

MINUTES OF THE MEETING OF THE FEDERAL ADVISORY COUNCIL

April 3, 1962

A special meeting of the Federal Advisory Council was held in Room 928 of the Mayflower Hotel, Washington, D.C., on April 3, 1962, at 8:15 P.M.

Present:

Milton H. Glover, Alternate	District No. 1
George A. Murphy	District No. 2
Howard C. Petersen	District No. 3
Reuben B. Hays	District No. 4
Robert B. Hobbs	District No. 5
J. Finley McRae	District No. 6
Kenneth V. Zwiener	District No. 7
Sidney Maestre	District No. 8
John A. Moorhead	District No. 9
Maurice L. Breidenthal	District No. 10
I. F. Betts	District No. 11
Elliott McAllister	District No. 12
Herbert V. Prochnow	Secretary
William J. Korsvik	Assistant Secretary

Absent:

Ostrom Enders	District No. 1
---------------	----------------

President Murphy stated that Chairman Martin had indicated that the Board would like to have the views of the members of the Federal Advisory Council on the desirability of amending Regulation Q. This was outlined in a letter dated March 21, 1962 from Merritt Sherman, Secretary of the Board of Governors. A copy of the letter, together with enclosures, is made a part of these minutes.

The ensuing discussion disclosed that the majority of the members of the Council favored no change in the present Regulation. However, there was a feeling on the part of some members of the Council that in addition to the present \$2 a month absorption allowance, the absorption of exchange charges on items of \$50 or less might be in the best interests of the banking system as a whole.

The Council felt strongly that the Regulation, as finally determined by the Board of Governors, should be rigidly enforced by the appropriate agencies.

The meeting adjourned at 10:35 P.M.

HERBERT V. PROCHNOW
Secretary

WILLIAM J. KORSVIK
Assistant Secretary

COPY OF LETTER

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

March 21, 1962

Mr. Herbert V. Prochnow, Secretary,
Federal Advisory Council,
c/o First National Bank of Chicago,
38 South Dearborn Street,
Chicago 90, Illinois.

Dear Mr. Prochnow:

In accordance with arrangements made by Chairman Martin with President Murphy, the Board would like to have the views of the Federal Advisory Council with respect to a problem of considerable importance and difficulty that arises out of the Board's efforts to interpret and enforce provisions of the Federal Reserve Act that prohibit member banks from paying interest on demand deposits, directly or indirectly, by any device whatsoever. A special meeting of the Council with the Board has been set tentatively for 10:00 a.m. on Wednesday, April 4, 1962, in the Board's building, with the thought that as much of the day as may be necessary will be devoted to discussion of this subject.

For many years the Board has consistently followed the position that the absorption by member banks of exchange charges deducted by drawee nonpar banks in remitting for checks collected by the member banks for their depositors involves an indirect payment of interest on demand deposits in violation of the law. However, the practical difficulties of effective enforcement of this position have become increasingly apparent. The Board has also been concerned by the inequities of the resulting situation in which member banks are placed at a disadvantage in competing with nonmember insured banks, since the Federal Deposit Insurance Corporation has interpreted similar provisions of law as not precluding the absorption of exchange charges on behalf of demand depositors.

Repeated efforts to find acceptable administrative means of meeting the problem without imposing undue burdens upon member banks have been unsuccessful. Consequently, the Board is now giving consideration to the desirability of amending Regulation Q to provide that the absorption of normal and customary exchange charges by member banks, in connection with the routine collection for their depositors of checks drawn on other banks, will not be considered a payment of interest on deposits. This would be consistent with the position taken by the Federal Deposit Insurance Corporation with respect to nonmember insured banks.

Mr. Herbert V. Prochnow

There is enclosed a memorandum that summarizes the background of this problem and indicates some of the arguments that might be advanced for and against reversal of the Board's position that absorption of exchange charges by member banks constitutes an indirect payment of interest on deposits.

If any member of the Council should be unable to be present at the special meeting tentatively set by Chairman Martin and President Murphy for April 4, it is hoped that an alternate might attend in his place, and if neither the member nor an alternate can attend, the Board would appreciate receiving the member's views in writing.

Very truly yours,

(Signed) Merritt Sherman,
Secretary.

Enclosure

P.S. A copy of this letter is being sent direct to each member of the Council together with the enclosure.

cc: Mr. Korsvik

ENCLOSURE

ABSORPTION OF EXCHANGE CHARGES AS A PAYMENT OF INTEREST ON DEPOSITS

For many years, the Board has been confronted by the problem growing out of its efforts to interpret and enforce the provisions of section 19 of the Federal Reserve Act and the Board's Regulation Q prohibiting the payment of interest on demand deposits by member banks, particularly as applied to the absorption by member banks of exchange charges deducted by drawee nonpar banks in remitting for checks collected by the member banks for their depositors.

