

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 2761]
[January 31, 1944]

ABSORPTION OF EXCHANGE CHARGES

*To all Banks and Trust Companies
in the Second Federal Reserve District:*

For your information, in connection with the public discussion of the subject of the absorption of exchange charges as constituting a payment of interest on deposits, there is enclosed a copy of a letter dated January 24, 1944, from the Board of Governors of the Federal Reserve System to the Chairman of the Committee on Banking and Currency of the United States Senate expressing the opinion of the Board of Governors as to the merits of a bill which has been introduced in the Congress to amend Section 19 of the Federal Reserve Act to provide that the absorption of exchange and collection charges shall not be deemed the payment of interest on deposits.

ALLAN SPROUL,
President.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

January 24, 1944.

Honorable Robert F. Wagner, Chairman,
Committee on Banking and Currency,
United States Senate,
Washington, D. C.

Dear Senator Wagner:

This is in response to the request for the opinion of the Board of Governors of the Federal Reserve System as to the merits of S. 1642, "A Bill 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."

The pertinent part of section 19 of the Federal Reserve Act, as amended, which the proposed bill would further amend, now reads as follows:

"No member bank shall, directly or indirectly, by any device whatsoever, pay any interest on any deposit which is payable on demand: * * *"

The foregoing prohibition was enacted by the Congress as a part of the Banking Act of 1933. Prior to 1933 there was no such prohibition. Widespread abuses had developed in the practice of paying interest on deposits. Many banks, in order to attract accounts from other banks, offered and paid excessive rates of interest on demand deposits. Accounts of others, particularly national concerns, were likewise sought and obtained. The result, as concerned correspondent bank relationships, was, in many cases, an unnatural and unhealthy concentration in the larger centers of funds from the smaller communities without regard either to geographical or business affiliation between the two points. Moreover, these balances proved to be the most volatile deposits such banks had. When, during the depression, deposits declined, the impact of the demand made by the real owners of the deposits was felt by two and sometimes more banks, rather than one. The depositor in the smaller community demanded his balance, and his banker, in order to meet the demand, had to withdraw or to try to withdraw his balance from his correspondent bank in the larger center. Meanwhile the banks in the larger centers were also receiving like demands from their individual customers. National and other accounts, obtained by the

VICTORY

BUY
UNITED
STATES
WAR
BONDS
AND
STAMPS

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inducement of high rates of interest, were being brought closer home and "smart money" was the first to go. One has only to remember the experiences in Detroit, Cleveland, Baltimore, New Orleans, and many other large centers to recall what happened to many of the smaller banks and would have happened to more but for the intervention of the Banking Holiday and the measures which followed. These are the reasons, as understood by the Board, for the enactment of the legislation and the Board believes any relaxation of the statute would be a step backward and not in the public interest.

The proposal in S. 1642 and in the companion bill in the House of Representatives, H.R. 3956, would relax the existing statutory prohibition to the extent that exchange or collection charges might be absorbed by a member bank as an inducement to a depositor, bank or otherwise, to maintain an account with it. Senator Maybank, in introducing the bill in the Senate, stated: "The substance of the bill is to prohibit the Federal Reserve from interpreting a law to the effect that small banks are unable to charge exchange and larger banks are unable to absorb the country's banking exchange." The Board hastens again to state that it has not interpreted section 19 of the Federal Reserve Act (which is the statute in question) to the effect that small banks are unable to charge exchange. At the request of the Comptroller of the Currency it has interpreted section 19 in its application to the facts of a specific case and, under such facts, expressed the view that the bank in question was violating the statute and the Board's Regulation Q. This ruling was published in the September 1943 issue of the Federal Reserve Bulletin. The Board understands that the bank in question amended its practices in respect to the subject matter of the ruling. It also understands that other banks, reviewing their practices in the light of the ruling, have likewise amended their practices, and this no doubt accounts for the proposal that the statute be amended to legalize the practice.

