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THE FEDERAL RESERVE SYSTEM AND THE BANKING ACT OF 1935

ADDRESS BY

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DELIVERED AT

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Mr. Chairman and fellow members of the American Institute of Banking:

It gives me the greatest pleasure to visit chapters of the American Institute of Banking and see the effort and interest devoted to improvement of the technique of banking. The activity of the institute's chapters is evidence of an initiative that makes for progress. Bankers as never before are studying the technique of their business and developing their knowledge of the conditions affecting it. Supervision of banking in the public interest is no deterrent to initiative, for the desire of the supervisory authorities is not to interfere with the banker's initiative but to cooperate with him in every possible way for the improvement of American banking. A real spirit of cooperation is characterized in the relations of your Institute, the American Bankers Association, and the Federal Reserve authorities. Out of the day to day contact of bankers with their customers in banking offices throughout the country, there arise certain broad questions of policy and practice, which, in the public interest need to be followed by especially constituted authorities. These are questions that can only be seen in the large and when one detaches himself sufficiently from the day to day routine. It is from this point of view that I wish to speak to you about the Federal Reserve Banks and the Board of Governors and the duties they exercise with respect to the interest of the public as a whole in the banking business.

The Federal Reserve System is not a commercial banking system, nor a savings bank system, nor an investment banking system. It deals with reserves. It is a system which does not work for individual banks, but for the banking system as a whole. It is not a system operated for profit;

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it deals with reserves which must be held back at certain times and utilized at others in order to correct extreme tendencies one way or other in credit conditions. It is operated in the public interest - as created by Congress - crossing all state lines and covering the nation as a whole.

Its organization is such that responsibility is partly centralized and partly decentralized. Certain general responsibilities are entrusted to the Board of Governors in Washington and to the Federal Open Market Committee; regional responsibilities are entrusted to the twelve Federal Reserve Banks.

The cooperation between the central Board of Governors and the twelve regional Banks is illustrated by the fact that five of the members of the Federal Open Market Committee are elected from the Reserve Banks and by the fact that discount rates originate in the districts, even though they are subject to review and determination by the Board in Washington. The System is represented in the Federal Advisory Council which now consists of twelve bankers elected by the Boards of Directors of twelve Federal Reserve Banks. It is represented also in the conferences of presidents of the twelve Federal Reserve Banks which are held periodically in Washington. There are many other System conferences in the law department, examination department, economic department, operating department and in other fields.

The System consists of 6,400 member banks. These include 5,368 national banks and 1,032 member state banks. As you know all national banks are required to be members of the System. State banks may voluntarily make application for membership, and if they qualify, are accepted

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into the System. Although the number of member banks is less than half the banks in the country, they do about two-thirds of the banking business of the country.

As you also know the member banks hold stock in the Federal Reserve Bank of their district. Each subscribes to six percent of its capital and surplus - three percent of which is paid in at once and the other three percent may be called at any time.

There are twelve Federal Reserve Banks located in different sections of the country. There are also twenty-five branches of these twelve Federal Reserve Banks, and two agencies.

At each Federal Reserve Bank is a Board of Directors, consisting of nine men. Six of these men are elected by the member banks and three are appointed by the Board of Governors of the Federal Reserve System in Washington. One of these three men appointed by the Board of Governors in Washington, is designated as Chairman of the Board and Federal Reserve Agent.

The Federal Reserve Bankshave the power of selecting their presidents and vice-presidents. The Board has no power to force an unnaceptable candidate on the Federal Reserve Banks, but those selected by the Federal Reserve Banks must have approval of the Board of Governors in Washington. This results in a more harmonious operation of the System, which naturally requires a meeting of minds between the directors of the bank and the Board in Washington in the selection of key officials.

The officers of the Federal Reserve Banks keep in close touch with

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their member banks in order to insure that the service of the Federal Reserve Banks is satisfactory and that their facilities are fully known. The officers of the Federal Reserve Banks as well as the members of the Board welcome criticism and constructive suggestions, for it is their desire to do everything within their authorized powers to make the services of the Federal Reserve Banks useful and valuable to their member banks. Visits are also made to nonmember banks, in order that no bank interested in becoming a member of the Federal Reserve System need feel doubtful as to what the conditions and advantages of membership are.