The problem has been emphasized by the difficulty of reconciling the Board's position that absorption of exchange charges constitutes an indirect payment of interest with its position that certain free services performed by member banks for their customers do not constitute an indirect payment of interest. Moreover, the Board's position with respect to absorption of exchange charges has had the effect of placing member banks at a disadvantage in competing with nonmember insured banks, since the Federal Deposit Insurance Corporation, in applying similar provisions of law, has taken the position that the absorption of such charges by nonmember insured banks does not involve an indirect payment of interest.

In connection with further consideration of this problem, there are set forth below (A) a summary of the background of this matter, and (B) some considerations relating to the possibility of a reversal of the Board's position as a means of achieving a solution of the problem.

(A) *Summary of the Background*

1. The Banking Act of 1933 amended section 19 of the Federal Reserve Act to prohibit member banks from paying interest on demand deposits "directly or indirectly, by any device whatsoever." Shortly thereafter, the Board took the position that the absorption by a member bank of exchange charges on checks collected for its demand depositors would result in an indirect payment of interest if the amount of exchange absorbed bore a substantially direct relation to the amount of the deposit.
2. The Banking Act of 1935 expressly authorized the Board "to determine what shall be deemed to be a payment of interest". The same Act for the first time made the prohibition against payment of interest on demand deposits applicable

also to *nonmember* insured banks, although the FDIC was not expressly authorized to determine what constitutes a payment of interest. Pursuant to the new legislation, both the Board and the FDIC drafted regulations on the subject to become effective January 1, 1936. The Board's Regulation would have expressly defined "interest" as including the absorption of exchange charges. The FDIC, however, objected to this provision, and the proposed definition was never included in Regulation Q.

3. As a compromise, the Board and the FDIC in 1937 agreed to amend their respective regulations to define "interest" in identical language as follows:

"Within this regulation, any payment to or for the account of any depositor as compensation for the use of funds constituting a deposit shall be considered interest."

At the same time, the Board and the FDIC issued a joint press statement to the effect that these amendments were intended only to declare "existing law" and that the definition of interest would permit "the general application by each agency of a uniform law and a determination of specific cases upon the facts involved." In other words, "interest" would be defined in accordance with general court decisions and without resort to the Board's specific statutory authority to define the term.

4. In 1943, the Board ruled that absorption of exchange charges by a particular member bank in the circumstances of the particular case constituted an indirect payment of interest. (By this time, the Board had concluded that it was not necessary for the amount absorbed to vary with the amount of the deposit in order for such absorption to constitute interest.) The 1943 ruling immediately gave rise to heated controversy. The House of Representatives passed a bill that would have expressly declared absorption of exchange *not* to be a payment of interest, but the bill failed of enactment in the Senate.
5. The FDIC, in 1944, amended its regulation on this subject to include the following footnote:

"6 The absorption of normal or customary exchange charges by an insured nonmember bank, in connection with the routine collection for its depositors of checks drawn on other banks, does not constitute the payment of interest within the provisions of this Part."

As explained by counsel for the FDIC at that time, this provision meant that virtually no absorption of exchange by *nonmember* insured banks would be regarded as a payment of interest.

6. In 1945, the Board sought an administrative solution of the problem by adopting the position that absorption of exchange charges in amounts of not more than \$2 per month for any one depositor would be considered trivial and would not be regarded as interest, but that if a member bank absorbed exchange in greater amounts it would be presumed to be in violation of the law.

