BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

February 18, 1944

Subject: Absorption of Exchange.

To the President of the Bank Addressed:

Enclosed is a facsimile of the report of the Committee on Banking and Currency of the House of Representatives on H. R. 3956, which contains the majority and minority views of its members. A reading of both the majority and minority sections of the report should assist in clarifying the issues that are involved in the proposed amendment to the Federal Reserve Act in H. R. 3956 and its companion bill, S. 1642. Because of the importance of this measure to the banks of the United States, the Board of Governors, which is charged by Congress with responsibility for enforcing the law with respect to the payment of interest on demand deposits by member banks, has instructed me to furnish a copy of the report for your information.

One member of the Committee signing the minority report requested that reference also be made to the following excerpt from a letter filed as part of the record of the hearing but not incorporated in the report: "* * * This matter of exchange charges is nothing but a 'gouge', a kind of racketeering against the depositors of banks, and, against the commerce and industry of the Nation."

You previously have been furnished with a copy of the Board's report to Senator Wagner, Chairman of the Banking and Currency Committee of the Senate, on the companion bill, S. 1642. The views of Senator Carter Glass are set out in the report of the minority. The views of the Treasury and of the Federal Advisory Council on this subject will be sent you upon request.

Very truly yours,

Chester Morrill,
Secretary.

Enclosure

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78TH CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
2d Session } { No. 1126

AMENDMENT TO THE FEDERAL RESERVE ACT RELATING TO THE ABSORPTION OF EXCHANGE AND COLLECTION CHARGES NOT BEING PAYMENT OF INTEREST ON DEPOSITS

FEBRUARY 15, 1944.—Committed to the Committee of the Whole House on the state of the Union and ordered to be printed

Mr. SPENCE, from the Committee on Banking and Currency, submitted the following

REPORT

[To accompany H. R. 3956]

The Committee on Banking and Currency, to whom was referred the bill (H. R. 3956) to amend the Federal Reserve Act, as amended, to provide that the absorption of exchange and collection charges shall not be deemed the payment of interest on deposits, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

STATEMENT

THE PURPOSE OF THE BILL

The purpose of the bill as reported is to permit member banks of the Federal Reserve System to continue their long-standing practice of absorbing the expense of exchange and collection charges imposed by other banks on check clearings, which a recent ruling of the Board of Governors of the Federal Reserve System proposes to outlaw.

THE PRESENT LAW AND THE FEDERAL RESERVE BOARD'S INTERPRETATION

The twelfth paragraph of section 19 of the Federal Reserve Act, added by the Banking Act of 1933, section 11b, provides (with certain exceptions) that no member bank shall, directly or indirectly, by any device whatsoever, pay any interest on any deposit which is payable on demand.

The Federal Reserve Board has ruled that absorption of exchange or collection charges by member banks is a device for the payment of interest within the prohibition of this section.

The ruling of the Federal Reserve Board related only to a particular bank, but it has been made applicable, in practice, to all member banks and has been used widely in recent weeks by Federal Reserve banks and national bank examiners to eliminate the practice of absorbing exchange regardless of the circumstances under which a bank may be absorbing exchange. This ruling has met with widespread opposition among State bank supervisors and bankers; and it is particularly inappropriate at this time when bankers are devoting their time and energies to the war effort, including ration banking, war-loan drives, and similar activities.

EXCHANGE AND COLLECTION CHARGES

Exchange charges are service charges imposed by banks, primarily against other banks, for remitting funds in settlement of checks and drafts forwarded to them for collection or payment, where settlement is necessary at a place other than that at which the remitting bank transacts business. Collection charges are service charges imposed by banks for handling the collection of commercial instruments. Both by express statutory regulation in a number of States as well as by long custom in others, exchange charges have been imposed at a rate of one-eighth or one-tenth of 1 percent of the total face amount of the checks and drafts presented. The clearings for most banks which are not members of the Federal Reserve System are handled by their city correspondent banks whereas member banks customarily clear through the Federal Reserve banks.

City banks acting as collecting or clearing agents for country banks customarily have paid these service charges and have absorbed the expense thereof as part of their operating overhead. The effect of the recent ruling of the Federal Reserve Board is to compel member banks, which have been heretofore absorbing these expenses, to charge them back to the other banks for which they act, or to their individual customers, with the result that the depositing public must bear an additional cost which until now has been absorbed as an operating expense by the commercial banking system, just as the Federal Reserve banks now absorb for their member banks the cost of clearing checks and transferring currency or funds for their account.

