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ADDRESS REPLY TO
 FEDERAL RESERVE BOARD

FEDERAL RESERVE BOARD

WASHINGTON

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April 24, 1920.

X-1914

Subject: Distribution of Earnings of Federal
 Reserve Banks -- Suggested Amendment
 to Federal Reserve Act.

Dear Sir:-

By direction of the Federal Reserve Board,
 there is transmitted to you herewith, for the information
 of your board of directors, a letter which has been
 addressed by the Governor of the Board to the Chairman
 of the board of directors of a Federal Reserve Bank
 whose directors were considering the adoption of reso-
 lutions favoring an amendment of the Federal Reserve
 Act to provide for the distribution of a large part
 of the earnings of the Federal Reserve Banks among
 member banks.

Very truly yours,

Enclosure.

Secretary.

To Chairmen of all F.R. Banks.

April 22, 1920

Dear Sir:-

The desire of the member banks for a larger participation in the profits of the reserve institutions is quite general and perhaps not altogether unnatural. A careful study, however, of the Federal Reserve Act and due consideration of all the equities in the case will, I think, convince those who are willing to consider the matter dispassionately of the soundness of the Board's point of view.

The primary purpose of the Federal Reserve Act as stated in its short title is to "*** furnish an elastic currency, to afford means of re-discounting commercial paper, to establish a more effective supervision of banking in the United States ***". The framers of the Act did not contemplate that the Federal Reserve Banks should be essentially money-making institutions, and but for the entry of the United States into the world war early in 1917 and the necessity of raising vast sums through bond issues in order to meet the costs of military and naval establishments, causing a credit expansion on a scale hitherto unknown, there is no reason to believe that the earnings of the Federal Reserve Banks would have been out of line with those of private institutions. You will remember that in the early days of the system some of the Federal Reserve Banks found difficulty in earning amounts sufficient to pay operating expenses and that up to 1916 only one of them (the Federal Reserve Bank of Richmond) was able to pay the six per cent. dividend which under the law the stockholding member banks are entitled to receive. In 1916 several of the banks paid dividends, but they were mainly on account of arrearages for 1915. Although the earnings of the Federal Reserve Banks increased substantially during the year 1917 on account of the heavy rediscounting with them by member banks of paper secured by war obligations, it was not until June 30, 1918, that all of the Federal Reserve Banks had paid their dividends in full.

You will doubtless remember that during the year 1915 there was a good deal of agitation in favor of the reduction of the paid in capital of the Federal Reserve Banks, the argument being made that in ordinary circumstances the banks could never hope to pay their six per cent. dividends fully paid up notwithstanding the very liberal provisions of the Act with respect to the taxation of Federal Reserve Banks.

The law expressly exempts Federal Reserve Banks from Federal, state and local taxation except taxes upon real estate, thus they are relieved of paying corporation, income and excess profits taxes. Section 7, however, in its original form provided that after dividend claims had been fully met "all the net earnings shall be paid to the United States as a franchise tax, except that one-half of such net earnings shall be paid into a surplus fund until it shall amount to forty per centum of the paid in capital stock of such bank." It further provides that "should a Federal Reserve Bank be dissolved or go into liquidation any surplus remaining after the payment of all debts, dividend requirements as hereinbefore provided, and the par value of the stock, shall be paid to and become the property of the United States". The Act approved March 3, 1919, amended Section 7 by providing that "after the aforesaid dividend claims have been fully met the net earnings shall be paid to the United States as a franchise tax, except that the whole of such net earnings, including those for the year ending December 31, 1918, shall be paid into a surplus fund until it shall amount to one hundred per centum of the subscribed capital stock of such bank, and that thereafter ten per centum of such net earnings shall be paid into the surplus."

The effect of this amendment is to defer the payment of large franchise taxes by the Federal Reserve Banks to the Government; it will permit the accumulation by each Federal Reserve Bank of a surplus fund, belonging in the last analysis to the Government, which will give unusual strength and security to the position of the capital stock. Any losses occurring in the Federal Reserve System

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will be provided for out of current earnings or out of the accumulated surplus; and the possession by a bank of a surplus fund equal to twice the amount of its paid in capital practically assures the prompt and regular payment of the six per cent. cumulative dividends on the stock.

The Federal Reserve Banks are affording important facilities to the member banks, and through them to the public, which were absolutely unobtainable a few years ago; they are performing certain services which are not actually required by the Federal Reserve Act but which are a very great convenience and which involve large expense. This expense is in reality borne by the Government for it reduces the amount available for the franchise tax. Specific instances of the important services rendered by the Federal Reserve Banks are the operation of branches in various cities for the greater convenience of the local and nearby banks, and the payment by the Federal Reserve Banks of all transportation charges on currency delivered to and received from member banks; telegraphic transfers are made available to all member banks without charge and by means of the Federal Reserve pay clearing system checks deposited with member banks by their customers are being collected more expeditiously than formerly and without expense to the sending banks. In extending these facilities the Federal Reserve Banks have necessarily experienced a very heavy increase in their operating costs. For the year 1919 the operating expenses of the Federal Reserve Banks exceeded by nearly five million dollars their gross earnings for the year 1917 and were only about two million dollars less than their net earnings for the year 1918.