Prior to the establishment of the System it was felt that an outstanding weakness of our banking was the lack of a satisfactory system of reserves. As I said before the fundamental purpose of the Federal Reserve Banks is to hold reserves of member banks.

Just prior to the panic of 1907 - which played a large part in bringing about the establishment of the Federal Reserve Banks - each country national bank was required to keep reserves of 15 percent, six percent of which was to be kept as cash on hand. The rest was on deposit in correspondent banks in reserve cities or central reserve cities. National banks in reserve cities were required to keep reserves of 25 percent, at least 12 1/2 percent in cash and 12 1/2 percent on deposit with correspondent banks in central reserve cities. New York, Chicago, and St. Louis constituted the three central reserve cities, and the banks in these cities had to keep reserves of 25 percent - all in vault cash.

The percentage of reserves which such banks are now required to keep on demand deposits is 10 1/2 percent for country banks, 15 percent for

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reserve city banks, and 19 1/2 percent for central reserve city banks. All banks must keep 4 1/2 percent on time deposits.

The great difference, however, is that whereas at the time the banks partly kept their legal reserves in their own vaults and partly kept them with one another, they had no certain means of augmenting their reserves except when everything was easy. The banks now have to keep their legal reserves with the Reserve banks and they have in the Reserve banks a means of augmenting their reserves by the discount or sale of assets.

It was the purpose of the original Federal Reserve Act to encourage banks to make commercial loans. It definitely discriminated in favor of such loans by limiting the class of paper eligible for discount (in the words of the Act) to "notes, drafts, and bills of exchange issued or drawn for agricultural, industrial or commercial purposes." This paper, however, had to mature in three months or less from the time of discount, with the exception of agricultural paper, which might mature in six months.

This limitation did not in fact result in an abundance of such paper in the portfolios of banks - on the contrary such paper, for many years, showed a tendency to occupy a relatively smaller place among the bank assets. In 1929 it amounted to about 12 percent of loans and investments of member banks. In 1934 it was 8 percent. This shows that the American banks, instead of specializing in any one type of credit, have dealt in all kinds of credit - long term as well as short - according to the requirements of their communities. The effect of this was to limit the power which it was originally intended that the Reserve Banks should have

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of discounting for member banks which wished to replenish their reserves.

The Banking Act of 1935 sought to correct this condition by amendment, which would authorize the Federal Reserve Banks to make advances to member banks for not to exceed four months on any security satisfactory to the Reserve Bank, Previous legislation had enlarged the lending powers of the Reserve Banks, but this change made it possible for a member bank to discount any sound asset at the Reserve Bank regardless of type.

Now you might ask - how can reserves be augmented or, in other words, built up - how can the banking system increase the amount of reserves available to it at the Federal Reserve Bank? First, it can do so by depositing currency, but this is not a practicable means, because the amount of currency required by the public is a definite amount at a given time and the banks cannot very well change that amount. Second - it can do so by depositing gold. However, the availability of gold is not dependent on the action of the banks, but on the international flow of funds and the output of domestic mines. Substantially, therefore, increase of reserves can be brought about only by member banks borrowing at the Federal Reserve Banks, or by the Federal Reserve Banks buying securities or acceptances. When the amount of Federal Reserve credit increases, member bank reserves increase, and when member bank reserves increase, there is ordinarily a corresponding increase of several times that amount in the volume of member

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bank deposits as the result of loans or purchases of investments by the member banks. On the other hand, when the volume of reserve bank credit diminishes either through the repayment of discounts by a member bank or through a sale of securities by the Federal Reserve Bank, there is a loss of reserves which in the absence of currency or gold movements can be made up only through a decrease in the banks' loans and investments of several times the amount of the decrease in reserves. This is the leverage through which the Federal Reserve System can influence the volume and cost of money.

Another activity of the Reserve banks is the issuance of Federal Reserve notes. These constitute the paper money authorized by the Reserve Act for the purpose of supplying the country an elastic currency - that is, a currency whose volume can be readily increased or decreased according to the public demand for it.

Federal Reserve notes are obligations of the United States and are secured by specific collateral pledged by the Reserve bank. The bank is required to keep reserves in gold certificates at least equal to forty percent of the notes in actual circulation. The Federal Reserve banks, of course, do not supply the entire currency of the country. The Government issues silver dollars, minor coin and some paper money and, until July of last year, the National banks continued to have the privilege of issuing National bank notes. The larger part of money in circulation, however, consists of Federal Reserve notes.