There are approximately 2,500 banks in the United States which derive a substantial part of their operating revenues from exchange charges. These institutions, in most instances, are small, locally owned, independent banks, operating in rural communities. They are in every sense not only small businesses, but are the financial institutions which serve small business. They are, in most cases, the only financial institutions serving their communities. By and large these institutions must keep their legal reserves and surplus funds (i. e., cash funds) on deposit with city banks. Since the city banks derive a substantial benefit from the deposits which they carry for other banks, they are well able to absorb these expenses, without passing them back to the public and many were doing so until prevented by the Federal Reserve Board's ruling.

SUPPORT FOR THE BILL

State bank commissioners and supervisors from many States have given their support to the bill, principally on the ground that it will

prevent widespread disturbance of depositor relations with country banks which otherwise would result from the Federal Reserve Board's ruling and will also avert the liquidation of many small banks.

Bankers generally support the bill because they believe the Reserve Board's ruling will have the effect of depriving many country banks of earnings from exchange which is necessary to enable them to continue in operation. Some bankers have pointed out that the Reserve Board's ruling imposes upon banks the burden of keeping detailed records of exchange charges at a time when, with greatly reduced personnel, they are performing many important functions for the Government. The accounting cost to banks of charging these expenses back to their individual depositors, in many instances, exceeds the amount of the charges themselves.

It has been the almost unanimous opinion of bankers operating small banks that the effect of the restriction upon absorption of exchange charges will be to create a severe disturbance in their relations with their depositors. This is borne out by the evidence produced at the hearings that some nationally known business houses have notified their patrons that they will no longer accept checks on banks which charge exchange because member banks are no longer permitted to absorb the exchange charges.

Most of the 2,500 banks adversely affected by the ruling are insured by the Federal Deposit Insurance Corporation. That Corporation has expressed concern over the effects caused by the Federal Reserve Board's ruling upon the operations of these banks. The Corporation believes that a number of banks probably will be forced to discontinue business unless this bill is passed. The Federal Deposit Insurance Corporation has given unqualified support to the measure.

The committee believes that the proposed bill will carry out the intention of the Congress in enacting the present law and will simply nullify an erroneous administrative interpretation thereof.

The Federal Reserve Board's ruling was predicated upon the provision in the Banking Act of 1933 which prohibits the payment of interest on demand deposits by any device. None of the evils sought to be eliminated by prohibiting the payment of interest on demand deposits appears to be present in the practice of absorbing exchange. Nor is it fair to assume that the mischief sought to be remedied by the interest prohibition will be revived, if absorption of exchange is permitted to continue. The suggestion that acquiescence by Congress in the practice of absorbing exchange will lead to an unnatural growth in bankers' balances, appears to the committee to be wholly unfounded. The committee believes that the supervisory powers of the Federal banking agencies under existing law, if intelligently and judiciously used, are adequate to deal with any banking problems of this character which may arise, regardless of cause. The evidence submitted by the Federal Reserve Board to the effect that other bank deposits had increased by 70 percent between 1940 and 1943 while interbank deposits had increased by only 7 percent during the same period has satisfied the committee that there is no genuine danger of injurious expansion of bankers' balances.

The committee is of the opinion that neither the Seventy-third Congress in enacting the Banking Act of 1933, nor the Seventy-fourth

Congress in enacting the Banking Act of 1935, which acts contain the interest regulatory laws, intended to affect the practice of absorbing exchange or to authorize the Federal Reserve Board to do so. This practice had been in existence for a great many years and had always been recognized as a practice wholly separate and distinct from that of paying interest on deposits. The committee observes that Congress expressly prohibited the payment of interest but made no reference to the absorption of exchange. The committee reports, debates, and testimony relating to the 1933 and 1935 Banking Acts give no evidence of any intention to permit disturbance of the then well-known practice of absorbing exchange. After 1933, the practice of absorbing exchange continued openly and without substantial interruption or interference until January 1, 1944, at which time many correspondent city banks, compelled by the Federal Reserve Board's new ruling, notified their bank customers and other depositors that they were no longer permitted to absorb exchange. Thus we have a situation of an administrative ruling interpreting a law more than 10 years old so as to prohibit an established banking practice which has continued up to the present—a practice peculiarly adapted to the customs of a large group of small banks, many of which may be forced to liquidate if such interference with their operations is not discontinued.

