salary raised from $12,000 to $15,000. They cannot be reappointed after serving a full term. These appointments are so arranged that for the first Board the President will appoint one member to serve for two years, one for four years, one for six years, one for eight years, one for ten years, one for twelve years and one for fourteen years, and thereafter the successor will be appointed for a full term of fourteen years. The purpose of this provision is to make the Board of Governors more free from the possibility of dictation by any Administration which desires a monetary policy framed for political ends.

The Board has the responsibility for influencing credit through changes in reserve percentages. It has the responsibility for making rules and regulations that are workable and meet banking conditions under the law. It also has the responsibility for the rediscount rates effective in the several Federal reserve banks, for while each Federal reserve bank has the right to establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount to be charged by the Federal reserve bank on each class of paper, which shall be fixed with a view of accommodating commerce and business, the new law adds the provision that each such bank shall establish such rates every fourteen days or oftener if deemed necessary by the Board. This gives the Board of Governors the right to review these rates every fourteen days and to withhold its approval if the rate is not considered proper by the Board. In the last analysis, it means that while the Board of Directors of the local Federal Reserve Bank can make suggestions, the Board of Governors actually sets the rates.

In addition to the above, under the Securities Exchange Act of 1934 "for the purpose of preventing the excessive use of credit for the purchase or carrying of securities" the Federal Reserve Board is to prescribe rules and regulations with respect to the amount of credit that may be extended and subsequently maintained on any security (other than an exempted security) registered on the National Securities Exchange.

When the original Federal Reserve Act was approved there was little consideration given to open market operations.

Section 14 of the original Act under the heading "Open Market Operations", provided that any Federal Reserve Bank may, under rules and regulations prescribed by the Federal Reserve Board, purchase and sell in the open market bankers acceptances and bills of exchange of the kinds and maturities made eligible for discount; also to buy and sell bonds and notes of the United States and bills, notes, revenue bonds and warrants with a maturity from date of purchase of not exceeding six months issued in anticipation of the collection of taxes.

Under the rules and regulations originally issued by the Federal Reserve Board there was no coordination of open market activities of the twelve Federal Reserve Banks, and it soon developed that they were working at cross purposes and some times in competition with each other. Their open market activities as early as 1915 included transactions in Government securities, purchase of warrants in anticipation of taxes and the purchase of bankers acceptances. It was found that unity of action on the part of all banks was desirable and it became an established practice for the Governors of the banks to consider open market policy at their conferences. However, it was up to the board of directors of each individual Federal reserve bank to determine the policy of the bank. Then what had been known to the central banks in Europe for many years became apparent. The Federal reserve banks by operations in the open market could increase or decrease the amount of credit member banks had to use with their customers. It was not until about 1922 that the reserve banks really awoke to this possibility, but as the result of the economic need, the Open Market Committee became an established instrument. Nothing was said about it in the law until the Banking Act of 1933, when the Federal Open Market Committee was established, consisting of a representative of each one of the twelve banks, who were to meet in Washington at least four times a year. They would initiate the open market operation, submit it to the Board for approval, and then a conclusion so reached was submitted to the directors of the twelve Federal Reserve Banks., each bank having a right to decide for itself whether it would participate in the operation. This gave a united forum for the formulation of an open market policy, but did not insure that the policy would be carried out. It is evident there are times when if open market operations are to be effective they should be concluded with a great deal of rapidity, and while the methods seem cumbersome, in actual practice it did not take as long to put the policy into operation as the various steps to be taken would seem to indicate. The chief criticism was to the effect that it was too hard to fasten responsibility, as the responsibility was too much diffused.

Under the new law the Federal Open Market Committee is composed of the seven members of the Board of Governors and five representatives of the Federal reserve banks, selected by designated groups of Federal reserve banks. They must meet at Washington at least four times each year upon the call of the Chairman of the Board of Governors of the Federal Reserve System, or at the request of any three members of the Committee. This Committee shall consider, adopt and transmit to the several Federal reserve banks regulations relating to the open market transactions of such banks, and where heretofore the several Federal reserve banks could use their discretion as to participation in the conclusions of the Committee, it is now provided that "no Federal Reserve Bank shall engage or decline to engage in open market operations under Section 14 of this Act except in accordance with the direction of an regulations adopted by the Committee." The law provides that "the time, character and volume of all purchases and sales of paper eligible for open market operations shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country." It is also provided "that any bonds, notes, or other obligations which are direct obligations of the United States, or which are fully guaranteed by the United States as to principal and interest, may be bought and sold without regard to maturities, but only in the open market."

Of the four agencies of credit control affecting the whole Nation, that is (1) the changing of reserve percentages, (2) the final approval of the discount rate, (3) the establishing of margins in stock market transactions and (4) open market operations, the first three to all intents and purposes are in the sole control of the Board of Governors of the Federal Reserve System. In order to change the reserve requirements, a change must be upon the affirmative vote of not less than four of the seven members of the Board of Governors. The fixing of the discount rate is established by the Board of Governors approving or disapproving the rates set by the directors of the respective Federal reserve banks until a rate is set which meets with the judgment of the Board. The fixing of stock market margins is solely within the power of the Board. In regard to open market operations, the Federal reserve banks are represented by five members as against the Board's seven members, and then so far as direct obligations of the United States or obligations which are fully guaranteed by the United States as to principal and interest are concerned, the Committee operations are confined to the open market. The Federal reserve banks are given the power to and they are the ones that must carry out the instructions of the Federal Open Market Committee.

