The Federal Reserve System—Our Financial Safety-Valve

This is Number Three of a series of special articles published by The National City Bank of New York, co-incident with the opening of its up-town branches. Number Four will shortly appear in this paper.

BANKS in the United States operate in a manner quite different from those of most other important countries. We have more than 30,000 banks in this country, most of which are moderate-sized institutions owned by people of their immediate neighborhood and which confine their operations to a single city or town. In most of the European countries and in Canada, the banking business is carried on by a few large banks having many branches scattered throughout the country.

The American system of individual banks, each serving its own field, has much to recommend it, because it assures a close contact between the bank and its clients and because it enables the officers of banks to be in close touch with the affairs of the business men and other depositors whom the bank serves. However, until the Federal Reserve System was put into operation in 1914, this system of separate banks suffered from a very serious difficulty in times of stress or when the demands for banking accommodations exceeded the capacity of the banks.

A bank, of course, does not keep on hand all the money that has been deposited with it. Modern industry and the carrying on of business require the use of the credit which is based on the deposits in the banks, which simply means that the banker is able to lend out most of the funds left in his care to borrowers in whose solvency and ability to repay he has confidence.

Under the old regime, each bank had to stand alone in times of money stringency and there was no strong central reservoir of credit which could be tapped to supply unusual requirements for credit. The money panic of 1907 illustrates the difficulties with which the banks had to contend; there was plenty of wealth and plenty of consumable goods in the country, but the machinery was lacking by which these goods could be made the basis for sound credit and the issuance of sound currency.

Fortunately the Federal Reserve System came into existence before the outbreak of the European war and provided the means by which all of the banks of the country are able to pool their strength, so that, in effect, the united strength of the banks in the country is back of the system. The system provides machinery by which the individual banks may shift their limited assets and liabilities to a strong Reserve Bank which, in addition to its other functions, has the power to issue lawful money.

Restrictions on Note-Issuing Power

THIS power of the banks to issue reserve notes is carefully restricted by law, and such currency cannot be put into circulation unless it is amply secured by a gold reserve and by prime commercial paper arising from actual transactions. That is, it protects the United States from any fiat money scheme, which means the attempted manufacture of money by means of a printing press. The stability of America's banking system today as compared with most of the European countries is due to the fact that an adequate reserve of gold and prime commercial paper stands behind every dollar of currency in circulation, while in Europe recent devices for providing governments with money have only resulted in such serious depreciation of their currencies that the ends attempted have been defeated.

But the Federal Reserve Banks were never intended to make easy a great expansion of credit, such as we had in this country during the recent war period. The primary purpose of the System is to make possible the substitution in an easy and sound manner of one kind of credit by replacing it with another just as sound. It does this by replacing the sound credit obligations of small, local banks with the note obligation of a strong Reserve bank having the backing of the national government. In fact, the reserve notes which are issued by the Federal Reserve Banks are actually obligations of the United States Government.

During the war, the heavy borrowing requirements of the Government made it necessary that the machinery of the Reserve Banks should be largely used in providing loans against governmental war issues, and this helped to produce the period of inflation from which we are now emerging.

The real purpose of the country's entire banking system is to make every dollar do its share of work. The liquid capital of the United States is represented by the actual money or paper representatives of money in the hands of its people, and the genuine function of the banks is to keep this money on the move in handling the business of the nation. The banks can only operate on a sound basis when they restrict their operations to loans on tangible, moving, realizable values which have been created by labor. They violate their natural reason for existence whenever they attempt to manufacture, by any means whatsoever, a supply of credit over and above that which the actual goods in hand allow. That is why a jealous watch must be kept to safeguard our Federal Reserve System, which if untampered with, will see the country through the present period of readjustment along sound and economic lines.

Federal Reserve's Value Already Proved

THE Federal Reserve Banks have justified every hope up to date. Without them the heavy financing of the war would have been extremely difficult. They give the people of the United States the assistance of a strong Reserve banking system with the entire strength of the nation behind it, while at the same time the intimate personal touch of local banks and their customers is in no sense hindered, but on the contrary, the ability of the small banks to aid their depositors and borrowers is tremendously enhanced.

Banking in the United States today rests on a far sounder and more thoroughly economic foundation than at any previous time in the country's history; the part which the American people will assuredly play in the important financing operations of the world henceforth will find the country's banking system thoroughly able to adequately do its share.

Facilities of The Trust Department

ANOTHER development of American banking by which national banks have been able to round out their facilities to their clients has been the amendment to the Reserve Act permitting national banks to exercise trust powers. During recent years there has been a marked inclination to look to banks for the performance of trust powers rather than to place dependence on individuals, and the rapidly growing desire to extend the benefits of thrift and savings beyond the lifetimes of their owners makes this added provision of national banking service of the greatest value.

It is so clear that a bank, with its existing facilities for the safe and economical conservation of funds, offers ideal equipment for the exercise of trust powers that persons desiring to create trusts or use any of the facilities conferred by law on trustees have been quick to avail themselves of the opportunity now offered under the Federal Reserve System.

One of the strongest incentives toward using national banks for this purpose has been the knowledge that all trusts administered by them would be under Federal supervision. Stringent regulations governing the conduct of national banks in the administration of trusts have been drawn by the Federal Reserve Board; they assure that all the duties undertaken by the banks in their trust departments will receive experienced and competent attention and will be at all times under the direct watchfulness and examination of the United States Government. These regulations include:

1—Provision that the work of the Trust Department be performed entirely separately from that of the bank's other work.

2—Provision that securities and investments held in trust be kept segregated from the securities owned by the bank, and be in the joint custody of two or more of the bank's officers, specially designated by the Board of Directors.

3—Provision calculated to thoroughly guard the investment of funds held in trust.

4—Provision that examiners, designated either by the Comptroller of the Currency or the Federal Reserve Board, make periodic audits of the Trust Department's cash, securities, accounts and investments.

The right to establish a Trust Department means that a national bank is now able to extend to its clients a service that goes beyond the span of a single life. It may act as trustee under the will of a client, and thus extend to his estate and his heirs the same business judgment and financial responsibility on which the client was accustomed to rely during life.

Besides the services which the Trust Departments of national banks may perform for individuals, there are many services peculiar to corporations which may be performed. These services, because of the extreme complexity of modern business, are practically indispensable.

The many vicissitudes surrounding the life of the individual trustee are practically overcome when a bank becomes the trustee. As executor or trustee, or in any other status permitted by law, its services are available every business day of every year. Its financial responsibility stands as a final safeguard for the property entrusted to its care. Thus, with the rapidly growing use of trusts, a bank's peculiar fitness to serve has come to be generally recognized and accepted. Its integrity and ability in financial matters, and its constant experience as a financial manager have all combined to give a bank an unusual equipment for making trust services easily, safely and economically available.