FEDERAL RESERVE BANK OF DALLAS

Dallas, Texas, April 6, 1944

ABSORPTION OF EXCHANGE CHARGES

To All Banking Institutions in the
Eleventh Federal Reserve District:

We invite your attention to the MAYBANK BILL (S-1642) now pending in the United States Senate and to some of the serious and far-reaching effects which in our opinion it may have on our commercial and Federal Reserve banking systems if it is enacted.

This bill, like the companion measure passed by the House over the strong protest of five members of the House Banking and Currency Committee, would amend Section 19 of the Federal Reserve Act so as to make it read in part as follows:

> "No member bank shall, directly or indirectly, by any device whatsoever, pay any interest on any deposit which is payable on demand: . . . **Provided . . . that this paragraph shall not be deemed to prohibit the absorption of exchange or collection charges by member banks."**

The underscored proviso is the proposed change in the existing law.

Historical Background

A clear understanding of this proposed legislation may be had from a brief review of its historical background. In 1933, following the epidemic of bank failures that were due in part to excessive competition among banks for deposits, the Congress amended the Federal Reserve Act so as to prohibit the payment of interest on demand deposits. In 1935, after many questions of interpretation had arisen, the Congress further amended the Act by clothing the Board of Governors of the Federal Reserve System with the specific power "to determine what shall be deemed to be a payment of interest," in the case of member banks.

Immediately following this legislation, the Board of Governors proposed the adoption of a definition of "interest" that would have included exchange charge absorptions under certain specific circumstances and which was to have been incorporated in a regulation applicable to all such cases of absorptions by member banks. The unwillingness of the Federal Deposit Insurance Corporation to apply a similar rule to the nonmember insured banks under its supervision caused the Board of Governors to drop the proposed definition of "interest" in order to avoid an unbalanced competitive situation, and, instead, to decide to rule upon cases of possible violations under the rules of general law on the basis of the facts and circumstances of each particular case.

In 1943 the Comptroller of the Currency submitted to the Board of Governors a specific case in which a member (national) bank had absorbed $18,000 of exchange charges in 1942, out of a total of $25,000 of such charges it had paid. In this case the bank had widely publicized an offer to absorb all exchange charges for any banks that would carry compensating balances with it, and the facts otherwise indicated that the absorption of exchange constituted compensation for the maintenance of demand deposits. Under these circumstances, the Board ruled that the absorptions constituted payments of interest and therefore violations of the law. THIS RULING APPLIES ONLY TO SUCH MEMBER BANKS AS MAY SIMILARLY ENGAGE IN THE PRACTICE OF ABSORBING EXCHANGE CHARGES FOR THE PURPOSE OF OBTAINING OR RETAINING DEMAND DEPOSITS. IT DOES NOT PROHIBIT NONMEMBER BANKS FROM ABSORBING EXCHANGE CHARGES. IT DOES NOT PROHIBIT ANY BANK FROM INITIATING EXCHANGE CHARGES.

Following the publication of this ruling in September, 1943, most of the larger member banks throughout the nation announced that they would no longer absorb exchange charges. These events resulted in the introduction of the Brown and Maybank bills, asking the Congress specifically to exempt the absorption of exchange charges from the prohibition against the payment of interest on demand deposits.

Fundamental Issue Involved

The important issue involved in the proposed legislation is stated in the following question:

Is it in the public interest for member banks to engage in unbridled competition with each other for deposits, by offering to pay interest on demand deposits through the device of absorbing for depositors the exchange charges involved in collecting checks drawn on nonpar banks?

We think this question should be answered in the negative.

One of the chief evils of the practice of absorbing exchange charges is that it causes a serious disruption of normal relations between banks. The lure of these absorptions diverts millions of dollars of deposits from sections of the country where they would normally accumulate, to other sections which are not natural and logical centers for the accumulation of reserve funds. The practice brings about abnormal, expensive and hazardous competition between banks.

A large number of unnatural concentrations of deposits would invite disaster in case there should ever be another banking emergency, for such deposits would be the first to take flight from the banks to which they were bound by the purely artificial ties of expediency. Furthermore, the accumulation of large deposits at considerable expense encourages speculative investment of funds which should be avoided.

A further evil of the practice of absorbing exchange charges is to cause circuitous routing of checks and delay in collection. It is believed that a return to the slower and costlier methods of collection which banks used prior to the passage of the Federal Reserve Act is not in the best interest of the banks, business, or commerce of the country.

