

THE MUTUAL INTEREST OF COMMERCIAL BANKS  
AND THE FEDERAL RESERVE

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All or a portion of seven different states comprise the Eighth Federal Reserve District. Arkansas is significant since it is the only one of the seven states which is totally within the boundaries of the district.

In Arkansas there are 241 banks. Of these, 184 are state chartered while the other 57 have Federal charters. Roughly, 1/3 of the banks of the state - with 2/3 of the resources - are members of the Federal Reserve System. Each of the 3 kinds of institution - national banks, state member banks, and nonmember state banks - has contributed richly to the development of this nation's economy. The tradition of state chartered banking stretches back through most of the country's history. National banking this year is observing its 100th anniversary, and the Federal Reserve System, which is the nation's regional central bank and monetary authority, will next year observe its 50th anniversary. You may recall that the Federal Reserve Act became law on December 23, 1913 and the Federal Reserve Banks opened for business during November the following year.

The history of banking is not all sweet, peaceful and of one accord. To the contrary, in the past, just as with us today, there were issues to be debated and problems to be solved. Currently, we in banking find ourselves facing problems, some new and some old, and as always there are differences of opinion. Certainly there is no unanimity regarding branch banking, and there are decided differences of opinion with respect to such matters as mergers and holding companies.

Recently, the matter of compulsory membership in the Federal Reserve System for all banks has been raised again. I say "again" because this issue was

a matter of debate as early as 50 years ago when the Federal Reserve Act was under consideration. On occasions we are prone to become dissatisfied with ourselves because of this discord, but it is significant that through these years and even amid our problems and differences banks, regardless of the source of their charters or their affiliations, through good times and bad, have made a rich contribution to the growth, development, and well being of our political and economic life.

Admitting the differences of opinion in the banking community, through it all there has been and continues to be a great common bond among commercial banks and between commercial banks and the Federal Reserve. Each is vested with a public interest. Each and all are concerned with serving their community whether it be local, area, or in varying degrees on a national basis.

For the moment I would like to put aside these differences and think with you on this positive side - the side of service. This includes those services that commercial banks and Federal Reserve join in providing, such as receiving, holding, and transferring deposits, supplying currency and coin, collecting checks, and numerous other functions, including assisting the U. S. Treasury in several capacities.

One current example of our effort to serve the public better and more efficiently is the development of the Magnetic Ink Character Recognition Program. Here all banks have united to develop a means for handling the ever-growing volume of checks. On their own and without any subsidy, the banks of the country have cooperated. When we began there was no plan, no method, no machinery.

Under the leadership of the American Bankers Association and with the cooperation of the Federal Reserve System, we not only have a plan but machine companies have been stimulated to develop equipment and today the program is in operation. High speed processing of checks is as yet limited but its growth has been and continues to be rapid. This is not only fortunate but essential because there is no question but that without this program the banking system, within a few years, would not be able to handle the volume of checks which is expected. This program has cost the banking system a considerable sum of money for research and development and will be successful only with the continued cooperation of all banks.

We in the Eighth District can be proud of the progress which we have made during the past year when our volume of preprinted checks increased 26.7 per cent. On the other hand, due to a slow start we are forced to admit with some embarrassment that, based on the most recent survey, our district is low on the totem pole. Our total percentage of preprinted items was 63.1 per cent as compared with 86.7 per cent in the Philadelphia District which is high, and with 78.7 per cent which is the national average for all Federal Reserve Districts. We continue in this district to have much room for improvement in this area of service and I hope that the results of the next survey in August will show that we have closed the gap.

Let me turn now from our work together in operations and mention the monetary system of the country. The commercial banks and the Federal Reserve share the responsibility of providing our economy with an appropriate amount of money and credit. We thereby promote a high level of business activity, and

reasonably stable prices with due regard to our international balance of payments situation. This public service is accomplished by the Federal Reserve System supplying reserves to the member banks. The commercial banks, in turn, whether they be member or nonmember, and whether they be State or Federal, perform the essential and important function of distributing loan funds where they are most needed by business. Here again we see the benefit of our cooperation. So, all commercial banks are concerned in the matter of the availability and cost of reserves and, consequently, in the manner in which these reserves are supplied. The Federal Reserve System effects the supply of reserves and, therefore, of total money supply and bank credit in several different ways: (1) through changes in the reserve requirements of member banks; (2) through loans to the member banks; and (3) by operations in the open market for government securities. I would like to touch briefly on one or two aspects of the discount function of the Federal Reserve Banks and the mechanics of the operation of the Open Market Committee.