There is thus provided a semblance of a system of checks and balances so far as credit control is concerned.

There is a further provision which seems to me of great importance and it reads as follows: "The Board of Governors of the Federal Reserve System shall keep a complete record of the action taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations and shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying the action of the Board and the Committee in each instance. The Board shall keep a similar record with respect to all questions of policy determined by the Board and shall include in its annual report to the Congress a full account of the action so taken during the preceding year with respect to open market policies and operations and with respect to the policies determined by it and shall include in such report a copy of the records required to be kept under the provisions of this paragraph".

This is important, as control of credit placed within the power of one agency, which in European countries would be a central bank, is a comparatively new thing in the United States of America, and has developed since the inauguration of the Federal Reserve System. We have little precedent in this country to guide us as to the time, what, and how to do, but we do have the records of foreign central banks to help us to come to conclusions, though no foreign banks have had as large and varied domestic territory to care for and consequently have given most of their attention to considering credit control in relation to foreign exchange transactions. Our problem it seems to me is like theirs, but has some distinct differences.

The Federal Reserve Board has one of the best organizations in the world for research and statistics in regard to monetary affairs and thus there is at the command of those charged with the responsibility for credit control data as adequate as can be compiled.

Since under the law the proceedings of the Board of Governors of the Federal Reserve System and those of the Federal Open Market Committee are to be published each year, the reasons for changes in reserve percentages, the fixing of discount rates, the establishing of stock market margins and open market operations can be carefully studied, with the result that from year to year there will be added ability to develop the proper technique.

It is well said by Mr. R. G. Hawtrey in his "The Art of Central Banking", that "The art of central banking is something profoundly different from any of the practices with which it is possible to become familiar in the ordinary pursuits of banking or commerce. It is a field within which a certain degree of technical knowledge is necessary even to take advantage of expert advice."

These reports of the Board of Governors of the Federal Reserve System will furnish the material for a careful study of central banking as applied to the United States and the reasons given for credit control can be checked as to soundness by the results obtained. However, as the actions of money and credit in the last analysis are dependent on so unstable a thing as human nature, even what has occurred in the past can be used only as an approximate guide of what may happen under a given set of statistics at another time when human nature may be in a different mood from the previous period.

This also should be borne in mind that as conditions exist today, the Federal Reserve System should not be held solely responsible for credit conditions. The Government has such resources at its disposal that it could nullify any action taken by the System. In order to produce results it will be essential that the System and the Government work to sound ends harmoniously.

We have reviewed the changes under which the Federal Reserve System will function after the passage of the Banking Act of 1935 and in order to make the picture complete I have included some provisions of the Banking Act of 1933 which remain unchanged. To summarize, member banks, due to the guarantee of deposits up to $5,000 are, in large measure, removed from the apprehension of a counter run and through the change that will now enable them to rediscount all sound assets at the Federal Reserve Banks will probably place more reliance on sound assets than on liquidity.

The member bank is under certain limitations as to lending on stocks as collateral and as to the investment in securities.

There is now power in the supervisory authorities to change incompetent management in the banks.

This all means that a bank under sound management can make loans to its community with greater freedom than heretofore.

The Federal Reserve Board has the right to issue rules and regulations under which the operations of the Federal Reserve Banks are conducted. The Board has shown every desire to have the banks cooperate in the writing of these regulations because it has submitted tentative drafts to the several Federal Reserve Banks and also to a committee of the American Bankers Association, representing all banks, for their criticisms and suggestions. When the rules and regulations are finally promulgated it should be said that the Board of Governors has done everything in its power to make them meet the situation and to be acceptable to all fair-minded banks.

As to the three agencies of credit control (a) the changes of reserve percentages (b) approving of the discount rate and (c) the fixing of margins on stock market collateral, there would seem to be sufficient power to meet any of the situations that may arise.

The Federal Open Market Committee is a separate organization, but a majority are members of the Board of Governors, and that board, if it is unanimous, can control open market operations.

Our American system of checks and balances is somewhat apparent in the credit control machinery. Sufficient provision is afforded for thorough and careful discussion and it is hoped for action quick enough to meet the various situations. The principle of the coordination of the component member banks is preserved. Their individuality remains with only such limitations as experience has seemed to make necessary in order to enable the member banks more safely and efficiently to serve their local communities.

There would seem to be no reason why all the monetary needs of this country cannot be adequately met by the Federal Reserve System under the new banking law, but in order that this be done knowledge is necessary, sincerity is necessary, ability to read the factors of economic change is necessary, and the courage for independent action is necessary even though it is realized that criticism may be severe and that it will come whatever is done. It is also essential to bear in mind that the System of itself can really accomplish very little without the thorough cooperation of the Treasury Department. The System and the Treasury must act together to achieve the proper results.