The Cost of Fed Membership

By Helen Fessenden and Gary Richardson

Since the Federal Reserve's founding, it has paid a regular dividend to banks that are Fed members in exchange for those banks holding stock in Federal Reserve Banks. Recent transportation legislation reduced these dividends and used the savings to help fund the bill. While this move provided a short-term financing fix, it also raised a bigger question of whether banks will want to remain members of the Fed.

Federal transportation legislation may seem like an unusual place to address the Federal Reserve's functions and operations, including its relationship with member banks. But that is what happened last December, when President Barack Obama signed a comprehensive transportation bill that boosted funding substantially across many categories. On the one hand, the law was good news for the nation's aging highways, tunnels, and bridges. But it also tapped an unorthodox source for some of its financing: the Federal Reserve System. Rather than raise the gas tax, the traditional source of highway funding, lawmakers opted to take some money that the Fed would otherwise have paid to its member banks in the form of dividends. They also took a much bigger sum from the Fed's surplus account. Over the legislation's five-year authorization, the amount from the Fed surplus account will total $33 billion, while the dividend-payment savings will come to $2.7 billion—together financing more than 10 percent of the highway law's total cost.

Outside the banking industry, many Americans had been unaware that the Fed paid dividends to banks until the highway bill hit the news. In fact, these payments have been central to the relationship between the Federal Reserve System and commercial banks since the Fed's founding in 1913. The dividend was a key part of a bundle of benefits and costs that came with Fed membership. Under this arrangement, the Reserve Banks paid member banks a dividend amounting to 6 percent on the stock that the Federal Reserve Act required member banks to pay in to the Reserve Bank in their district.

Under last year's law, however, Congress cut the dividend from 6 percent to the current 10-year Treasury rate (now less than 2 percent) for banks with assets more than $10 billion; smaller banks continue to receive the historical return. This measure marked a compromise over an earlier draft of the bill, which had cut the dividend to 1.5 percent and exempted only banks with assets less than $1 billion. In that version, the total five-year savings from the dividend cut would have come to $17 billion instead of $2.7 billion. Amid heavy lobbying by banks, Congress scaled back the scope of the dividend provision and found an alternative financing source in the Fed surplus account.[1] These moves drew criticism from senior Fed officials for setting a poor precedent on fiscal policy and impinging on Fed independence.[2]

Given the relatively small sum of the dividend provision, it may be tempting to dismiss its significance. But a closer look at the history of the Fed-bank relationship shows that the value of these dividends is greater—and more complicated—than just the dollar amount. These payments are part of a long-running story: the Fed's challenge, over time, to encourage banks to join and stay in the Federal Reserve System to reduce the risk of what is now known as "shadow banking."

Shadow banks perform similar functions as commercial banks without joining the Federal Reserve System or being regulated by it. In the 1920s, this financial activity was concentrated in the state-chartered bank and trust companies, which declined to join the Federal Reserve; in the 1980s, it took off in the savings and loan institutions and money market mutual funds; and most recently, it was seen in the explosive growth of mortgage lending and the securitization boom ahead of the 2007–08 financial crisis. In effect, the dividend payments are one piece of a larger debate: how much financial activity will take place in institutions regulated by the central bank, and how much will occur outside that regime?

Costs Versus Benefits?

Of all the challenges facing the Fed's founders, one of the toughest was how to bind all commercial banks together in a nationally supervised organization that would be responsive to different regional needs. During the rapid economic growth before World War I, banking activity sharply increased, especially among small banks that took a state, rather than national, charter. From 1906 to 1913, the number of state banks grew 65 percent while their combined assets rose 46 percent; among national banks, by contrast, that growth was only 24 percent and 42 percent, respectively. State banks enjoyed several advantages over national banks that drove this surge, including the ability to make real estate loans, fewer restrictions on branching, lower capital requirements, and more relaxed supervision.[3]

Most of the drafters of the 1913 Federal Reserve Act believed the United States would be better off if all commercial banks belonged to the Federal Reserve System. However, they were also political realists and did not believe that Congress would compel all banks to join. In addition, the Fed's founders had to find a way to finance the establishment of 12 regional Reserve Banks without using taxpayer dollars, which would have been politically unpopular. Finally, they had to figure out how to collect enough gold to back Federal Reserve notes (dollars).