With respect to advances and discounts, it bothers me a little to hear the discount function referred to as a "window" which seems to me to imply that it may be open, closed, or partly open. I prefer to think of the function as a "counter" rather than a "window" because it is always available for use by member banks for appropriate purposes on exactly the same terms except for rates. The discount rate usually reflects the current monetary policy whether that policy be one of restraint or ease. It would be pointless to attempt to regulate the growth of the money supply and credit through open market operations if, at the same time, we permit a free flow of reserves by the discount route.

While access to the Federal Reserve discount facilities is a privilege of membership rather than one of right, it is a privilege which banks are expected to use when it is needed and when the purpose of the borrowing is appropriate. There are, however, a few basic principles which are applicable in connection with administering the discount function.

The Board of Governors of the Federal Reserve System has defined in its Regulation A the circumstances under which member banks may borrow. The general principles covering appropriate use appear in the foreword to the regulation as follows:

Federal Reserve credit is generally extended on a short-term basis to a member bank in order to enable it to adjust its asset position when necessary because of developments such as a sudden withdrawal of deposits or seasonal requirements for credit beyond those which can reasonably be met by use of the bank's own resources. Federal Reserve credit is also available for longer periods when necessary in order to assist member banks in meeting unusual situations, such as may result from national, regional, or local difficulties or from exceptional circumstances involving only particular member banks. Under ordinary conditions, the continuous use of Federal Reserve credit by a member bank over a considerable period of time is not regarded as appropriate.

In considering a request for credit accommodation, each Federal Reserve Bank gives due regard to the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally. It keeps informed of and takes into account the general character and amount of the loans and investments of the member bank. It considers whether the bank is borrowing principally for the purpose of obtaining a tax advantage or profiting from rate differentials and whether the bank is extending an undue amount of credit for the speculative carrying of or trading in securities, real estate, or commodities, or otherwise.

This wording is, of necessity, general but it affords a helpful guide without setting down a fine line of demarcation between appropriate and inappropriate borrowing. Circumstances with respect to each and every borrowing differ and each case must be appraised individually.

Briefly, it seems to me that this may be summarized by saying that while the member banks endorse the principle that they should operate within their own resources, they have the privilege of borrowing from their Federal Reserve Bank for short periods of time to adjust for sudden withdrawals or seasonal needs or to meet unusual situations such as might result from national or local difficulties. Continuous use over a period of time can not be regarded as appropriate.

Another point which I would like to mention is that, contrary to some impressions, the mechanics of borrowing from the Federal Reserve are not insurmountable or extremely difficult. Most borrowing is effected by the use of a simple collateral note which is executed by the member bank and secured by United States government securities. In this instance, all the bank needs to do is to execute the note and authorize its Federal Reserve Bank to set aside specific government obligations which ordinarily are in safekeeping with it.

The other assets of a bank can also be used as collateral for a loan from the Reserve Bank. Either of two discount rates may apply when collateral other than government securities is offered. That collateral which may be classified as "eligible paper" under the provisions of the Act would qualify a loan for the basic rate which also applies to loans secured by governments. A loan secured by assets other than governments or eligible paper carries a rate which, under the

statute, is 1/2 per cent higher than the basic discount rate. This latter class of loans was not permitted under the original Act, but was added in the banking legislation of the mid-30's so that member banks could still obtain credit from the Federal Reserve even though they were out of government securities and eligible paper.