7. By 1954, there was evidence that the so-called "\$2 rule" was not being strictly adhered to by all member banks. The Federal Reserve Banks were requested to make a survey; and the FDIC was asked to reconsider its position in this matter. However, the survey led to no acceptable solution and the FDIC in March 1955 reiterated its position that no absorption of exchange by nonmember insured banks was considered to be a payment of interest.
8. In 1956, when the "Financial Institutions Act" was under consideration in Congress, the Board proposed that Congress settle the issue one way or the other as to both member and nonmember insured banks. However, no such legislation was enacted.
9. In August 1960, the Board took the position (1) that absorption of exchange constitutes a payment of interest on demand deposits even where the amounts absorbed by a member bank are less than the cost of collecting them from depositors, and (2) that a member bank would be considered as paying interest on demand deposits if it maintained balances with another bank in return for which such other bank would directly or indirectly absorb for the member bank (and for the ultimate benefit of the member bank's depositors) exchange charges made by the drawee banks. The Board stated that this position should be regarded as superseding all earlier interpretations on the subject. (1960 BULLETIN 858)
10. The position just described was modified by a published ruling of the Board in November 1960 (1960 BULLETIN 1226), which stated that, pending a survey of the matter and as a tentative authorization, member banks were "authorized to absorb exchange charges in amounts aggregating not more than \$2 for any one depositor in any calendar month or any regularly established period of 30 days." This modification made no change in the second part of the August 1960 ruling regarding the maintenance of balances with other banks, but it had the effect of relaxing the first part of that ruling so as in effect to restore the so-called "\$2 rule".
11. Since 1960, a further survey of the matter has been made through the Federal Reserve Banks. The possibility of adopting an administrative rule in lieu of, or in addition to, the "\$2 rule", has been explored; but no such rule appears to afford a satisfactory solution of the problem. Moreover, the FDIC has again reiterated its unwillingness to change its own position in this matter.

(B) Considerations Relating to Possible Reversal of the Board's Position

Arguments against reversal of the Board's position that absorption of exchange constitutes a payment of interest may be summarized as follows:

1. The Board's past position has been based on the ground that, when a member bank pays an exchange charge in collecting a check for its depositor and credits the depositor with the full amount of the check, the member bank makes a "payment" to its depositor in the amount of the exchange charge and that the circumstances usually warrant the conclusion that such payment is made as compensation for the use of the deposit and is therefore a payment of "interest". The soundness of this position is supported by the fact that the law broadly prohibits payment of interest on demand deposits, directly or indirectly, by any

device whatsoever, and by the fact that absorption of exchange has clearly been utilized by member banks as an indirect means of attracting and retaining demand deposits.

2. Reversal of the position followed by the Board for more than 20 years could be attacked as constituting an arbitrary or capricious action by the Board, particularly if it should appear that the real reason for such reversal was to place member banks on competitive equality with nonmember insured banks, rather than to implement the prohibition of the statute against direct or indirect payment of interest on demand deposits.

It might, of course, also be argued that reversal of the Board's position would tend to encourage the *making* of exchange charges by nonpar banks and that this would be an undesirable result. However, the Board's only authority under the law is to determine what constitutes a payment of interest on demand deposits; and the fact that reversal of the Board's interpretation in this respect might tend to encourage exchange charges themselves would not be a relevant legal consideration. Even as a practical matter, it may be arguable whether reversal of the Board's position in the long run would have that result.

Arguments for reversal of the Board's position as to absorption of exchange charges may be summarized as follows:

1. It is difficult to reconcile the position of the Board that absorption of exchange involves a "payment" to a depositor with the position taken by the Board in a number of cases in recent years that a variety of free services (such as free armored car and messenger service, free safe deposit boxes, etc.) do not involve an indirect payment of interest, even though the Board has recognized that such services are offered in order to obtain deposits. In November 1961, in an unpublished opinion, the Board held that the absorption by a member bank of wire transfer charges, although similar to absorption of exchange charges, represented only an expense incident to a normal banking service which the bank might refrain from charging to its customer, and that therefore the absorption of such transfer charges should not be considered an indirect payment of interest. By the same reasoning, it may be argued that an exchange charge paid by a member bank (regardless of the justification for such a charge) is nevertheless an expense incident to a normal banking service rendered by the member bank for its customers.
2. In many instances, the clerical expense to a member bank of charging exchange back to its customers would be greater than the amount of exchange involved; and on this basis again it may reasonably be argued that, to this extent, absorption of such charges does not involve a payment of interest.
3. The Board's express statutory authority to determine what constitutes a payment of interest affords a basis for going beyond what may be regarded as the "general law" and for defining interest in such manner as the Board may deem best in order to achieve effective enforcement of the statute.

Practical arguments for reversal of the Board's position are (a) the inequity of

applying different rules, under similar statutory provisions, to member banks and non-member insured banks, and (b) the impracticality of enforcing or policing the Board's present position with respect to absorption of exchange by member banks. While these are not legal grounds for reversal of the Board's position, they might be regarded as sound policy reasons for such a reversal if it would otherwise be supportable on legal grounds.

March 21, 1962.

MINUTES OF JOINT CONFERENCE OF THE FEDERAL ADVISORY COUNCIL
AND THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

April 4, 1962

At 10:00 A.M., a joint conference of the Federal Advisory Council and the Board of Governors of the Federal Reserve System was held in the Board Room of the Federal Reserve Building, Washington, D. C.