The September 1943 ruling has been discussed in informal hearings before the Committee on Banking and Currency in the House of Representatives. It is appropriate, however, to acquaint all of the members of the Committee with the background of the ruling and the principles involved. In 1935, section 19 of the Federal Reserve Act was further amended to authorize the Board "to determine what shall be deemed to be a payment of interest." But the Board in its Regulation Q has not availed itself of the power to define as thus authorized. On the contrary, the Board has rested the meaning of the term "interest" squarely upon its meaning as a matter of general law.

The Board's reasons for not exercising the authority given it in 1935 are as follows. The general question whether the absorption of

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exchange charges by a bank for a depositor maintaining a compensating balance constituted the payment of interest has been a controversial one from the beginning. In 1935, the Board amended its Regulation Q to include a definition of interest under which the absorption of exchange and collection charges by a member bank as compensation for the maintenance of a deposit would have been expressly defined as a payment of interest on such deposit; but the effective date of this amendment was deferred from time to time and the amendment never became effective. This was largely because the Federal Deposit Insurance Corporation would not take the same position with respect to the banks it supervised. The Federal Deposit Insurance Corporation contended first that the absorption of exchange did not constitute the payment of interest and secondly that it did not have authority, corresponding to that of the Board, to define the term "interest" and thus, by definition, to extend its ordinary meaning. Always, however, the Federal Deposit Insurance Corporation has emphasized, more than the question whether the practice should be construed as constituting the payment of interest, the question of the effect such a construction would have on some 2,500 banks which were charging the exchange being absorbed. Finally, in 1937, in order partially to solve the dilemma, the Board proposed and the Federal Deposit Insurance Corporation agreed to the adoption of uniform language in their respective regulations. Thereupon both regulations were amended to provide that for the purposes of the regulations the term "interest" should mean "any payment to or for the account of any depositor as compensation for the use of funds constituting a deposit." By joint announcement it was made clear that the purpose of the action was merely to restate principles of law as decided by the Courts and to provide for dealing with each case upon the facts of that specific case. The action also had the effect of eliminating the question of any difference in the respective powers of the Federal Deposit Insurance Corporation and the Board because it was also made clear that the intention was not to use any rule-making power to extend the definition of the term "interest" beyond its meaning as already declared by the Courts. Since then the Board has adhered to the position thus agreed upon and made no ruling upon the question, either general or specific, until it was requested to do so by the Office of the Comptroller of the Currency.

On December 6, 1943, the Federal Deposit Insurance Corporation adopted a ruling of general application to insured nonmember banks on the subject of "Absorption of Exchange Charges as Payment of Interest". This general ruling expressed 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 regulations 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."

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In the specific case with which this Board dealt in its September 1943 ruling the facts were that the bank had absorbed exchange charges for customers keeping so-called compensating balances; that in 1942 it had absorbed for such customers \$18,000 out of \$25,000 exchange charges paid; that in the first three months of 1943 it had absorbed for such customers \$4,600 out of \$5,600 exchange charges paid; that in some instances the amount absorbed for some customers amounted to as much as 2 or 3 per cent of their balances; that its total correspondent bank deposits had increased from less than \$7,000,000 at the end of 1941 to nearly \$18,000,000 in 1943, a ratio far greater than the increase in its total demand deposits or of the corresponding increases of other banks in the same area; that exchange charges were not absorbed but were charged back when, because of a lack of a compensating balance, the bank had "no way of making it back"; that, on occasion, the bank had written to its correspondent banks suggesting that they par items sent to such banks in return for the parring by the subject bank of items received from such banks; and finally that, in at least one instance, accounts had been shifted from a competing bank to the subject bank because of its willingness to absorb such charges. In these circumstances, the Board expressed the view that the bank in question was violating the prohibition against the payment of interest on demand deposits. The Board believes that it would be difficult to conceive of clearer "facts or circumstances establishing that the practice is resorted to as a device for the payment of interest".

The bill before the Committee would legalize a practice such as described in the Board's September 1943 ruling and would permit a member bank to reward or compensate its customers for the use of their demand funds so long and only so long as the reward or compensation consisted of absorbing exchange charges.