Under the Banking Act of 1935 the Federal Deposit Insurance Corporation was required by regulation to prohibit, and has by regulation prohibited, the payment of interest on demand deposits in insured nonmember banks. This Corporation has issued a ruling that absorption of exchange is not a device for the payment of interest, thus taking a view of the law diametrically opposite from that taken by the Board of Governors of the Federal Reserve System. Its view is that Congress did not authorize either agency to affect or regulate the practice of absorbing exchange under the guise of enforcing the interest prohibition. As the supervisory powers of these two agencies affect different segments of the banking system—the Federal Deposit Insurance Corporation supervising insured nonmember banks and the Federal Reserve Board being concerned with member banks—these two divergent rules have created an imbalance in the regulation and supervision of banks, which this committee believes should be corrected.

QUESTION OF PAR CLEARANCE

The Federal Reserve Board has conceded that the matter of exchange absorption is inextricably related to the issue of par clearance of checks, that is, the remittance between banks of funds in settlement of bank clearings without charging exchange. The committee believes that the Federal Reserve Board's ruling tends to force universal par clearance. Par clearance is one of the most controversial subjects in the history of modern banking, and enforcement thereof against nonpar banks would cause far-reaching economic changes throughout the country. Therefore, the committee is of the opinion that if universal par clearance is to be achieved, it should be by congressional enactment and not by administrative interpretation. However, the committee believes that it would be most unwise to open the par clearance issue at this time.

BILL PROTECTS SMALL BUSINESS AND PRESERVES STATES' RIGHTS

The committee believes that the enactment of the bill is manifestly in the interests of the small, independent banking institutions of the country as well as in the interests of the small business concerns which these institutions serve.

Loss of income from exchange charges coming at this time would be particularly disastrous to many small banks. On the average the nonpar banks would have their profits reduced by two-thirds, which would bring them to levels far below those of the member banks. At least half of the nonpar insured banks would either be stripped of their entire profits or would have them seriously reduced.

If nonpar banks were to seek to replace the income from exchange charges by imposing additional service charges, the heavy burden thereof would virtually deny banking facilities to small depositors. As these small depositors constitute most of the nonpar banks' customers, this would seriously impair the usefulness of these banks to their communities. A comparison of income from service charges for various groups of banks is shown in the following table:

Service charges per $100 of demand deposits 1942

National banks	$0. 28
State member banks	. 30
Nonmember banks	. 30
Nonpar banks:	
Actual	. 27
Amount necessary to maintain profit without exchange charges on remittances	1. 04

Nor could nonpar banks replace their income from exchange charges by increased investment in United States Government obligations. Such investment, if in Treasury bills at three-eighths percent, would require investment of three to four times the banks' present holdings of "cash and due from banks"; if in certificates of indebtedness at seven-eighths percent, 1⅓ times their actual holdings of "cash and due from banks" would be required; if in United States Government obligations yielding 1 percent, 1⅙ times their "cash and due from banks" would be required; and, if in obligations yielding an average of 1½ percent, four-fifths of their "cash and due from banks" would be necessary. In other words, in most instances the banks would have to invest more funds than they have available for investment. Even investments yielding 1½ percent would leave most of the banks with cash resources not only below the limits of prudence but also below the actual minimums required by State laws. The banks would thus be in such position as to be unable to serve the daily needs of their communities.

Moreover, bankers have testified that, after taking care of all proper local credit needs, they have been buying United States Government securities to the maximum extent consistent with prudence, with United States Treasury policy, and the cash requirements of their customers. Nevertheless, because of the unprecedented rate of increase of their customers' deposits and the rapid repayment of their outstanding loans, due to wartime conditions, their interbank balances have increased.

The ruling of the Federal Reserve Board is a direct blow at the dual-banking system. By protecting the 2,500 small, State-chartered

banks from having their method of doing business interfered with by a Federal agency which has neither supervisory control over nor responsibility for them, Congress will preserve the rights of the States to maintain their independent banking system.

BILL DOES NOT CHANGE EXISTING PRACTICES

The bill does not change existing practices among banking institutions nor validate a practice heretofore proscribed; the bill serves only to preserve the status quo and to allow the practice of absorption of exchange to continue as it has for a great many years and to eliminate the legally questionable ruling of the Board of Governors of the Federal Reserve System which would terminate such practice. The bill does not require any bank to absorb exchange charges if it does not wish to do so.

PROMPT LEGISLATIVE ACTION ONLY FEASIBLE SOLUTION

Although it would appear that the provision against the payment of interest upon demand deposits when enacted into the present law, was not intended to prohibit member banks from absorbing exchange or collection charges nor to authorize its prohibition, it is the opinion of this committee that the problem created by the Federal Reserve's administrative ruling can be resolved only by an express provision to that effect in the law. In this sense the present bill is no more than a technical amendment to the law wihch leaves the intent of Congress no longer open to dispute.