Present: Members of the Board of Governors of the Federal Reserve System:

Chairman Wm. McC. Martin, Jr.; Vice Chairman C. Canby Balderston; Governors A. L. Mills, Jr., J. L. Robertson, Chas. N. Shepardson, G. H. King, Jr., and George W. Mitchell; Mr. Howard H. Hackley, General Counsel of the Board of Governors; also Mr. Merritt Sherman, Secretary, and Mr. Kenneth A. Kenyon, Assistant Secretary of the Board of Governors.

Present: Members of the Federal Advisory Council:

Mr. George A. Murphy, President; Mr. Milton H. Glover, Alternate for Mr. Ostrom Enders; Messrs. Howard C. Petersen, Reuben B. Hays, Robert B. Hobbs, J. Finley McRae, Kenneth V. Zwiener, Sidney Maestre, John A. Moorhead, Maurice L. Breidenthal, I. F. Betts, Elliott McAllister, Herbert V. Prochnow, Secretary, and William J. Korsvik, Assistant Secretary.

Absent: Mr. Ostrom Enders.

In introductory comments, Chairman Martin indicated that the Board was concerned about the difficulty of enforcement of its position in the absence of a uniform point of view among Federal banking agencies.

Mr. Howard Hackley, General Counsel, Board of Governors of the Federal Reserve System, then outlined the history of the problem beginning with the Banking Act of 1933 which, among other things, prohibited member banks from paying interest on demand deposits directly or indirectly by any device whatsoever.

Chairman Martin then asked Governor Robertson to comment, noting that he had worked on this problem for many years.

Governor Robertson summarized negotiations that had taken place in an effort to achieve uniformity of approach among Federal banking agencies.

President Murphy then reported that the Council had held a lengthy discussion of this subject. He stated that the members of the Council felt that the position of the Board over the years had been a sound one; that the absorption of exchange charges was in fact the payment of interest on demand deposits.

Mr. Moorhead noted that there were more nonpar banks in the ninth district than in any other district and that they would like to see the Board's present rule maintained without change.

In the extended discussion which followed, there seemed to be widespread agreement in support of the present Regulation as enforced by the Board of Governors.

President Murphy, in a concluding comment, said that whatever the decision of the Board, the Council would recognize that it represented the Board's best judgment and that the banking industry would support it.

The meeting adjourned at 12:10 P.M.

HERBERT V. PROCHNOW
Secretary

WILLIAM J. KORSVIK
Assistant Secretary

NOTE: This transcript of the Secretary's notes is not to be regarded as complete or necessarily entirely accurate. The transcript is for the sole use of the members of the Federal Advisory Council. The concise official minutes for the entire year are printed and distributed later.

H.V.P.
W.J.K.

The Secretary's notes of a special meeting of the Federal Advisory Council on April 3, 1962, at 8:15 P.M., in Room 928 of the Mayflower Hotel, Washington, D. C. All members of the Council were present except Mr. Enders. Mr. Milton H. Glover, President of the Hartford National Bank and Trust Company, Hartford, Connecticut, attended as an Alternate for Mr. Ostrom Enders.

President Murphy briefly reviewed his conversation with Chairman Martin. The Chairman had indicated that the Board would like to have the views of the members of the Federal Advisory Council on the desirability of amending Regulation Q to provide that the absorption of normal and customary exchange charges by member banks in connection with the routine collection for their depositors of checks drawn on other banks, will not be considered a payment of interest on deposits.

President Murphy stated that an estimated \$9 million of exchange charges were collected last year. He then displayed a map showing the distribution of non-par banks in each state and a summary of a Federal Reserve survey (of 111 banks) of non-par items and exchange charges. Copies of the map and the summary are attached and made a part of these minutes. An extended discussion followed in which each member described the situation in his respective district.

Moorhead, representing the Ninth District, which includes a large number of non-par banks, stated that he vigorously opposed a change in the Regulation which would permit banks to absorb exchange charges. He stated that his bank alone processed over one million non-par items a month and that exchange charges collected exceed \$1 million a year. He also argued that the cost figures indicated by the Federal Reserve survey were not meaningful as those banks which are obliged to process a large volume of non-par checks have streamlined the process so that costs are relatively nominal.

Hobbs of the Fifth District, which also includes a substantial number of non-par banks, urged that the Regulation not be changed. He estimated that the exchange collected in his district exceeds \$2 million annually.