"Exchange" is the name applied to charges exacted by some banks for paying checks drawn upon them by their customers when presented through the mails for payment. There has been so much misunderstanding as to what is meant by "exchange charges", particularly by some Members of Congress from sections or communities where the practice does not exist, that it may be worth while to describe the practice in some detail. Let us assume that a bank in Forest, Mississippi, charges exchange on its checks presented through the mails. A customer of the bank, John Jones, wishes to settle a transaction in Louisville, Kentucky, and to do so he sends his check drawn on the Forest bank for \$1,000 to Smith Mail Order Corporation in Louisville. Smith Mail Order Corporation deposits the check in its bank in Louisville. The Louisville bank sends the check to the Forest bank for payment but the Forest bank remits only \$999. The dollar which the Forest bank has retained is the "exchange charge". The use of the one dollar figure is not to be construed as meaning that the

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charge made is at the rate of \$1.00 per \$1,000. Such charges are fixed by exchange-charging banks individually and vary. The Board's September 1943 ruling does not prohibit the Forest bank from making the charge; but it does deal with the question whether a member bank may pay the charge as a means to compensate a depositor for the use of his funds. This latter question can arise in a number of different ways. In the first place it may be that Smith Mail Order Corporation maintains a balance with the Louisville bank deemed to be sufficiently large to justify an arrangement whereby the Louisville bank is willing to absorb all or a part of the exchange charges. This case probably would arise only in the event Smith Mail Order Corporation did enough business at points where there are exchange-charging banks to cause the amount of exchange charged to be a factor. Secondly, it may be that the Louisville bank has an account with a New Orleans bank with an arrangement under which the Louisville bank will send the checks it receives on exchange-charging banks in the New Orleans area to the New Orleans bank, maintaining with the New Orleans bank a compensating balance deemed sufficient by the New Orleans bank to justify it in absorbing all or a part of the exchange charges exacted by the Forest bank. In this case Smith Mail Order Corporation would deposit the check with the Louisville bank; the Louisville bank would send it to the New Orleans bank; and the New Orleans bank would send it to the Forest bank for payment. The Forest bank would pay only \$999 but the New Orleans bank would credit the Louisville bank with \$1,000 and the Louisville bank in turn would credit Smith Mail Order Corporation with \$1,000. Thirdly, it may be that the New Orleans bank and the Forest bank will have an arrangement whereby the Forest bank will maintain a compensating balance with the New Orleans bank and the New Orleans bank will absorb all or a part of the exchange charges which the Forest bank has exacted on checks sent it by the New Orleans bank. Here again, the Forest bank would remit only \$999 on the \$1,000 check drawn by John Jones, its customer, in favor of Smith Mail Order Corporation. The New Orleans bank would absorb the \$1.00 exchange charge; and the Louisville bank and, in turn, Smith Mail Order Corporation would receive the full amount, \$1,000.

Since the transaction which the \$1,000 check was to settle was between John Jones and Smith Mail Order Corporation, one would think that the \$1.00 charge should be paid either by John Jones for services rendered by the Forest bank or at least by Smith Mail Order Corporation as a charge for transferring the funds from Forest to Louisville. By no stretch of the imagination could the obligation to pay such charges be that of either the New Orleans or Louisville banks, and this Committee can be sure that they are not so paid gratis. The absorbing bank pays the charge only because it is getting the use of someone's funds and it would not pay them otherwise. Considering that there is a statute prohibiting the payment of interest on demand deposits it is plain to see

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what could be done competitively by the use of the device which the bill before the Committee would sanction.

It is small wonder, therefore, that already one outlying suburban bank by using this device to reward correspondent banks spread its business even into surrounding States and ran its deposits from \$800,000 to over \$8,000,000 in less than a year. Of this over \$6,800,000 or 82 per cent was represented by correspondent bank accounts and, mind you, this is a small outlying suburban bank. Another bank, hailed as a \$150,000,000 country bank, the largest individual or unit bank in any city with a population of 110,000 or less, has \$90,000,000 correspondent bank balances as against \$38,000,000 individual deposits. Obviously, demand bank balances would not be concentrated in such amounts at such points if there were not some corresponding reward or compensation for their use. That this is the fact is further substantiated by the current fear that the balances will not be maintained as they now are unless the absorption of exchange is continued. It is inconceivable to the Board that the Congress would continue the statutory prohibition against the payment of interest on demand deposits and at the same time legalize a practice which partakes of the characteristics of the old secret rebates by railroads and which would accomplish for a limited few and by indirection the same result as though interest were being openly and directly paid.