The committee recommends the speedy enactment of the bill as it believes that such action is necessary to set at rest a troublesome situation which has created much agitation among banks. Considerable publicity has been given both to the ruling of the Federal Reserve Board and to the testimony given at the hearings on this measure. Numerous witnesses were heard and many statements were submitted by bankers who could not wait to be heard. The hearings extended over a period of 13 days. Even as this legislation is being considered, the Federal Reserve's prohibition against absorption of exchange is being enforced and banks are rearranging their correspondent relationships to conform to the ruling. It is, therefore, of the greatest importance to the institutions affected that early action be taken as the banks principally and adversely affected have no judicial recourse open to them since, not being member banks, they are not directly subject to the Federal Reserve ruling. Moreover, it is not feasible for banks to contest rulings of supervisory agencies for it is self-evident that the implications of such contests are damaging to the public standing of such institutions. Consequently, they have no satisfactory redress against the ruling despite the fact that they are the real parties in interest; legislation alone will clarify the situation. Prompt action, therefore, is essential if the enactment of this bill is to achieve its purpose; otherwise, it may come too late.

The committee hopes also that the passage of this measure may serve to deter Federal agencies from making administrative rulings which have far-reaching economic effects, without clear legal authority and directions from Congress so to proceed.

CHANGES IN EXISTING LAW

In compliance with paragraph 2a of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as introduced, are shown as follows (new matter is printed in italics, existing law in which no change is proposed is shown in roman):

FEDERAL RESERVE ACT

SEC. 19. * * *

No member bank shall, directly or indirectly, by any device whatsoever, pay any interest on any deposit which is payable on demand: *Provided*, That nothing herein contained shall be construed as prohibiting the payment of interest in accordance with the terms of any certificate of deposit or other contract entered into in good faith which is in force on the date on which the bank becomes subject to the provisions of this paragraph; but no such certificate of deposit or other contract shall be renewed or extended unless it shall be modified to conform to this paragraph, and every member bank shall take such action as may be necessary fo conform to this paragraph as soon as possible consistently with its contractual obligations: *Provided further*, That this paragraph shall not apply to any deposit of such bank which is payable only at an office thereof located outside of the States of the United States and the District of Columbia: *Provided further*, That until the expiration of two years after the date of enactment of the Banking Act of 1935 this paragraph shall not apply (1) to any deposit made by a savings bank as defined in section 12B of this Act, as amended, or by a mutual savings bank, or (2) to any deposit of public funds made by or on behalf of any State, county, school district, or other subdivision or municipality, or to any deposit of trust funds if the payment of interest with respect to such deposit of public funds or of trust funds is required by State law: *Provided further, That this paragraph shall not be deemed to prohibit the absorption of exchange or collection charges by member banks.* So much of existing law as requires the payment of interest with respect to any funds deposited by the United States, by any Territory, District, or possession thereof (including the Philippine Islands), or by any public instrumentality, agency, or officer of the foregoing, as is inconsistent with the provisions of this section as amended, is hereby repealed.

MINORITY REPORT

Section 19 of the Federal Reserve Act provides that "no member bank shall, directly or indirectly, by any device whatsoever, pay any interest on any deposit which is payable on demand." This bill would relax the foregoing prohibition by providing further "That this paragraph shall not be deemed to prohibit the absorption of exchange or collection charges by member banks."

For many years it has been customary for banks to make charges for the services rendered their own customers. These charges are a matter of contract between the bank and its own customers and, by and large, are based on the bank's theoretical estimate of its own cost of doing business, including, usually, the estimated cost of handling each check the customer draws. Charges of this type have come to be known as "service charges."

Although a deliberate effort has been made to lump the two together as though they are one and the same thing, "service charges" are not to be confused with "exchange charges" with which this bill deals.

The "exchange charges" referred to in the bill are charges levied not against the bank's own customers, but are deductions from the face amount of the checks which have been drawn by the customers when such checks are presented by mail to the bank for payment. Thus when one of the customers of an exchange charging bank draws a check for $1,000 and sends it to an out-of-town payee, the bank deducts $1 from the face amount of $1,000 and pays only $999. Banks which pay their checks at face value, 100 cents on the dollar, are known as par banks. Banks which charge exchange and pay less than face value are known as nonpar banks.

It was startling to learn from the testimony of some of the proponents of this bill that some nonpar banks, particularly the larger ones, not only exact service charges from their customers for the checks which they draw but also exact an exchange charge when the same checks are presented for payment.