Congress settled on a voluntary membership model: nationally chartered banks were required to join, state-chartered banks were not, and national banks that did not want to join were allowed to switch to state charters. Banks that wanted to join the Fed had to purchase stock in their district's Reserve Bank equal to 3 percent of their capital and surplus. An equal amount was placed "on call" at the behest of the Federal Reserve Board, which, at any time it believed necessary, could compel commercial banks to double their stock holdings.

This stock served as the initial capital for the regional Reserve Banks. It also paid the Fed's operating expenses for its first few years, until the Reserve Banks earned sufficient amounts to pay for themselves. Another important requirement was that commercial banks had to pay for their stock subscriptions in gold. This provision transferred much of the nation's gold reserves from commercial banks to the Fed, enabling it to issue notes backed by gold, as federal law demanded.

Meanwhile, commercial banks that joined the Fed received a dividend on the stock that they purchased. The annual dividend was set at 6 percent and was cumulative, meaning that if a Reserve Bank did not earn enough to pay dividends to member banks in one year, it could make up the missed payments in future years. Congress set the dividend rate comparable to the rate of return on similar investments, which had some risk in the short run, but which seemed like a reasonably good bet in the longer term. This rate was comparable to European central banks, which had raised capital for their operations using a similar model and generally offered returns on their stock of 4 percent or 5 percent. The dividend was also close to the rate of return on the gold with which banks were compelled to make the purchase. From 1913 to 2013, in fact, gold earned an average annual return between 4 percent and 5 percent.

The only problem was that this idea didn't work once the Fed was up and running. To be sure, the Fed succeeded on other core mandates, including establishing a national payments system and creating a market for bank assets. But it failed to attract state banks as members in significant numbers. At the end of the Fed's first decade, fewer than 8 percent of state banks had joined the System. Over the years, subsequent laws tried to make Fed membership more attractive by cutting the amount of notice a state bank had to give if it wanted to leave the System (from 12 to six months), among other inducements. Still, most state banks opted out of the Fed through the 1920s, and most new banks chose to be state, rather than national, institutions. Most of the growth in lending was concentrated in state banks as well.

To Paul Warburg, the German-American financier who was one of the intellectual framers of the Fed, this risk of a dual banking system threatened to undermine broader financial stability.

How can non-member banks "justify themselves in staying out the system and in throwing the entire responsibility and burden upon the shoulders of the national banks and those few trust companies and state banks that have become members?" asked Warburg, speaking to a bankers' group in 1916. "They do not contribute their fair share of gold to the general reserve fund of the nation, nor do they provide their share of the capital to the Federal Reserve Banks."

"Not only do they fail to contribute their share of strength to the system, but, unconsciously perhaps, they become forces that make for the direct weakening of its strength and efficiency," he warned.[4]

The Rise of Shadow Banking

Among the banks that opted out, the belief was that the advantages of Fed membership—namely, the dividend payments and access to the Fed discount window—weren't enough to offset the costs. For example, Fed members had to adhere to higher reserve requirements and couldn't earn interest on those reserves, whereas non-members could hold less in reserves and earn up to 2 percent interest. Non-members could charge for check-clearing, whereas members could not. In addition, Fed regulation was often seen as more onerous than state regulation. As for the discount window, many non-member banks were able to access it indirectly through their ties with correspondent banks that were members, so they viewed formal Fed membership as unnecessary.[5]

The imbalance between incentives and disincentives meant that the banks that did join the Fed tended to be large institutions that were attracted to discount window access as a way of getting more deposits from non-member banks; these banks tended to be big enough to absorb the extra compliance costs, and were well-positioned in the interbank network. Membership also was compelling to banks that had great fluctuations in seasonal loan demand from farmers because the discount window eased their liquidity risk. But small banks that encountered less seasonal loan fluctuation, and that were close to Fed member banks that could provide discount window access, could easily borrow from the latter and were less likely to join.[6]

As for the dividends, they didn't have a big role during the banking debates of the day once they became routine for member banks. But they indirectly played into the broader issue of low membership rates among state banks as concerned policymakers sought ways to address the Fed's poor record in encouraging universal bank membership. In 1928, one of those policymakers, Sen. Carter Glass (D-Va.), tried to advance a measure that would raise the annual dividend payments to banks from 6 percent to 10 percent to 15 percent (depending on the Reserve Bank) with the difference coming out of the Fed surplus account. His measure failed, however.