Effect of Confusing "Exchange" Charges with "Service" Charges

The sponsors of the Maybank bill assert that the failure to enact it will deprive the nonpar banks of a type of service charges without which they cannot exist. Such an attempt to perpetuate "exchange" charges under the guise of "service" charges directly invites Federal and State regulation by law of both types of charges. It imperils the freedom of all par banks to establish by contract, without governmental interference, such service charges as they may deem necessary and as their customers are willing to pay.

Par Clearance, Branch Banking and Dual Banking System

Charges have been made to the effect that the ruling of the Board of Governors was designed to (1) force par clearance, (2) promote the spread of branch banking, and (3) bring about the destruction of the dual system of banking.

While frankly we are in favor of universal par clearance, and have been for many years, the charge that the Board designed to bring it about through this ruling is absolutely unfounded. By the Banking Act of 1933, Congress in unmistakable language prohibited the payment of interest, directly or indirectly, by any device whatsoever, on demand deposits. The Board of Governors was called upon by the Comptroller of the Currency to determine whether or not under a specific statement of facts a national bank had violated this Act of Congress. By the application of well established general principles of law to the facts, the Board was compelled to express the opinion that the absorption of exchange charges in the case at interest constituted a violation of the prohibitions enacted by the Congress against the payment of interest on demand deposits. By no possible stretch of imagination, therefore, could this be termed an "administrative ruling." It is our view that the Board of Governors did no more than to express the same opinion that would have been expressed by the courts of the country had the question been presented in a litigated case.

In the circumstances, member banks will decline to absorb exchange charges and as a result the charges will no doubt be passed on back to the depositors of nonpar banks. If the exchange charges are proper charges in the opinion of such depositors, no change in the practice of the nonpar banks will result, but if the charges are regarded as being improper, the depositors are likely to register complaints against the practice, as they are the real parties at interest. This will no doubt create a tendency on the part of nonpar banks to discontinue the making of exchange charges and to become par-remitting banks. The extent to which this may go, however, is entirely problematical.

On the other hand, the passage of the bill would create an equal, if not a stronger tendency in the opposite direction, causing banks which now remit at par to adopt the practice of charging exchange and to become nonpar banks, with a resulting increase of expense to banks and business generally and an increase in the circuitous routing of checks.

The charge that the ruling was designed to promote the spread of branch banking is fully answered in the minority report of the House Banking and Currency Committee which reads in part as follows:

> "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.
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> "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."

We share the view expressed in the minority report that nonpar banks can survive without the revenue derived from exchange charges. The claim to the contrary is untenable and is not supported by the figures which were submitted to the House Banking and Currency Committee. The tabulation provides a basis for comparing the operations of nonpar banks with those of par banks of about the same size. It shows that the average earnings of nonpar banks are slightly higher than those of par banks of similar size, but in addition, it shows that the small par banks uniformly keep a greater proportion of their deposits invested in loans and Government securities than do nonpar banks; that the par banks uniformly keep a smaller proportion of their deposits in cash resources than do nonpar banks; that the par banks, except the extremely few with deposits under $100,000, obtain a higher proportion of their income from service charges than do nonpar banks, and that the par banks pay out less interest on their time deposits than do nonpar banks. In short, the evidence is overwhelming that nonpar banks could dispense with exchange charges and still continue to operate if they would adopt policies and practices similar to those being followed by the small par banks.

As to the charge that the ruling was designed to bring about the destruction of the dual system of banking, it should be sufficient to call attention to the fact that the Federal Reserve System is based on the dual system. Of its 6,700 member banks, 1,700 are state banks. While the effectiveness of the System is dependent upon its membership, the membership of state banks is entirely voluntary. All member banks are required by law to remit at par in payment of checks presented to them by Federal Reserve banks. There are at the present time 4,800 par-remitting nonmember banks, and 2,500 nonpar nonmember banks. The September ruling of the Board in no way requires any bank in either group to join the System.

From the foregoing analysis it would appear that the injection of these charges into the discussions only beclouds the real issues and confuses the thinking about them.

The principles involved in this whole matter are so clear and are of such importance to the bankers of this district, I feel that it is proper to advise them that we are unalterably opposed to the passage of the proposed legislation and to give them our reasons for opposing it.

Sincerely yours,

R. R. GILBERT

President