This bill neither subtracts from nor adds to the lawful power of a bank to charge exchange. What it does is to permit a member bank to pay the difference between the face amount of the check and the amount the exchange-charging bank paid and to credit the depositor of the check with the full face amount. This is known as the absorption of exchange and here is the way it works: Some banks, in order to attract balances from other banks or from large national accounts, are willing to pay the exchange charge rather than pass it back to the depositor. The testimony establishes conclusively that banks which absorb exchange charges do so only for customers who keep a compensating balance. For instance, such a bank will say to another bank or other customer large enough to maintain a sizable account: "If you will keep a balance of $100,000 with us, you may send to us checks which you receive drawn on nonpar banks and we will collect these checks and pay the exchange charges up to an amount equal to interest on your balance at the rate of 1 percent per annum." Or the

bank may say to the nonpar bank: "If you will keep a compensating balance with us, you may deduct $1 from every $1,000 worth of your checks which we send to you and, rather than pass this charge back to the owners of the checks, we, ourselves, will absorb it up to an amount equal to interest on your balance at the rate of 1 percent per annum." This bill would legalize this practice.

If Congress, in the Banking Act of 1933, had not provided that "no member bank shall, directly or indirectly, by any device whatsoever, pay any interest on any deposit which is payable on demand," no question would have arisen. However, no sooner was the statute effective than banks and clearing-house associations independently concluded that the practice of absorbing exchange in consideration of the maintenance of compensating balances was a violation of the law. The question of whether it was a violation immediately occurred to others. In the 6 months between the enactment of the prohibition and the end of the year the Board of Governors of the Federal Reserve System received 20 formal inquiries. In 1934 it received further inquiries, and rulings were published. In this background Congress, in the Banking Act of 1935, not only reenacted the prohibition, but, in addition, authorized the Board "to determine what shall be deemed to be a payment of interest, and to prescribe such rules and regulations as it may deem necessary to effectuate the purposes of this section and prevent evasions thereof."

We present this background because of the specious argument advanced by some of the proponents. They assert that exchange charging and exchange absorption have been practiced since time immemorial—long prior to the enactment of the Banking Act of 1933. They assert that, apart from absorbing exchange, banks also paid interest on demand deposits. From these premises it is argued that Congress dealt only with the payment of interest and not with the absorption of exchange charges and that, accordingly, the latter practice could, under no circumstances, be a "device" to pay interest or, for that matter, even to evade the statute. This ignores the fact that there is nothing ambiguous about the language of the statute and, accordingly, no reason to search the legislative history to ascertain legislative intent. We add also that the devices and tricks which the minds of men had devised were manifold and none of them were enumerated in the statute. It is plain that their argument in this respect leads to the preposterous conclusion that Congress, when it prohibited the payment of interest "directly or indirectly, by any device whatsoever", meant only such device as could be cooked up in the future and not any device already in existence and already being used.

We do not argue that some banks, from time immemorial, have not charged exchange on their incoming checks nor that some banks have not absorved exchange charges and at the same time paid interest directly on demand deposits. We do say, however, that the absorption of exchange was used precisely for the same purpose as was the payment of interest and as a device to increase the rate of interest paid. In an article appearing in the Bankers' Magazine in 1900 the writer estimated that in 1898 some banks "which were paying 2 percent interest on deposits of correspondent banks as well as extending the usual fees of par collections were actually paying 4.65

percent on the available deposits." In the proceedings of the American Bankers Association for 1911 it is said

> Par facilities for compensating balances did not mean that the items were really cleared without cost; the expense merely came out of the interest account where it was not noticed.

W. E. Spahr in a book published in 1926 devotes many pages to a discussion of the absorption of exchange charges clearly indicating that the practice was just another name for paying interest.

How then can it be said either that prior to 1933 the matter of absorption of exchange was not considered as having any relation to the payment of interest or that no such relation exists now? Certainly, the board of directors of the Federal Deposit Insurance Corporation is not of that opinion or they would not have said what they did in their ruling of December 6, 1943, as follows:

> The Board is of the view that the absorption of exchange charges by an insured nonmember bank in connection with its routine collection for its depositors of checks drawn on other banks cannot be considered a payment of interest, within the terms of the interest regulation of the Federal Deposit Insurance Corporation, in the absence of facts or circumstances establishing that the practice is resorted to as a device for the payment of interest.

Certainly, also, the Corporation's general counsel does not entertain that view or he would not have qualified his opinion that the absorption of exchange was not the payment of interest by adding—

> This opinion will not apply to cases where the particular circumstances are such as to establish that the practice has been resorted to deliberately as a device for the payment of compensation to a depositor for the use of his funds.