It is appropriate also to analyze the proposal under consideration to ascertain to whom it would apply and the favors it would grant. There are some 2,500 exchange-charging banks. These are known as non-par banks because they do not remit at par. Other banks which remit at par are known as par banks and total in number about 11,500, of which about 4,800 are not members of the Federal Reserve System. From the charts attached to this report the Committee will note that there are 20 States and the District of Columbia in which no banks charge exchange and in which all of the 4,763 banks remit at par. These States are Arizona, California, Colorado, Connecticut, Delaware, Idaho, Iowa, Maine, Maryland, Massachusetts, Nevada, New Hampshire, New Jersey, New Mexico, New York, Ohio, Pennsylvania, Rhode Island, Utah and Vermont. In addition, it is noteworthy that in Illinois only 12 out of 828 banks are non-par banks; in Indiana 3 out of 496; in Kansas 2 out of 627; in Kentucky 10 out of 389; in Michigan 1 out of 443; in Oklahoma 12 out of 384; in Oregon 1 out of 69; in West Virginia 6 out of 180; and in Wyoming 1 out of 56. Iowa has required its banks to remit at par.

The proposed legislation would permit a practice tantamount to the payment of interest on demand deposits but its application would be limited to those having checks on exchange-charging banks and to the amount of the exchange charged on such checks. In practice it would be limited still further because banks would not be willing to absorb the exchange except for depositors maintaining compensating balances, and only depositors having enough checks on non-par banks to justify the

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maintenance of compensating balances would keep such balances. The practical result would be that, with few exceptions, the amendment would be applicable only to correspondent banks and large national accounts.

The Board has a further objection to the proposed legislation. In the hearings before the Banking and Currency Committee in the House the Board's September 1943 ruling has been characterized as an attempt to enforce par clearance. This charge is not in accordance with the facts. The Board has repeatedly stated that it favors par clearance and it is, of course, a fact that the question of absorption of exchange is inextricably involved in the question of par clearance, as it is also with other questions. On the other hand, to charge that the ruling was directed at the 2,500 non-par banks disregards the fact that the ruling applied to a member bank which was absorbing the exchange, not charging it, as well as the fact that the ruling could result in causing member banks desirous of resorting to the practice to decide to withdraw from the Federal Reserve System. The Board recognizes that the final determination of the question of par clearance is one for appropriate legislative bodies. Congress has already enacted legislation which requires remission at par of all checks collected by Federal Reserve Banks. The legislation to which the Board refers is known as the "Hardwick Amendment" to section 13 of the Federal Reserve Act. It was enacted in 1917 and reads as follows:

"Provided, further, 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, to be determined and regulated by the Board of Governors of the Federal Reserve System, but in no case to exceed 10 cents per \$100 or fraction thereof, 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; but no such charges shall be made against the Federal reserve banks." (Underscoring supplied)

It will be noted that, by virtue of this provision of law, about 6,700 member banks are prohibited from charging exchange on checks presented by Federal Reserve Banks. Checks on some 4,800 nonmember banks are collected through the Federal Reserve collection facilities which, under this amendment, involves remission at par. Since a fair estimate would be that 90 per cent or more of the amount of all out-of-town checks are collected through the Federal Reserve collection system, the practical effect of the Hardwick Amendment is to prohibit all member banks from charging exchange and to require all nonmember banks wishing to avail themselves of Federal Reserve collection facilities to forego making any such charges.

