

October 26, 1915.

## MEMORANDUM FOR THE BOARD:

In submitting the conference report on the Currency Bill to the House of Representatives, Congressman Glass, in explaining the purpose of the provisions relating to bank clearances, exchange and collection charges, said:

"One of the most important provisions of the currency bill passed by this House was that which sought to put an end to the flagrant abuse involved in excessive charges by banks throughout the country for collections and exchanges. The House bill provided that exchanges should be made at par and that charges for collections should not exceed the actual cost to the banks. This item of the bill, as most of you remember, was bitterly controverted in the Democratic caucus, and also in the House..... However, those of us in the House who sought to tear down these tollgates upon the highways of commerce prevailed..... In brief, as the bill now is reported to the House the banks can not make exchange and collection charges a source of profit; they can not any longer charge constructive interest; they can not exact a tax for a theoretical transfer of funds from point to point when no transfer is actually made, but only an entry on the books. ....The provision, as it stands, will result in an immense saving to the tradespeople of the United States. It will eliminate the amazing wastefulness incident to many independent collection organizations by substituting one compact collection system. It will abolish the exchange charges altogether and appreciably reduce charges against collections. I speak thus confidently only in anticipation of wise action by the Federal Reserve Board when appointed. If the Board will have the wisdom and courage to establish immediately a comprehensive and economical plan of bank clearings, it will be difficult to compute the advantages that this section of the currency bill will secure."

It is clear from this unequivocal statement of the Chairman of the House Committee on Banking and Currency that the members of that Committee at least intended to accomplish a definite purpose when those provisions were incorporated in the Act which relate to bank clearances, exchange and collection charges.

In order to determine to what extent this purpose may be accomplished by way of supervision of the operations of Federal reserve and member banks, it is necessary to analyze the specific language used and to determine its legal effect when construed in accordance with the established rules of interpretation recognized by our courts. To do this it is necessary first to give consideration to the usual or ordinary acceptation of the terms (a) bank clearances, (b) collection and remittance charges, and (c) exchange charges, all of which subjects are dealt with in the Act. These subjects are so closely inter-related it is very natural that confusion of thought should result from their consideration and that the terms should be used more or less interchangeably. In order, however, that the language of the Act may be properly interpreted and the duty of the Federal Reserve Board may be defined, it is necessary to consider each of these subjects separately. This can be best accomplished by reviewing by way of illustration an ordinary commercial transaction which involves the transfer

of funds from one part of the country to another, and by considering the relative rights of the parties involved at the various stages of such transactions.

We will assume, therefore, that John Doe of Wilmington, North Carolina, sells a bill of goods to Richard Roe, Baltimore, Maryland. The contract between the parties may call for payment to be made (a) at Wilmington, North Carolina, (b) at Baltimore, or (c) in exchange on New York, Chicago, or some other city. This is a question, however, to be determined by the parties to the sale and should be governed by the terms of the contract.

.....EXCHANGE CHARGES.....

If Richard Roe has agreed to remit in New York or Chicago exchange he may purchase from some bank having a credit balance in New York or Chicago a draft on a bank in one of those cities and may send or deliver this draft to John Doe.

When funds are transferred by this means the transaction involves the purchase of exchange and the charges made by the selling bank for a part of its credit balance in New York or Chicago are generally referred to as "exchange charges" as distinguished from collection and remittance charges.

.....COLLECTION AND REMITTANCE CHARGES.....

On the other hand let us assume that payment is to be made in Baltimore. In this case Richard Roe may send to John

Doe a check drawn on his bank in Baltimore which is payable at the banking house in that city. John Doe deposits this check in his bank at Wilmington to be placed to his credit immediately or else to be collected to the account of the depositor. In either case the Wilmington bank must look to the depositor for any expense involved in transferring the funds from Baltimore to Wilmington and the charge made for this service is generally referred to as a "collection and remittance charge" as distinguished from an exchange charge.

In other words, where a bank sells exchange it sells funds which it has in another city standing to its credit, whereas, in charging for collection and remittance it charges for acting as the agent of the depositor in sending on the item in question to another city and having the proceeds of such item remitted to the place of deposit. This distinction should be borne in mind in considering those provisions of the Act which relate to these subjects.

.....CLEARANCE OF CHECKS.....

To obviate the necessity of making an actual physical transfer of funds, accounts as between banks are settled or cleared through clearing house associations or other banks acting as intermediaries by an exchange of credits, such transactions being generally referred to as

"bank clearances".

It has heretofore been immaterial to the depositor whether checks deposited by him are collected by an actual remittance of funds or by an exchange of credits, except in so far as the element of time is involved when the deposit is received for collection and deferred credit. Ordinarily, therefore, the rights as between the bank and the depositor need not be dealt with in considering as an independent matter the subject of bank clearances. From an analysis, however, of those provisions of the Federal Reserve Act which relate to this subject it will appear that the charges to be paid by the depositor will depend upon the method of collection used by the bank receiving the deposit and this subject must be treated as a factor in fixing collection and remittance charges.