In my judgment, the understanding of eligibility requirements is not difficult. However, classifying a commercial bank's assets as to eligibility does require understanding of the requirements and examination of the credits. In this respect, our staff would be pleased to assist any bank which has any questions with respect to eligibility. Briefly stated, under Regulation A of the Board of Governors, eligible paper must, of course, be negotiable and endorsed, and in addition, must be short-term. Agricultural paper cannot have more than nine months to run, and other paper not more than 90 days to run at the time of the advance. The paper must have arisen in the production, purchasing, carrying or marketing of goods, including agricultural products, or to meet the current operating expenses of a business so engaged. Such paper is not eligible if the proceeds were used for fixed capital purposes, merely investments or for the purpose of carrying or trading in stocks, bonds or other investment securities except those of the United States Government.

The other point I would like to mention is the operation of the Open Market Committee of the Federal Reserve System. All of you are aware that this Committee effects the reserves of banks by the purchase and sale of government

securities in the open market. Its role in formulating monetary policy is significant and, I believe, its method of operation would be of interest to you.

The Committee, which is provided for by statute, is composed of 12 members, including the 7 members of the Board of Governors and 5 Presidents of Federal Reserve Banks. The President of the Federal Reserve Bank of New York is a permanent member of the Committee while the other 4 presidential positions are supplied on a rotating basis from the other Federal Reserve Banks. Your Reserve Bank is grouped with that of Dallas and Atlanta. Currently, the President of the Dallas bank is a member of the Committee, and the President of the St. Louis bank is the alternate member and, in ordinary circumstances and procedures, would be a member next year.

The formulation of policy by the Open Market Committee is not done in a vacuum nor on the spur of the moment nor by any one or two people. The members of the Board of Governors and the presidents of each of the 12 Federal Reserve Banks are continually studying reports, statistics, and all available information in an effort to keep up with developments nationally and internationally. Each of the banks and the Board of Governors is supported in this undertaking by staffs who are specialists in their fields. These staffs are regularly engaged in gathering statistics, making surveys, analyzing reports and formulating views and considerations for their respective principals.

In addition, the 12 Reserve Banks and their 24 branches each has a Board of Directors with a total of better than 250 men who come from various areas of banking, business, and professional life. These also are important

sources, not only of current business and statistical information, but also of grassroot, practical understanding and judgment.

The Open Market Committee meets at the offices of the Board of Governors of the Federal Reserve System in Washington, D. C. approximately each three weeks and more often when it is advisable. These meetings are attended by the 7 members of the Board of Governors and the 12 presidents of the Federal Reserve Banks. In addition, selected and key members of the staffs of the Banks and the Board are also present.

The Chairman of the Committee opens the meeting and calls on members of the staff of the Board of Governors for reports. These include information on the general economic situation, the banking and financial picture, and regarding our balance of payments. This is followed by a report made by the Manager of the Open Market Account who is the staff member responsible for carrying out the policies established by the Open Market Committee for the purchase and sale of government securities. Another report on international activities and operations is submitted by the Special Manager for foreign currency operations for the Account.

Following the staff reports, the President of the Federal Reserve Bank of New York makes a report and concludes by making a statement with respect to what he thinks monetary policy should be for the current period. The Chairman then calls on each President and each member of the Board of Governors for his comments and statement. The President of each Federal Reserve Bank comments specifically on the economic and financial situation in his district in addition to making such other observations as he may choose, and also makes a statement with respect to what he believes current monetary policy should be. The last observations are made by the Chairman of the Committee.

If a consensus for monetary policy is apparent, this becomes the Committee policy. If there is no consensus and a difference of opinion exists, the Chairman calls for a vote and the majority view is established as the current monetary policy. The Committee then formulates a written directive addressed to the Manager of the Open Market Account which guides him in the administration and operation of the Open Market Account until that policy is changed at a subsequent meeting of the Committee. An account of the deliberations of the Federal Open Market Committee appears each year in the annual report of the Board of Governors of the Federal Reserve System.

In summary, our banking system, including member banks and nonmember banks, national and state, and the Federal Reserve, provide the public with essential banking services and with credit. In the field of credit, the Federal Reserve creates the reserves which enable commercial banks to extend credit to the public.

I think we can all regard the past 50 years with some degree of satisfaction. Our economic growth under our competitive enterprise has been remarkable and would not have been possible without the functioning of the banking system. There were rough spots during the past 50 years, it is true, but in the broad view, the banking system has worked, and worked well.