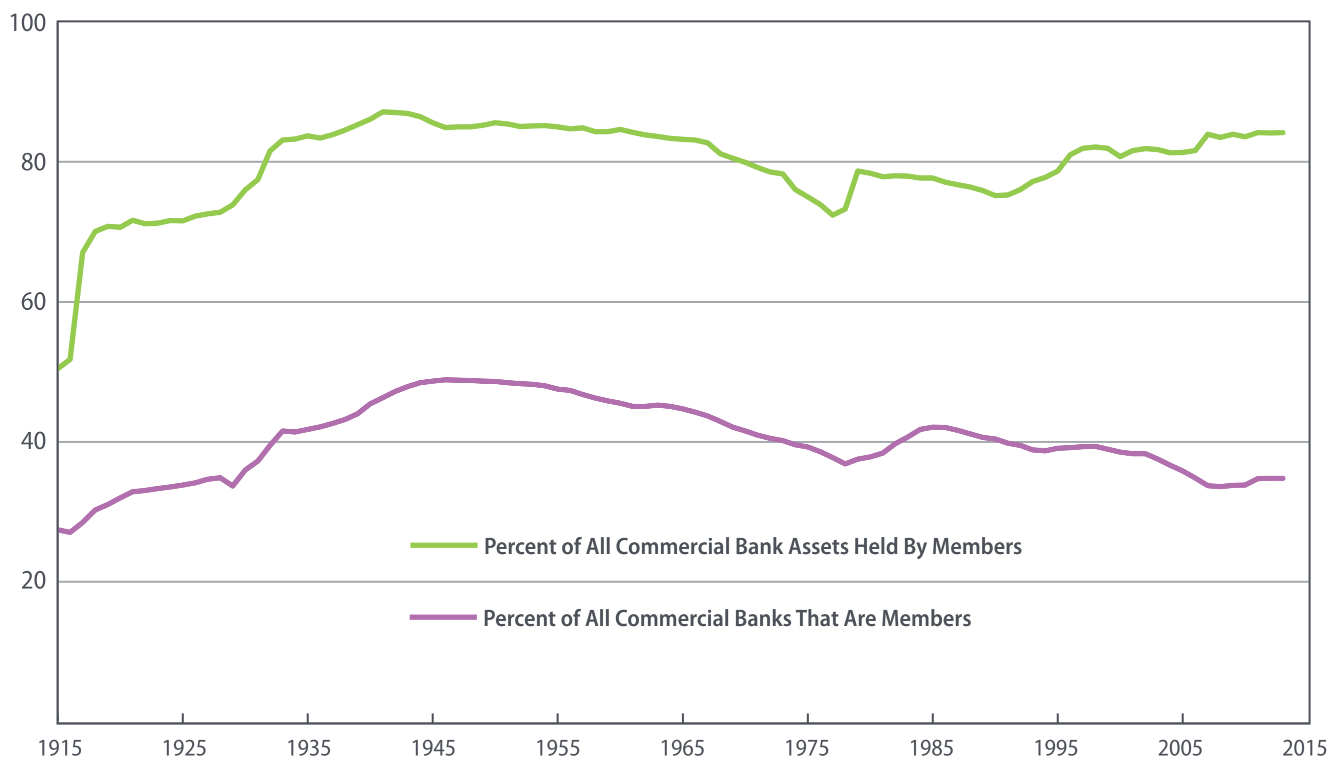
Fifteen years after Warburg's warning, the Fed's failure to attract state-bank members played a part in the collapse of the financial system during the Great Depression. The commercial banking crises that prolonged the initial contraction began among non-member banks. At the time, the Federal Reserve System was unable to craft a unified response that could have helped all institutions, such as rediscounting and open market operations. Instead, Fed leaders disagreed on the extent to which the Fed could and should aid non-member banks.[7] These debates partly reflected concerns about the System's obligations to financial institutions that did not contribute to its upkeep or submit to its regulations. As non-member banks failed in greater numbers than member banks, the portion of all commercial banks that were members increased from less than 34 percent in 1930 to nearly 49 percent in the 1940s. (See Figure 1.)