Moreover, if, as argued, this bill does not in anywise relax the statute but only restates what was intended by the statute, it is strange indeed that Senator Glass, the author of the original measure, has expressed his views on the merits of this bill as follows:

> My attention has been called to S. 1642, introduced by Mr. Maybank, and a companion bill in the House, H. R. 3956. This proposed legislation, in my judgment, would entirely emasculate the statute prohibiting the payment of interest by banks on demand deposits, which, you will remember, I fought for and obtained in the Banking Act of 1933. Senator Maybank's bill would authorize member banks to pay interest by absorbing exchange charges made by a comparatively small group of banks which do not pay their checks at par. Member banks of the Federal Reserve System cannot even make these charges nor do the nonmember banks who participate in the par clearance system.
>
> The bill is rankly discriminatory and lacking in frankness. Its enactment could have vicious and far-reaching effects upon the Federal Reserve System, both in the number of member banks and in the perpetuation of a par clearance system which has saved the Nation's industry, commerce, and agriculture millions upon millions of dollars. I am unalterably opposed to the bill.

Finally, the testimony developed the fact that some banks which theretofore had not absorbed exchange, immediately after the enactment of the Banking Act of 1933 commenced to solicit accounts by offering to absorb exchange in lieu of interest. We think that where exchange is absorbed as a means of compensating a depositor for the use of the depositor's funds there is no escape from the conclusion that it is a device to pay interest. Moreover, if pages 114–117 of the hearings in December 1943 are examined, it will be found that Chairman Crowley of the Federal Deposit Insurance Corporation likewise agreed with this conclusion. We are reminded of the statement of one witness as follows:

> I am not a lawyer. I do not know whether, technically, the absorption of exchange charges is a payment of interest. That is a highly technical question on

which lawyers might differ. Counsel for the Federal Reserve hold that it is, and they issued their regulation in accordance therewith. But I do know from personal experience, having been in this particular business for 36 years, having been head of a very small bank and head of a very large one, *that the absorption of exchange is used competitively exactly as interest was used before the prohibition came into effect.* [Italics supplied.]

Let us examine the record to see how the device is used.

The following is a letter addressed by one bank to prospective customers:

> Our policy of clearing direct to nonmember banks of the * * * [the State in question] and absorbing all costs, including exchange, has proven so satisfactory that we now want to offer this service to the banks of * * * [two of the neighboring States]. If enough banks in * * * [the States mentioned] want this service, we plan to send direct to around 80 percent of the nonmember banks of these States, absorbing all costs, including exchange, providing a compensating balance is carried with us. Items on member banks to be cleared without charge through the Federal Reserve Bank of * * *. The balance necessary to offset all costs figures around $2 for each $1 of nonpar items during the month.
>
> All deposits with us are kept liquid either in cash or United States Government securities.
>
> Will you kindly advise us if you are interested in this.

One outlying suburban bank, by using the device, spread its business into several States and ran its deposits from $800,000 to $8,000,000 in less than a year. Eighty-two percent of this $8,000,000 was represented by correspondent bank accounts.

Another bank has become the largest bank in any city with a population of 110,000 or less; but, of its total deposits, $90,000,000 are deposits of banks as against $38,000,000 of other individual deposits.

A bank in Palm Beach, Fla. (population 3,747), increased its bank balances from $1,290,000 in 1940 to $10,150,000 in 1943, an increase of 685 percent. During the same period its other deposits increased from $12,210,000 to $22,250,000 or 82 percent.

A bank in New Orleans increased its bank balances from $2,650,000 in 1940 to $19,250,000 in 1943, an increase of 625 percent. Its other deposits increased from $34,400,000 to $43,580,000, or 26 percent. By comparison, the bank balances held by the three largest banks in New Orleans increased only 25 percent, 31 percent, and 47 percent, respectively.

A bank in Meridian, Miss., increased its bank balances from $330,000 in 1940 to $1,390,000 in 1943, an increase of 312 percent. During the same period its other deposits increased from $3,080,000 to $5,650,000 or 83 percent.

Finally, a bank in National Stock Yards, Ill. (an incorporated town of 244 across the river from St. Louis, Mo.), has built its bank balances up to $73,750,000.

All of this has occurred during a period when over-all interbank balances remained at a stable figure. From 1940 to 1943 the over-all figure showed an increase from $10,188,000,000 to $10,895,000,000 or only 7 percent.

Whatever disagreement may exist among the supervisory agencies as to whether or not the absorption of exchange for customers keeping a compensating balance is a violation of the statute, there is certainly no disagreement among them that its use has led to unsound results. This was attested by Governors Ransom and McKee of the Board of Governors of the Federal Reserve System and Chairman Crowley of the Federal Deposit Insurance Corporation. The suggestion is made,

however, that the supervisory authorities could sit down with the management of a bank and by persuasion obtain correction. This does not seem to be in accordance with the experience to date nor would it seem that it would be likely to happen in the future, particularly if Congress, with full knowledge of what is happening, enacts this bill legalizing the practice.