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A member bank that has satisfactory assets can always secure all the currency that it needs. If it has a demand for more cash than it has in its vault, it can readily obtain Federal Reserve notes at its Reserve bank. It can borrow and take the proceeds in notes or it can draw against its account and, if necessary, restore the account to the required level by borrowing. If it receives on deposit from its customers more currency than it needs to keep on hand for current requirements, it can send the excess to the Reserve bank to be added to its reserve balance.

The function of supplying elastic currency is important, but it is less important than the lending power, because, as you know, currency does not play a major role in present-day business transactions. About ninety percent of our business is conducted by the use of checks. Currency is used, for example, for purchases at retail stores and filling stations, for car fare, and for payrolls, but such uses account for only about ten percent of the total monetary transactions in the country. Such fluctuations in the demand for currency as appear regularly on pay days, during the period of Christmas shopping, and near holidays, are met completely by the machinery provided by the Federal Reserve Act.

Next I wish to mention a function of the Federal Reserve Banks whose existence and importance is frequently overlooked. I refer to what they do as fiscal agencies. As you know, the Federal Reserve Act provides that the Federal Reserve Banks "when required by the Secretary

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of the Treasury shall act as fiscal agents of the United States." The duties which the Federal Reserve Banks perform under this provision always have been extremely important to the government, and in recent years they have come to absorb a larger and larger part of the attention and time of the Federal Reserve Bank personnel. In addition to servicing the public debt, providing currency, and acting as depositary of the United States Treasury, the Federal Reserve Banks perform a large amount of work for various government agencies, such as the Reconstruction Finance Corporation, the Federal Home Loan Banks, the Federal Home Owners' Loan Corporation, the Farm Credit Administration, the Public Works Administration, the War Department, Veterans Administration and an additional number of government agencies and bureaus. In the year 1935 the Federal Reserve Banks handled almost 69,000,000 Treasury checks and over 16,000,000 checks issued to work relief employees. This was an average of about 20,000 checks a day at each of the twelve Federal Reserve banks.

The transactions involved in servicing government securities are of great importance; they comprise receiving applications for new issues, delivery of securities to subscribers, exchanging securities of different denominations, meeting maturities, and paying interest. During the year 1935 the Federal Reserve Banks delivered to subscribers almost 1,600,000 bonds, notes, certificates, and bills sold by the Treasury, and redeemed over 4,000,000 different government obligations.

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They exchanged over a million obligations for the convenience of their holders and paid over 14,000,000 interest coupons. In the same year they prepared and mailed over 24,000,000 bonus bonds to veterans.

Were it not for the Federal Reserve Banks, the government would have to provide other agencies for the purpose of handling these operations at a substantially increased cost.

In addition to holding the reserves of the United States banking system, making loans to member banks, furnishing an elastic currency which automatically increases or decreases according to the public demand, simplifying the procedure whereby banks collect checks drawn on other banks, acting as fiscal agents of the Government in connection with the issue and retirement of Government securities, etc., the Federal Reserve System has a certain national credit control through discounts, open market operations, direct action, reserve requirements, and margin requirements.

DISCOUNTS:

The Federal Reserve Act provides that each Federal Reserve Bank establish from time to time rates of discount, subject to review and determination by the Board of Governors of the Federal Reserve System. The Banking Act of 1935 added the requirement that such rates shall be established "every fourteen days, or oftener if deemed necessary by the Board." This does not require that such rates must be changed every time, but they must be regularly and frequently reviewed.

The presumption behind discount rates is that member banks will

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borrow at the Federal Reserve Bank, and when they are borrowing, of course, discount rates have some force. The lower the rate, naturally the easier it is to borrow, and the more funds are supplied to the public, through the member banks, and through the nonmember banks. The higher the rate, the more difficult it is to borrow, and, therefore, the less funds are made available through the banks to the public.

Originally at the time of the passage of the Federal Reserve Act, it was thought that the banks would borrow, as a regular thing, at the Federal Reserve Bank, and, therefore, the discount rates had more meaning. The rate was the thing that everybody watched for. Today the rate has significance of the cost of money, and little more.

As a matter of fact, banks do not borrow at the Federal Reserve Bank unless they have to. When they have an excess reserve, they naturally will not borrow at a Federal Reserve Bank. When their reserves are just above, they will not borrow, but when they get down to the point where they are below the required percent, they begin to watch the discount rate.