The bank membership divide affected another debate: whether collateral originating at or passing through non-member banks was eligible at the Reserve Banks' discount windows or for purchase on the open market. The legality of this practice was questionable. Some Reserve Banks — particularly Atlanta and New York—occasionally accepted collateral originated by non-member institutions. Other Reserve Banks and the Federal Reserve Board, however, did not.[8] In turn, contagion among non-member banks eventually afflicted Fed members. But by then, the Fed lacked the resources, and perhaps the will or knowledge, to prevent a complete collapse.

A Bigger Club

Since the Great Depression, the banking industry has undergone profound changes. In 1933, the Roosevelt administration established the Federal Deposit Insurance Corporation, which expanded federal supervision to most commercial banks. Later, in 1980, the Monetary Control Act allowed the Fed to open its

Figure 1: Federal Reserve Member Banks as a Percent of All Commercial Banks



Sources: Member-bank data for 1915 through 1970 come from the Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics*. Non-member-bank data for 1915 through 1970 come from the U.S. Census Bureau, *Historical Statistics of the United States, Colonial Times to 1957*, and from annual reports of the Board of Governors and the Federal Deposit Insurance Corp. Data for 1971 through 1977 come from the Board of Governors, *E.3.4 Domestic Offices, Insured Commercial Bank Assets and Liabilities Consolidated Report of Condition* (various issues). Data for 1978 through 1979 come from FDIC annual reports, and data for 1980 through 2014 come from annual reports of the Federal Financial Institutions Examination Counci.

Notes: Beginning with 1980, data are for insured commercial banks, but uninsured commercial banks held only a tiny percentage of commercial bank assets by 1980. Data from the Board of Governors' annual reports only include principal balance sheet items, so reported total assets of non-member banks suffer some downward bias from 1958 through 1968.

discount window to all banks, not just member banks. The Act also required all depository institutions, not just member banks, to set aside reserves. In 2008, the Fed began paying interest on all bank reserves as well. Due to such changes, the formal distinction between membership and non-membership matters less today than it used to. At the same time, the federal government's scope of banking supervision and regulation is far wider, due to the FDIC and subsequent legislation such as the 2010 Dodd-Frank reforms.

While much has changed, however, some things remain the same. Today, only about one-third of the nation's 6,348 banks, including the 10 biggest institutions, are members of the Federal Reserve. Furthermore, a substantial share of banking activity has migrated to institutions such as money market mutual funds, which act in many ways like commercial banks but operate outside of the supervision of the Federal Reserve and other bank regulators.

Throughout the decades, however, the dividends paid to member banks have been a constant and, for the most part, unchallenged component of the relationship between the Fed and commercial banks. Between Glass's proposal in 1928 and the 2015 highway legislation, there is only one case on the record where Congress considered a measure regarding Fed dividends. In 1964, Rep. Wright Patman (D-Texas) unsuccessfully proposed to discontinue the dividends and send the savings to Treasury. Fed Chairman William McChesney Martin Jr. spoke out against the idea, arguing that the bank stock contribution, while not "indispensable" to the Fed, helped integrate banks into the System. If the dividends ceased, he added, some might view the change "as a step toward nationalization of the banking system" or as "significant portent of basic monetary changes."

Today's political environment is a far cry from the 1960s, however. By the summer of 2015, as Senate negotiators were looking for a way to fill a financing gap in the long-stalled highway bill, they came across an idea that some House Democrats had first pitched a year earlier—to cut the Fed dividend to 1.5 percent for most banks and divert the savings to help fund the legislation. The lawmakers pointed out that in 2014 the Fed paid dividends totaling $1.7 billion, with the lion's share going to big banks such as Bank of America ($310 million) and Citi ($250 million) – banks that, by virtue of their size, are the biggest stockholders in the Fed. Banks lobbied against the proposal, and Congress responded by cutting the dividend by a lesser amount and exempting far more small banks than originally proposed. Lawmakers, reluctant to raise the gas tax or look to other sources of revenue, found the remainder of the money needed to fund the transportation bill from the Fed's surplus account.

