

Portion of Statement of

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Before  
The Financial Institutions Committee  
of the  
Minnesota House of Representatives

Concerning  
Par Banking Legislation

February 24, 1967

What is it?

A nonpar bank is a bank that pays less than the face amount of checks presented to it through the mail. The difference between the face amount of the check and the amount paid is called exchange. It is best illustrated by an example.

Mr. Merchant of East Town buys a load of seed for \$1,000 from Mr. Farmer across the state in West Town. In payment of the bill, Mr. Merchant sends Mr. Farmer a check for \$1,000 drawn on Mr. Merchant's account at Nonpar Bank of East Town. Mr. Farmer deposits the check to his account in the Bank of West Town. The Bank of West Town then sends the check for payment either direct to Nonpar Bank of East Town or by way of a correspondent bank through which Bank of West Town ordinarily collects checks. Upon receipt of the check, Nonpar Bank of East Town charges Mr. Merchant's account the full amount of \$1,000. However, it remits to Bank of West Town only \$999 for the account of Mr. Farmer. \$1.00 is retained by Nonpar Bank of East Town as a so-called exchange charge. Understandably, Mr. Farmer is distressed, but there isn't a great deal he can do about it. First, the size of the exchange charge, although it aggregates over \$3-½ million a year in Minnesota, usually is not large enough on the individual transaction to justify the costs of prolonged correspondence; and secondly, it is not only a legal charge in Minnesota, but an accepted practice for a majority of the state banks.

Viewed in the context of normal trade relationships, it is an unusual one, for banks, like other businesses, ordinarily charge only for services performed for their customers. I say ordinarily because nonpar

banks also collect from third parties like Mr. Farmer, who are not customers of that bank as we ordinarily think of the term "customer". In reality, the person who pays the exchange charge to a nonpar bank is an innocent bystander. Obviously, it wasn't always so. During much of the 19th Century, when checks were usually paid in gold and coin, there was a cost involved in shipping the gold and coin to distant points. The cost of this transportation gave rise to exchange charges, for there was a service outside the normal course of bank collections involved. This is no longer the case. Checks are no longer paid in coin, much less gold--the latter is illegal and the former obsolete. Interbank settlements are now accomplished by bookkeeping entries in accounts with Federal Reserve Banks or correspondent banks.

C' t Where are these banks?

But there are nonpar banks left in either 14 or 15 states depending upon the date of the statistics. Except as otherwise noted, the charts I have to show you today are based upon statistics accumulated by the Federal Deposit Insurance Corporation, which is the agency that insures deposits in nearly all commercial banks. In 1965 the last nonpar bank in Oklahoma converted, reducing the total to 14. This chart shows the par/nonpar structure of United States banking. In only 6 states do the nonpar banks constitute a significant proportion.

Chart      Why legislation?

The point is sometimes made that legislation is unnecessary--that the practice is gradually disappearing. This chart indicates the sharp decline between 1919 and 1966. But the decline in numbers is no longer very fact, particularly in these states. The practice is deeply rooted in custom, and there is no reason to believe it will decline significantly without legislation. Three states, Iowa, Nebraska, and Wisconsin, have followed this route. Federal legislation has been introduced, but it seems obvious that the vitality of our state banking system will be better safeguarded by corrective legislation at the state level.

Chart      How large are these banks?

Deposits/number of banks.

Chart      Where are they located?

Where are these banks located? Seventy-five percent of them are in towns of less than 2,500 population, although they are also to be found to a degree in Twin Cities suburbs. There are 42 in the seven counties of the metropolitan area.

What is the competitive pattern?

Generally they exist in one-bank towns. In only 18 do they compete with a par bank in the same community. Incidentally, though, there are 83 par banks operating in one-bank towns, so a generalization that nonpar banking is related to the survival of small towns is not valid.

In addition to my commitment as president of the Federal Reserve Bank of this district to the economic growth of this entire district which has far more small towns than large ones, I have a personal conviction born of years of a professional practice involved in the main with small towns throughout the district that the fact some bankers collect exchange does not enhance their role in community development over that of the par banker in the same or similar towns. Many nonpar bankers, like their par counterparts, are useful, constructive and important members of their communities. I believe in small towns and their right to survive and grow, but there are too many small towns in this district doing very well without exchange revenue flowing to their banks to warrant a conclusion that the small town banks need be subsidized by the exaction from those beyond its borders of charges not warranted by the service rendered.

Chart      How important is exchange revenue to these banks?