OPEN MARKET OPERATIONS:

The Banking Act of 1933 gave specific authorization for the Federal Open Market Committee and adopted the following statement for the purposes of open market operations:

> "The time, character, and volume of all purchases and sales of paper described in the section 14 of this Act as eligible for open-market operations shall be governed with a view to accommodating commerce and business and with regard to their bearing upon

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the general credit situation of the country."

The Act further provided that the seven members of the Board of Governors of the Federal Reserve System should be members of the Committee and that there should also be five members representative of the 12 Federal Reserve Banks.

The Federal Open Market Committee meets in Washington at least four times a year. Of course, it also meets upon call when conditions exist that must be met.

Open Market Operations consist of the purchase and sale by the Reserve Banks of securities, mainly government obligations, for the purpose of increasing or decreasing the supply of credit available in the money market as a whole. By selling securities the Reserve banks withdraw funds from the market and less credit becomes available. On the other hand, by purchasing securities the Reserve Banks place funds into the market and more credit becomes available.

When the Reserve Banks sell securities the reserves of member banks become diminished in the process of paying for the securities that are sold, whereas when they purchase securities, the funds which are released in payment flow directly or indirectly into the reserve accounts of the member banks and enlarge them.

The Banking Act of 1935 gave statutory recognition to the Federal Open Market Committee. It also prohibited any Reserve Bank to engage in open market operations except in accordance with regulations of the Board.

The purpose of the open market operations is not to make profit for

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the Federal Reserve Banks.

DIRECT ACTION:

Another means of credit control is by direct action. By this I mean efforts to discourage credit policies of given member banks in given circumstances. This is a policy of warning banks not to conduct certain operations or engage in certain credit practices, and of directing them to limit the amount of money that they lend for certain purposes, particularly speculative purposes.

If a bank continues to engage in practices about which it has been warned, there is power given to the Board to stop further extension of credit to the bank concerned. And if the bank continues with the practice criticized, there is power granted to effect the removal of the officers responsible.

Direct action is aimed at the correction of specific conditions in particular banks; also for the purpose of enforcing general credit policy.

RESERVE REQUIREMENTS:

The Banking Act of 1935 gives the Board of Governors power to increase, when necessary, the reserve requirements, and thereby to check at any time an excessive use of credit, but the Board is not permitted to lower them below the original requirements of thirteen, ten, seven percent on demand deposits, and three percent on time deposits, nor increase them to more than twice that amount.

Naturally the result of raising the rates would be to decrease the lending power of member banks and the amount of available credit, whereas

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the lowering of rates enlarges the lending power and the amount of available credit.

This power formerly could be exercised only in emergencies and with the approval of the President of the United States. It is now one simply of the Board's discretion.

MARGIN REQUIREMENTS:

There is still another means of credit control - it has to do with the lending of money on registered securities, by brokers, dealers, and by member and non-member banks. Authority for the Board to issue regulations governing this form of credit control was granted by the Securities Exchange Act of 1934.

Under this authority the Board has issued Regulations "T" and "U".

Regulation "T" governs the extension and maintenance of credit by brokers and dealers in securities for the purpose of purchasing or carrying securities. Regulation "U" governs loans made by banks for the purpose of purchasing or carrying stocks registered on exchanges.

The power given the Board to impose and relax restraints upon the demand for credit for speculative purposes is aimed at a particular use of credit and at the specific channels through which demand for it becomes effective.

It extends the powers of the Board outside the Federal Reserve System to reach directly brokers and nonmember banks. It differs from the powers of discount, because while these powers may be exercised to discriminate against paper directly involved in speculative uses, they cannot

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prevent the speculative use of funds procured by the discount of paper not directly involved in speculation. It also differs from the power to conduct open market operations which influence the total amount of funds, but not the uses to which they can be put. The same thing is true of the power to alter reserve requirements. Direct action can be used to discriminate against the speculative use of credit, but only in individual cases. In margin accounts, however, the regulation is directed at an unmistakable objective and cannot miss affecting the speculative use of credit.

Although the means I have discussed by which credit control may be exercised might appear comprehensive and powerful, I do not wish to convey the thought that a perfect control of credit is effected through them. Their application cannot be mechanical nor governed by unvarying rules. Credit and economic relationships are extremely intricate and circumstances under which the need for action arises are always to some extent different and special.