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In the current discussion of the Board's September 1943 ruling at the hearing it has been stated that many of the non-par banks will be forced to close if member banks are not permitted to absorb the exchange charges which they make. This is on the theory that if member banks do not absorb the charges but pass them back to their customers, the pressure from these customers will result finally in the abandonment of exchange charges. The Board makes no such prediction. It does aver, however, that there are in the same States, in the same counties, and often in the same towns equally small national or State member banks which, for all practical purposes, cannot charge exchange and which are living and competing with non-par banks which do. Now it is proposed that member banks be authorized to absorb the exchange the non-par banks charge. Here again it is inconceivable to the Board that the Congress would authorize member banks to absorb exchange charges for small non-par banks when equally small member banks are prohibited from making such charges.

For the reasons stated the Board is opposed to the enactment of S. 1642 and the companion bill, H.R. 3956. Since the Board has also received a request for a report on this legislation from the Banking and Currency Committee in the House of Representatives, a similar report is being sent to it.

Very truly yours,

Chester Morrill

Chester Morrill,
Secretary

Enclosures

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NUMBER OF BANKS ON PAR LIST AND NOT ON PAR LIST, BY STATES, ON DECEMBER 31, 1943¹

(Includes all member banks, and all nonmember banks on which checks are drawn, except mutual savings banks on a few of which some checks are drawn.)

State	Member banks	Nonmember bank on which checks are drawn			Total banks on which checks are drawn	Total banks on par list
		On par list	Not on par list	Total		
Alabama	84	5	127	132	216	89
Arizona	7	5	--	5	12	12
Arkansas	63	31	128	159	222	94
California	112	82	--	82	194	194
Colorado	92	47	--	47	139	139
Connecticut	62	54	--	54	116	116
Delaware	17	24	--	24	41	41
Dist. of Columbia	18	4	--	4	22	22
Florida	60	17	88	105	165	77
Georgia	64	16	263	279	343	80
Idaho	26	21	--	21	47	47
Illinois	464	352	12	364	828	816
Indiana	222	271	3	274	496	493
Iowa	162	491	--	491	653	653
Kansas	213	412	2	414	627	625
Kentucky	112	267	10	277	389	379
Louisiana	38	4	104	108	146	42
Maine	40	26	--	26	66	66
Maryland	79	96	--	96	175	175
Massachusetts	154	38	--	38	192	192
Michigan	227	215	1	216	443	442
Minnesota	209	41	420	461	670	250
Mississippi	25	2	174	176	201	27
Missouri	167	332	94	426	593	499
Montana	69	20	21	41	110	89
Nebraska	145	105	154	259	404	250
Nevada	8	2	--	2	10	10
New Hampshire	53	12	--	12	65	65
New Jersey	292	58	--	58	350	350
New Mexico	27	14	--	14	41	41
New York	586	113	--	113	699	699
North Carolina	54	18	127	145	199	72
North Dakota	42	3	111	114	156	45
Ohio	414	267	--	267	681	681
Oklahoma	213	159	12	171	384	372
Oregon	32	36	1	37	69	68
Pennsylvania	765	267	--	267	1,032	1,032
Rhode Island	13	9	--	9	22	22
South Carolina	28	3	114	117	145	31
South Dakota	59	5	98	103	162	64
Tennessee	76	52	166	218	294	128
Texas	533	225	88	313	846	758
Utah	34	23	--	23	57	57
Vermont	39	32	--	32	71	71
Virginia	193	83	37	120	313	276
Washington	56	50	22	72	128	106
West Virginia	105	69	6	75	180	174
Wisconsin	149	266	145	411	560	415
Wyoming	36	19	1	20	56	55
Total	6,738	4,763	2,529	7,292	14,030	11,501
Insured	6,738	4,223	2,278	6,501	13,239	10,961
Noninsured	--	540	251	791	791	540