The discussion disclosed that the majority of the members of the Council favored no change in the present Regulation. However, there was a feeling on the part of some members of the Council that in addition to the present \$2 a month absorption allowance, the absorption of exchange charges on items of \$50 or less might be in the best interests of the banking system as a whole.

The Council feels strongly that the Regulation, as finally determined by the Board of Governors, should be rigidly enforced by the appropriate agencies.

The meeting adjourned at 10:35 P.M.

* * * * *

ON APRIL 4, 1962 AT 10:00 A.M. THE FEDERAL ADVISORY COUNCIL HELD A JOINT MEETING WITH THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM IN THE FEDERAL RESERVE BUILDING, WASHINGTON, D. C. ALL MEMBERS OF THE COUNCIL WERE PRESENT EXCEPT MR. OSTROM ENDERS. MR. MILTON H. GLOVER ATTENDED AS AN ALTERNATE FOR MR. ENDERS.

THE FOLLOWING MEMBERS OF THE BOARD OF GOVERNORS WERE PRESENT: CHAIRMAN MARTIN, VICE CHAIRMAN BALDERSTON; GOVERNORS MILLS, ROBERTSON, SHEPARDSON, KING AND MITCHELL; MR. HOWARD H. HACKLEY, GENERAL COUNSEL OF THE BOARD OF GOVERNORS; MR. SHERMAN, SECRETARY, AND MR. KENYON, ASSISTANT SECRETARY, OF THE BOARD OF GOVERNORS, ALSO WERE PRESENT.

The minutes of the joint meeting are being prepared in the office of the Secretary of the Board of Governors of the Federal Reserve System. Their content will be compared with the notes of the Secretary of the Council. Assuming they are in substantial agreement, they will be reproduced and distributed to members of the Council.

The meeting adjourned at 12:10 P.M.

* * * * *

The next meeting of the Council will be held April 30-May 1, 1962.

SURVEY OF NON-PAR ITEMS AND EXCHANGE CHARGES

EFFECT OF VARIOUS ALTERNATE RULES FOR ABSORPTION OF SMALL CHARGES
(One Month Period-000 Omitted)

<u>Alternative Proposals</u> <u>Absorption of:</u>	<u>Number of Items</u>			<u>Exchange</u>			<u>Cost of Collecting*</u>			<u>Net Cost (-)</u>		
	<u>Deposited By</u>			<u>Deposited By</u>			<u>Deposited By</u>			<u>Deposited By</u>		
	<u>Banks</u>	<u>Others</u>	<u>Total</u>	<u>Banks</u>	<u>Others</u>	<u>Total</u>	<u>Banks</u>	<u>Others</u>	<u>Total</u>	<u>Banks</u>	<u>Others</u>	<u>Total</u>
Charges under 5¢	2,291	1,081	3,372	\$ 35.9	\$ 20.7	\$ 56.6	\$103.5	\$ 55.3	\$158.8	\$- 67.6	\$- 34.6	\$-102.2
Items \$25 or less	3,161	1,588	4,749	104.2	55.4	159.6	142.7	78.7	221.4	- 38.5	- 23.3	- 61.8
Items \$50 or less	3,857	1,961	5,818	143.8	77.5	221.3	174.2	97.5	271.7	- 30.4	- 20.0	- 50.4
Items \$100 or less	4,361	2,222	6,583	185.0	99.7	284.7	197.0	110.8	307.8	- 12.0	- 11.1	- 23.1
Items over \$100	657	371	1,028	271.5	168.0	439.5	31.0	20.8	51.8	+240.5	+147.2	+387.7
												Annual Basis \$4,652.4

*At median recording unit cost of $4\frac{1}{2}$ ¢ for all banks and median monthly charge cost of 17¢ for majority of banks.

Based on Report of Survey of 111 banks
by Federal Reserve System
March 27, 1961

STATES CLASSIFIED ACCORDING TO PERCENTAGE
OF NON-PAR BANKS TO TOTAL BANKS

Mississippi.....	71.0%
Georgia.....	66.0
North Dakota.....	62.8
South Dakota.....	59.2
Minnesota.....	57.7
Louisiana.....	54.2
Arkansas.....	44.3
South Carolina.....	43.8
North Carolina.....	41.1
Alabama.....	34.5
Tennessee.....	24.5
Alaska.....	14.3
Florida.....	12.7
Missouri.....	8.5
Texas.....	2.8
Oklahoma.....	1.3
Virginia.....	.3
Illinois.....	.1

December 31, 1961

Non-Par Banks in Each State and Percentage of Total Banks