For one thing, there has never been a time when the membership of the Federal Reserve System included as many as half the banks in the country. Although it is true that the System includes most of the large banks and that it, therefore, includes the bulk of the banking business of the country, still from the point of view of the communities they serve and of relations with other banks, the importance of the thousands of small banks which are outside the System is not negligible.

For another thing, United States Treasury activities must be taken

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into account. These have to do in part with the operations of the Exchange Stabilization Fund and the issue of circulating media, e.g., coins, silver certificates, and United States notes; and in part with the public debt, and the government's receipts and expenditures. These operations involve large sums and intimately affect the banking and credit situation.

Finally there are conditions that arise not only outside the System, but outside the country, and yet affect the domestic banking situation powerfully. There is, for example, the recent great movement of gold to the United States from abroad - a movement that in the last two years has added over three billion dollars to the reserves of member banks and created a quite unprecedented credit situation.

These factors, among others, necessarily limit and modify the exercise of credit control.

Credit control is a very technical matter. It is essential, however, and if the important objectives of credit control are to be achieved, their general purpose must be understood.

While I have discussed the more important changes effected by the Banking Act of 1935, there are a few others that might be mentioned for the sake of completeness.

1) The chief executive officer of each Federal Reserve Bank is designated president instead of governor, and the deputy governors are designated vice-presidents.

2) The Board has authority to waive in whole or in part the statutory

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requirements relating to the admission of State banks to membership in the Federal Reserve System, if such waiver is necessary to facilitate the admission of any State bank which is required to become a member in 1942 in order to be an insured bank or to continue to have its deposits insured.

3) The old designation of the Board as the Federal Reserve Board is changed to Board of Governors of the Federal Reserve System. At the same time an important change in the composition of the Board was brought about. The Secretary of the Treasury and Comptroller of the Currency are no longer members of the Board. The number of members is now seven, whose terms are for fourteen years. No member having served a complete term of fourteen years can be reappointed. The Act provides that such members shall be appointed by the President with the advice and consent of the Senate, and the President in making the selection shall have due regard to a fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country. The title of the chief executive officer of the Board is now Chairman, instead of Governor. Each of the seven Board members is a Governor.

4) The Board is required to keep a complete record of the action taken by it and by the Open Market Committee upon all questions of policy, and of the reasons underlying such action, and shall include a copy of the records in its annual report to Congress.

5) Provision is made for the purchase and sale by the Federal Reserve Banks of direct obligations of the United States and obligations which are fully guaranteed by the United States without regard to

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maturities, only in the open market. This prevents purchases of issues of government securities from the Treasury.

6) National banks may make real estate loans up to 50 percent of the appraised value of the mortgaged property for periods not exceeding five years; except that if the loan is on an amortization basis it may be made up to 60 percent of appraised value and for a term of not longer than ten years. Real estate loans must not exceed the capital and surplus of the bank, or 60 percent of the bank's time and savings deposits, whichever is greater.

As you know, the Board in Washington is constantly in touch, through our Federal Reserve Banks, with the general credit conditions of the country. We have data supplied us by the Federal Reserve Banks' statistical departments, and we have our own research and statistical department in Washington, which presents facts and figures constantly, so that we know what is going on. We compile and publish information bearing on banking and credit conditions, here and abroad, and include data on production, employment, trade, and prices.

We also publish the Federal Reserve Bulletin, a monthly publication, and the Annual Report of the Board, in which is presented information on the current banking and financial situation. Each of the Federal Reserve Banks also publishes a monthly review and an annual report.

No other central banking organization in the world makes available such comprehensive information on domestic banking and business developments.

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This information is of vital importance, especially to bankers.

I wish to emphasize particularly the importance of it as related to the operations of the Federal Reserve System. In that connection I am glad to know that many chapters of the American Institute of Banking are giving courses on the Federal Reserve System; and at the Institute graduate school of banking at Rutger's a course on the System will be given beginning next summer by Dr. Burgess of the Federal Reserve Bank of New York.

It has been a genuine privilege to be with you this evening. I hope my visit is evidence of the sincere desire of the Board of Governors and of the Federal Reserve Banks to cooperate with you as individual bankers, as members of the American Institute of Banking, and as members of the American Bankers Association in the development of an ever improving technique of banking in the interest of the public.

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