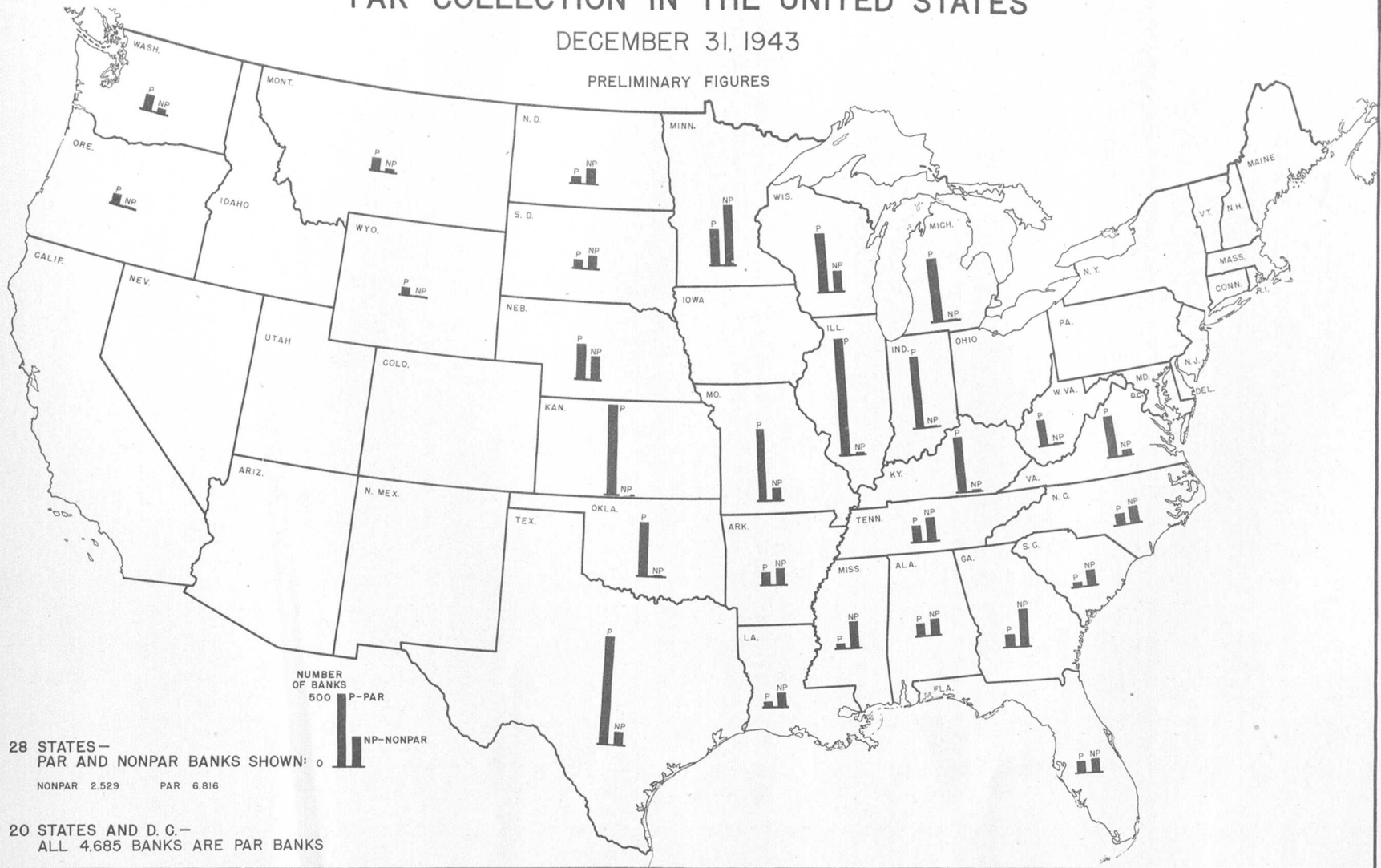
¹/Excludes 56 industrial banks and 54 non-deposit trust companies on which no checks are drawn; includes 104 private banks which do not report to State banking departments, and 13 cooperative banks (in Arkansas).

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM,
DIVISION OF BANK OPERATIONS,
JANUARY 20, 1944.