At the end of the negotiations, the amount of money at stake with the dividend cut was small. But the impact is still being played out as many banks are reconsidering the broader Fed-bank arrangement that was set up in 1913. Indeed, just as Fed officials had warned of "unanticipated consequences" of the highway bill, shifts in this relationship may already be underway.

As a case in point: just days after the highway legislation was enacted, as Congress took up a year-end spending bill to fund government agencies, banks pushed a measure to cut the amount of stock that large banks would have to hold at the Fed in "paid in" capital, from 3 percent to 0.5 percent. The proposal's financial effect would have been far bigger than the dividend cut, sending about $25 billion back to banks and leaving about $5 billion at the Fed. The proposal also would have limited the Fed's ability to demand the full 6 percent of capital, and it would have allowed small banks to choose whether they wanted to follow the example of their larger counterparts and take back their Fed stock.

The measure was shelved, but it may return this year. Just as importantly, it has prompted new questions from the banking industry. As one bank lobbyist recently told the *Wall Street Journal*, "This is not something that we … even thought about until the highway bill passed. If we're not getting the dividend we signed up for … do we need this entire system anyway?"

Indeed, the lobbyist's question of Fed membership remains relevant more than 100 years after the Fed's founding. There is no modern example to shed light on what might happen if banks decide Fed membership is no longer worth it. Nor is it clear what the consequences—intended as well as unintended—may be if member banks start leaving the System in substantial numbers. But what is clear is that a large decline in membership would directly challenge Warburg's prediction that "the future will belong to those banks—national or state—that are members of the Federal Reserve System."■

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Endnotes

1 For a more detailed discussion of the history and purpose of the Fed surplus account, please see the upcoming issue of the Richmond Fed's *Econ Focus* magazine. For an analysis of the transportation law, also known as the Fixing America's Surface Transportation (FAST) Act, see Robert Jay Dilger, "Federalism Issues in Surface Transportation Policy: A Historical Perspective," Congressional Research Service, December 8, 2015.

2 Fed Chair Janet Yellen commented on the financing provisions of the transportation bill as she spoke during congressional testimony; see Vicki Needham, "Yellen Concerned About Use of Fed Surplus for Highway Bill," *The Hill*, December 3, 2015. As the bill was advancing, Vice Chair Stanley Fischer called those measures "dangerous"; see David Harrison, "House Highway Bill to Use Fed Surplus Account for Funding," *Wall Street Journal*, November 5, 2015. And former Fed Chair Ben Bernanke called the measures "budgetary sleight of hand" in his Brookings Institution blog post on November 9, 2015.

3 In the early 1930s, the Federal Reserve Committee on Branch, Group, and Chain Banking prepared a report on the rise of state-chartered banks, "The Dual Banking System in the United States," which is available on the Federal Reserve Archive at www.fraser.stlouisfed.org.

4 See Paul M. Warburg, "The Federal Reserve System and the Banks," Address prepared for the New York State Bankers Association Convention, June 9, 1916.

5 See Charles W. Calomiris, Matthew Jaremski, Haelim Park, and Gary Richardson, "Liquidity Risk, Bank Networks, and the Value of Joining the Federal Reserve System," National Bureau of Economic Research Working Paper No. 21684, October 2015.

6 See Calomiris et al.

7 See Gary Richardson and William Troost, "Monetary Intervention Mitigated Banking Panics during the Great Depression: Quasi-Experimental Evidence from the Federal Reserve District Border, 1929 to 1933," *Journal of Political Economy*, December 2009, vol. 117, no. 6, pp. 1031–1073.

8 The Federal Reserve Board did not directly make discount window loans, but under the Federal Reserve Act, it had the authority to determine whether Reserve Banks could accept paper originated by non-members as collateral. In effect, in this one small area of discount lending in the Fed's early years, the Reserve Banks and the Board had joint decision-making authority.