So much for the question whether some banks have been absorbing exchange charges as a device for paying interest to customers who maintain compensating balances. We wish now to discuss some of the "smoke screens" which have been raised as to the motives which, it is charged, are behind the attempt to enforce the statute and the dire effects it is claimed enforcement of the statute will have on some 2,500 nonpar banks. It is charged that the real and underlying motives behind the enforcement efforts are to break down and undermine the dual system of banking; to advance and promote branch banking; and to compel a Nation-wide system of par clearance. We were surprised at the number of witnesses who testified confidently as to these sinister motives but who showed amazingly little knowledge, or no knowledge at all, of the admitted facts involved in the real question of whether interest was being paid on demand deposits by the device of absorbing exchange.

As to the motive being to break down the dual system of banking, it should be enough to say that the Federal Reserve System is based on the dual system. Of its 6,700 member banks 1,700 are State banks. Also, it will be noted that a majority of the member banks of the Federal Reserve System are small banks and many of them in the same group and equally as small as the 2,500 banks for whom the enactment of this bill is asked. Moreover, the testimony indicates conclusively to us that efforts to enforce the statute are more likely to drive members from the Federal Reserve System than into it.

It is hard to see how branch banking has much to do with the charging of exchange, the absorption of exchange, or with this bill, particularly when it appears from the testimony that some of the leading proponents are themselves branch bankers. In North Carolina alone there are 35 nonpar banks operating branches and there are 195 of such banks altogether. Compare this with the par States of Kansas and Colorado where there are no branches. Two hundred and four other nonpar banks are a part of a group or chain banking system. Sixty-five of these are in the State of Minnesota which is one of the nonpar areas.

The idea that the extension of branch banking is involved is based on the assumption that nonpar banks cannot live if they are deprived of exchange charges. The record simply does not support this claim assuming even that the 2,500 banks in question will find it necessary to discontinue entirely charging exchange.

The number of ways in which a bank may improve its position is limited. It may increase its income from investments; it may increase its income from service charges; or it may reduce its cost of operations. The Federal Deposit Insurance Corporation was asked to submit data from which the operations of nonpar banks could be compared with those of par banks of about the same size. These data are very interesting because they show that all nonpar banks are not in the small bank group which, it is asserted, this bill is to protect. It shows also that, in the case of the small banks (banks with deposits of $2,000,000 and

under), par banks uniformly keep a greater proportion of their deposits in loans than do nonpar banks; par banks uniformly keep a greater proportion of their deposits invested in Government securities than do nonpar banks; par banks uniformly keep a smaller proportion of their deposits in cash on hand and due from banks than do nonpar banks; par banks, except those extremely few banks with deposits under $100,000, obtain a higher proportion of their income from service charges than do nonpar banks; par banks uniformly pay less interest on their time deposits (both as to rate and dollar amount) than do nonpar banks; par banks, in general, pay out a smaller amount in salaries than do nonpar banks; and, finally, par banks uniformly pay out a smaller proportion of their income in dividends than do nonpar banks.

Beyond the matter of statistics there remains the inescapable and unanswerable conclusion that the two types of banks do operate side by side, the one claiming that it has to charge exchange in order to live, and the other actually living without it. It is highly significant also that banks in Iowa have managed to adjust their operations although the State of Iowa has outlawed exchange charging. As for Georgia nonpar banks, we recall the witness, who spoke for over 200 Georgia banks, stating frankly that the operations of Georgia banks would not be jeopardized at this time.

We come now to the matter of par clearance in its relation to the bill. Contrary to the claims advanced by its proponents we aver categorically that Congress, since 1914, has favored par clearance and has legislated accordingly. The Federal Reserve Act as originally enacted provided for the collection of checks through Federal Reserve banks and provided that Federal Reserve banks should receive such checks at par. Such a system was soon established although efforts to establish it met with resistance and complaints largely from the same type of banks and from the same areas which now support H. R. 3956. Organized efforts to upset par clearance were made in Congress in 1917. At that time legislation was before Congress to broaden further the collection powers of the Federal Reserve System. Senator Hardwick of Georgia offered a rider amendment to one section of this legislation. The rider had been drafted by a committee of bankers and was admittedly aimed at the defeat of par clearance by permitting member banks to charge exchange. It became known as the Hardwick amendment to section 13 of the Federal Reserve Act and, as originally offered and first passed, provided that:

> Nothing in this or any other section of this Act shall be construed as prohibiting a member or nonmember bank from making reasonable charges, based on the total of checks and drafts presented at any one time, for collection or payment of checks and drafts and remission therefor by exchange or otherwise.