One fact which is generally overlooked by those member banks which are complaining that they do not receive an equitable share of the earnings of the Federal Reserve Banks is that during the period of the war and up to the present time by far the larger part of the earnings of the Federal Reserve Banks has been derived from the discount of notes secured by war obligations of the Government

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and by Treasury certificates. In order to maintain the reserves required by law while carrying this large volume of discounts it has been necessary to issue Federal Reserve notes in large amounts, and the total amount outstanding at the present time is about three billion dollars.

Member banks should recognize the fact that the earnings of the Federal Reserve Banks therefore are derived very largely from the circulation of these notes. The Federal Reserve Board has the power under Section 16 of the Federal Reserve Act to impose an interest charge at such rate as it may deem expedient upon the Federal Reserve banks for that portion of their notes in circulation not covered by gold or gold certificates. It is rather a close question as to whether the Board has any option in the matter of imposing an interest charge upon Federal Reserve notes in circulation, but the Board

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some years ago decided to give the Federal Reserve Banks the benefit of the doubt, as it prefers not to have the discount policy of the Federal Reserve System complicated with the necessity for a large earning power. This view was justified by the further consideration that the surplus of the Federal Reserve Banks would revert to the Government upon their liquidation and that excess earnings, after the amount of surplus permitted by the statute had been accumulated, would be paid to the Government as a franchise tax. It was felt that it would be better policy to permit each Federal Reserve Bank to accumulate a large surplus rather than to reduce their net earnings by the imposition of heavy taxes.

In round figures the capital stock of the twelve Federal Reserve Banks combined is now about ninety-one million dollars while the accumulated surplus, which is the property of the Government, amounts to one hundred and twenty million dollars. The member banks get six per cent. dividends on their capital stock while the Government gets no return on the surplus which it has allowed the banks to retain. But as the abnormally large earnings now being made by the Federal Reserve Banks appear to be inviting criticism and are creating a spirit of dissatisfaction among the member banks, it seems that the Board should now take into consideration some means of reducing these large current earnings. It would be unwise to attempt to bring about this result by lowering discount rates for there is practically unanimity of opinion that credit

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expansion has gone far enough and that steps should be taken leading to the restoration of a more normal balance between the volume of credit and the volume of goods. Nor does it seem desirable to permit the Federal Reserve Banks to pay interest to member banks on reserve deposits. Reserve funds in the strictest sense have no earning power and any attempt to give such earning power to reserves by artificial means which they do not possess inherently would obviously be unsound. It is true that before the Federal Reserve Act was enacted a part of the lawful reserves of national banks located in cities other than central reserve cities had an earning power because of the privilege given banks in reserve cities of pyramiding one-half of their reserves with banks in central reserve cities and to country banks of pyramiding three-fifths of their required reserves with banks in reserve and central reserve cities. But even under the old law there was no earning power possible for the reserves which banks were required to carry in their own vaults (in central reserve cities 25% of their net deposits in lawful money). There is enclosed a memorandum outlining more fully the views of the Board regarding the payment of interest on reserve balances by Federal Reserve Banks.

It is evident therefore that the only means worthy of consideration of reducing the current earnings of Federal Reserve Banks is the imposition of an interest charge against Federal Reserve notes, as provided for in Section 16 of the Act. These notes are obligations of the United States and are issued to the Federal Reserve

banks under conditions prescribed in Section 16. In so far as they are not covered by an actual gold reserve they are equivalent to a loan to the Federal Reserve Banks by the Government, and an interest charge would be logical and equitable. These notes are receivable for all taxes, customs and other public dues by all national and member banks and Federal Reserve Banks and circulate freely in the hands of the public. In the opinion of many economists and students of finance the large volume of these notes in circulation is an essential factor in the present high cost of living. In any event, the profits earned by the Federal Reserve Banks through the circulation of the notes are paid by the public and the payment of an interest charge to the Treasury on the notes by the Federal Reserve Banks through which they are issued would be merely a reimbursement to the public.

Whether or not the Federal Reserve Board will deem the present as being an opportune time for the imposition of an interest charge on Federal Reserve notes I am not prepared to say, but I feel sure that if serious attempts are made to change the present method of distribution of the earnings of the Federal Reserve Banks by diverting a larger portion of the earnings from the people's Treasury to the coffers of member banks the Board would feel obliged to protect the interests of the Treasury by insuring to it in advance of any general distribution of earnings the revenue which would accrue from the imposition of a tax on Federal Reserve notes.

Very truly yours

(Signed) W. P. G. HARDING

Governor.