Every bank whose deposits are insured by the FDIC has to file a periodic report with the FDIC. On this report appears a line item related to other service charges. This includes service charges assessed against depositors, exchange charges, as well as non-operating income such as income from insurance agencies, etc. It is important, though, to note that the total of these items as a part of total operating revenue has declined from 19% to 9% from 1942 to 1964.

Chart      In an effort to isolate the contribution of exchange charges to this line item, a special survey was made by the FDIC of nonpar banks on a sample basis. In Minnesota figures were obtained from 104 nonpar banks. Of the total item, exchange charges make up approximately 6.2%.

How do the earnings of nonpar banks compare to par banks?

Commercial banks generally (both par and nonpar) obtain the bulk of their income from interest earned on loans and investments, but both need supplemental income, as well. Where does this supplemental income come from? The par banks rely heavily upon service charges, whereas the nonpar banks place their reliance on exchange. There is very little difference in gross profitability. While it is true that this is related to total operating income rather than net profit, and therefore the exchange charges in many cases bulk large as a proportion of net profit, so is it true of the service charges for par banks. In visiting with Mr. Jessup about this, the problems of dealing with net profit figures instead of total operating income were insurmountable, because of the lack of comparability in expense charges and income composition. Some banks, for example, had a higher proportion of tax exempt municipals than others; some had insurance agencies and others did not; and in some, owners took out a greater share of the earnings through salaries than others.

Chart      How difficult is it to make the change?

A study was made of all banks in the United States that changed from nonpar to par in the years 1962 and 1963. There was a total of 42. Of these, 16 were in the typical one-bank rural towns. The earnings of these 16 were compared in 1961, before the change, with the earnings of all the other nonpar banks in these same states in rural, one-bank towns, and then again in 1964 after the change. You will notice that they not only survived, but did slightly better than those that did not change.

## Summary

The reasons for the change to par clearance may be summarized in this way:

First of all, it's the cost of the exchange charges themselves. Although the individual items are not especially significant, in the aggregate they total over \$3-½ million for Minnesota. These charges are collected from a variety of people who receive checks drawn on nonpar banks--big business, little business, farmers, householders--in short, almost everyone who does business with a customer of a nonpar bank.

More than this cost, however, is the cost imposed on the banking system as a whole, and on business generally. We are gradually becoming a nation of bookkeepers of necessity, but bookkeeping costs money. To handle unusual items--such as nonpar checks that require computation and special entry--adds to regular and normal costs. This additional cost has been projected for the banking system at roughly the same amount as the charge itself. The cost to businesses, large and small, and the social cost of the irritation to all people, is in the same proportion.

The second reason has to do with the onset of automation. The day is coming--and in some areas it is already here--when money and credit will be transferred by electronic means. Through joint use of computers, even small businesses are now sharing in the economy of mechanization of accounting through the computer; but when the national system becomes operational, which it is estimated will be in the mid-70's, those communities that will not be part of this hook-up will suffer. Banks must be an integral process of this system. Nonpar banks, because their items require special handling, do not adapt to computerization--and those communities where nonpar banking persists

will be at a disadvantage. And this means not only the businesses there, but everyone who has any credit transactions at all--the housewife, the farmer, all will be touched.

The third reason has to do with equity among classes of people. The statement is frequently made that this does not affect the farmer or the small businessman, because it is aimed only at large business. This is not true. The larger customers of a nonpar bank frequently are able to make special arrangements to have their checks cleared at par to avoid criticism from their suppliers and creditors. There are roughly 2,000 special clearing arrangements in this district. But the suppliers and creditors of the small customer of the nonpar bank, who are unable to work out special arrangements to have their checks cleared at par, pay the exchange charge.

Most checks do not move very far. In a study made a few years ago, it was found that for banks of less than \$7-½ million, 80% of the checks drawn on them cleared within their own federal reserve district--and of these, 30% cleared within a relatively restricted area around the bank.

Finally, and perhaps most significantly, to those of us who are concerned with the economic development and growth of this area, is the adverse contribution that nonpar banking makes to the image of Minnesota. In the competition for new business among the states, we have to have everything going our way to get a fair share, simply because we are trying to break into the national scene against firmly lodged competitors. The difficulties of nonpar banking are well known in the financial community of the United States--witness an editorial in the New York Times a year ago about the subject. It does not contribute to the image of this state to have the practice continue.

I have had assembled and will now furnish each committee member  
a leaflet containing:

- (1) a 1-page summary of the principal points I have touched on today,
- (2) a condensation of Paul Jessup's thesis based largely on the  
FDIC's special study of nonpar banking, and
- (3) reproductions of the charts you have seen today.