However, when the public and representatives of business, commerce, industry, and other proponents of the principle of par clearance became conscious of what had happened they proceeded to make the case for par clearance. President Wilson addressed the following letter to Senator Owen who later read it to the Senate:

> MY DEAR SENATOR: I have been a good deal disturbed to learn of the proposed amendment to the Federal Reserve Act which seems to contemplate charging the Federal Reserve banks for payment of checks cleared by them, or charging the payee of such checks passing through the Reserve banks with a commission. I should regard such a provision as most unfortunate and as almost destructive

of the function of the Federal Reserve banks as a clearinghouse for member banks, a function which they have performed with so much benefit to the business of the country.

I hope most sincerely that this matter may be adjusted without interfering with this indispensable clearing function of the banks.

Sincerely yours,

WOODROW WILSON.

As a result, the amendment, upon final adoption, was changed by adding the following language: "but no such charges shall be made against the Federal Reserve banks" and it was made a matter of record that the language was added to undo what the language of the original amendment would have done.

Since then member banks have been prohibited from charging exchange on checks presented by Federal Reserve banks. In addition, checks on some 4,800 nonmember banks are collected through Federal Reserve collection facilities which likewise, under this amendment, means that they remit at par. It has been pointed out that the overwhelming majority of out-of-town checks are collected through the Federal Reserve collection system so that the practical effect of the Hardwick amendment, as finally enacted, is to prohibit all member banks from charging exchange and to require nonmember banks wishing to avail themselves of Federal Reserve collection facilities to forego making any such charges.

Of the 14,030 banks in this country 11,501 are par banks and only 2,529 are nonpar banks. The 6,738 member banks of the Federal Reserve System must be par banks in order to be members and 4,763 nonmember banks are par banks by choice. Twenty States have no nonpar banks and the great majority of nonpar banks are located in but a few States.

We cannot believe that anyone would wish to return to the old days of an unorganized, cumbersome, and expensive catch-as-catch-can collection system where checks wandered thousands of miles to reach a point next door from their origin. Yet this bill is offered for the purpose of protecting a practice which brings about this very result in the collection of checks on nonpar banks. More importantly it will tend to cause the practice to increase—to what limits no one knows nor can anyone foresee.

If this bill is enacted into law, it will be because of the pressure of a small and sectionalized minority who do not even claim that they cannot continue to charge exchange, so far as the law is concerned. Their claim is that they get by with exchange charging only because other banks absorb it and thus keep the public and their own customers from knowing that it is being charged. As one proponent of the bill, representing over 200 Georgia banks, testified: "It is the most beautiful form of revenue that they have ever had, and it is a form of revenue that you can collect with the least disturbance of public relations between you and your customer." If it is a fact that the public would not stand for such a practice, that alone is such an indictment of the case as to defeat it.

We oppose this bill because—

1. It is but a guise to permit the payment of interest under another name. If the prohibition against the payment of interest on demand deposits is to be relaxed, it should be done frankly and openly. This bill would make it possible to pay a depositor the equivalent of interest

but it would be possible only when the depositor had enough nonpar checks to justify him in maintaining a compensating balance. Depositors in this category will be, almost exclusively, banks and large national corporations. For these depositors the absorbing bank will rebate the charges. As one small banker has expressed it:

> If they do pass such a law, please have them fix it so this bank can get its seven-eighths of 1 percent in cash instead of in trade. We do not want to be paid in trade or in goods. We want to take the cash and then we will settle for the exchange, whatever it may be.

2. It is unfair and discriminatory and imposes upon member banks the cost of a practice in which they cannot engage. This bill would authorize member banks to absorb for other banks the exchange charges which equally small member banks are prohibited from charging.

In conclusion, we do not believe that the practices which the bill would legalize will remain static as claimed by its proponents. We believe that its enactment is more likely to result in withdrawals from membership in the Federal Reserve System, in an increase in the number of nonpar banks, and in an increase in the amount of exchange charges which will have to be paid either by the banking system or the public or both. For these reasons, we regret that the committee did not hear from organizations such as the American Bankers' Association and from spokesmen for the public, commerce, and industry, all of whom may be called upon to contribute to the support of nonpar banks.

We respectfully submit that this bill should not be passed.

Jesse P. Wolcott,
Fred L. Crawford,
Robert W. Kean,
Thomas F. Ford,
Wright Patman.