PAR COLLECTION IN THE UNITED STATES

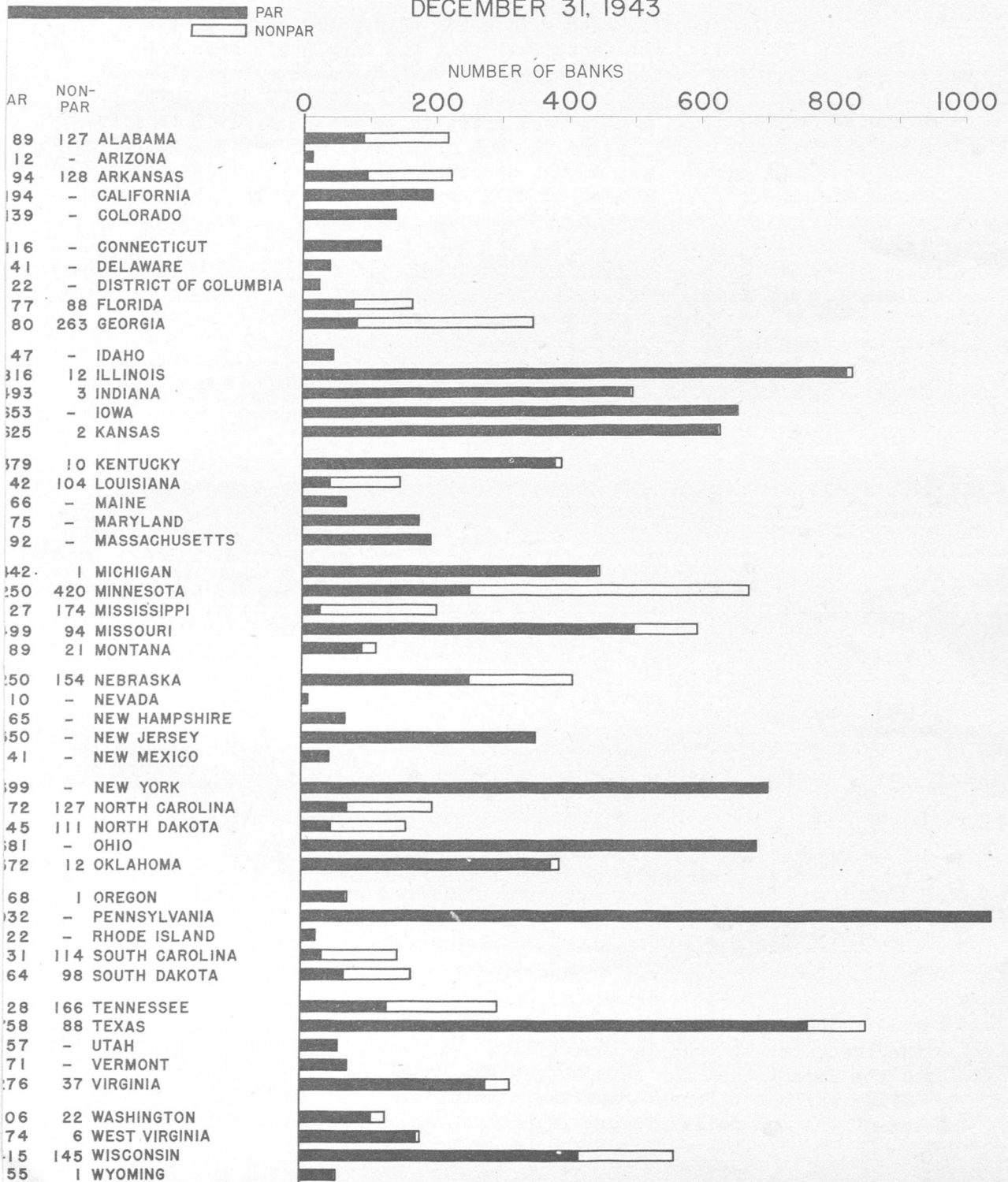
DECEMBER 31, 1943

PRELIMINARY FIGURES



ALL BANKS—MEMBER AND NONMEMBER PAR AND NONPAR

DECEMBER 31, 1943



PAR BANKS

NONPAR BANKS

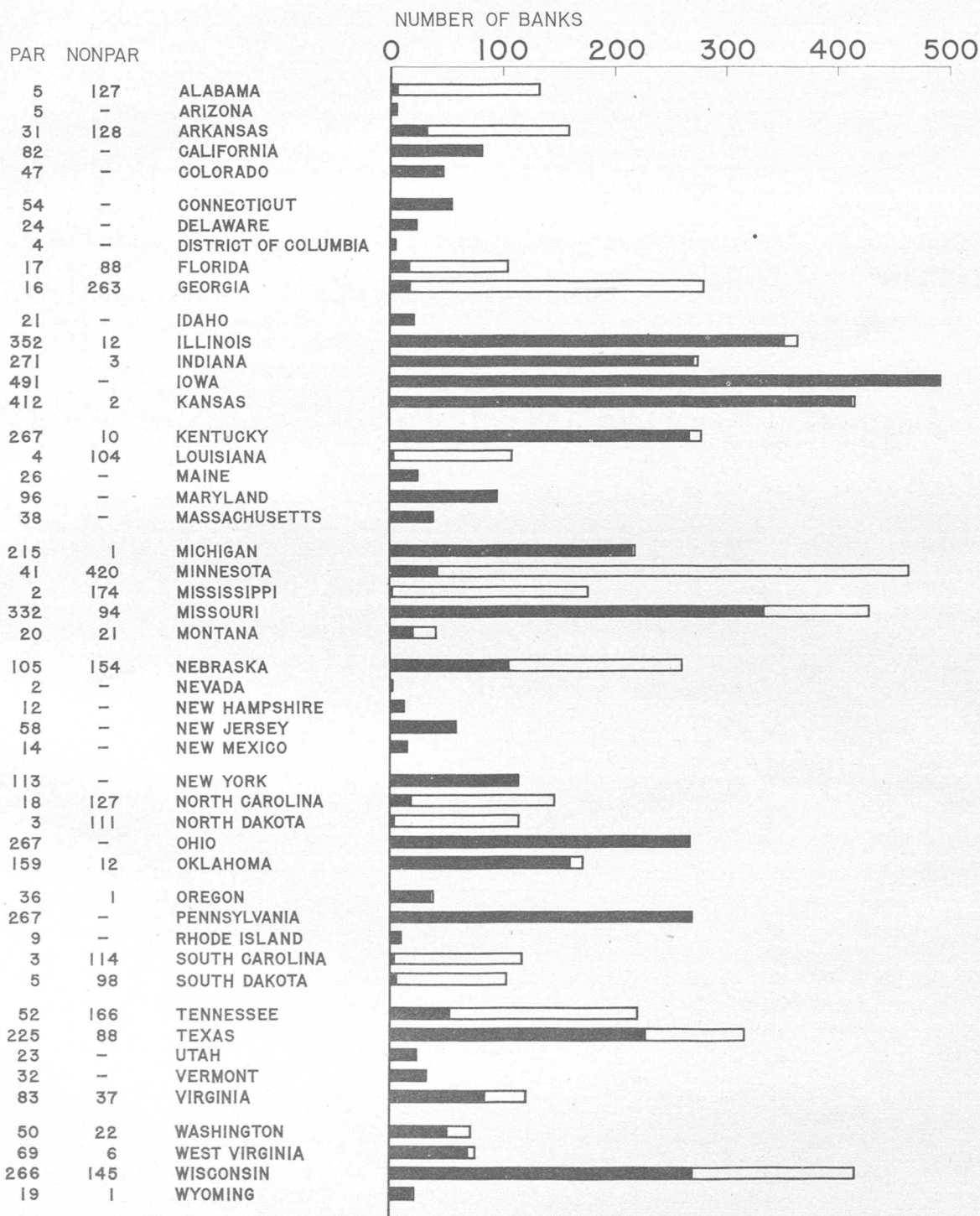
TOTAL 11,501

TOTAL 2,529

NONMEMBER BANKS PAR AND NONPAR

DECEMBER 31, 1943

■ PAR
□ NONPAR



■ PAR BANKS
INSURED 4,223
NONINSURED 540
TOTAL 4,763

□ NONPAR BANKS
INSURED 2,278
NONINSURED 251
TOTAL 2,529