.....BASIS OF EXCHANGE AND COLLECTION CHARGES.....

While the power to act as an agent of a customer or depositor in the collection of checks and other items is not one of the enumerated powers of national banks in the statutes creating such banks, it is well recognized by the courts that the transfer of funds from place to place is one of the important functions of banks and the power to collect and remit funds and to sell exchange is necessarily incident to the banking business, and is, therefore, one of the implied powers of

banks created under the laws of the United States.

The statutes having failed, prior to the passage of the Federal Reserve Act, to specifically authorize the exercise of this power, no limitation was placed upon charges to be made by banks for this service rendered to their customers. Accordingly, there has been no fixed or uniform rate established by the banks but in some instances the service is rendered as a matter of accommodation or the charge is based upon actual expense involved, while in others exorbitant and purely arbitrary rates have been established, and these charges have been treated as one of the principal sources of earnings by some banks.

Applying, therefore, the well settled rule of construction that in interpreting a statute we must consider "the old law, the mischief and the remedy", it is manifest, as pointed out in the remarks of the Chairman of the House Committee above quoted, that the purpose of Congress was to put an effective stop to arbitrary and exorbitant exchange charges and charges for collection and remittance of funds.

LIMITATIONS PRESCRIBED BY THE FEDERAL

.....RESERVE ACT.....

The provisions of the Federal Reserve Act which

relate to these subjects are as follows:

"Any Federal reserve bank may receive from any of its member banks, and from the United States, deposits of current funds in lawful money, national bank notes, Federal reserve notes, or checks and drafts upon solvent member banks, payable upon presentation; or, solely for exchange purposes, may receive from other Federal reserve banks deposits of current funds in lawful money, national bank notes, of checks and drafts upon solvent member or other Federal reserve banks, payable upon presentation.

"Every Federal reserve bank shall receive on deposit at par from member banks or from Federal reserve banks checks and drafts drawn upon any of its depositors, and when remitted by a Federal reserve bank, checks and drafts drawn by any depositor in any other Federal reserve bank or member bank upon funds to the credit of said depositor in said reserve bank or member bank. Nothing herein contained shall be construed as prohibiting a member bank from charging its actual expense incurred in collecting and remitting funds, or for exchange sold to its patrons. The Federal Reserve Board shall, by rule, fix the charges to be collected by the member banks from its patrons whose checks are cleared through the Federal reserve bank and the charge which may be imposed for the service of clearing or collection rendered by the Federal reserve bank.

"The Federal Reserve Board shall make and promulgate from time to time regulations governing the transfer of funds and charges therefor among Federal reserve banks and their branches, and may at its discretion exercise the functions of a clearing house for such Federal reserve banks, or may designate a Federal reserve bank to exercise such functions, and may also require each such bank to exercise the functions of a clearing house for its member banks".

It will be observed from this language  
First. That Federal reserve banks may receive

checks and drafts on member banks for deposit or collection.

Second. That such checks or drafts are to be received at par, subject to charges fixed by the Federal Reserve Board.

Third. That the Federal Reserve Board is to fix by regulation

(a) The collection and remittance charge which the member bank first receiving the check or draft is to collect from the depositor for the service of collecting and remitting the proceeds of the item deposited - provided such collection is made through the Federal reserve bank.

(b) The charge which the member bank first receiving such item is to pay its Federal reserve bank for the service of collection.

(c) The adjustment of expense as between the several Federal reserve banks in the matter of transfer of funds incident to the collection and remittance of checks and drafts.

Fourth. That when member banks collect items other than through Federal reserve banks, or sell exchange on other cities, they are limited in their charges to the actual expense involved.

(NOTE: The subject of "actual expense" will be discussed as an independent subject but should it be construed to mean the actual expense involved in the transfer of funds the Board may reasonably determine



that since these provisions are intended primarily to protect the customer of the bank from arbitrary and extortionate charges, the "actual expense" must in no case exceed the amount that member banks would have to pay their Federal reserve bank for the service of collection.)

LEGAL EFFECT OF LIMITATIONS PRESCRIBED  
.....BY FEDERAL RESERVE ACT.....

In order to determine the legal effect of these provisions when applied to the hypothetical case hereinbefore considered, let us assume that John Doe receives from Richard Roe a check drawn on a member bank in Baltimore and deposits this check in a member bank in Wilmington for credit to his account. The Wilmington bank must look to the depositor for any expense involved since Richard Roe has merely given John Doe an order on his bank in Baltimore to pay a stated amount when that check is presented in Baltimore. The Wilmington bank can not, therefore, require the drawer of the check to remit to Wilmington funds to pay this check. Whatever may be the equities between the maker and the payee of the check the bank receiving the deposit must look to the depositor to pay collection charges. As suggested, if Richard Roe's contract called for payment of funds in Wilmington he might have purchased Wilmington exchange from his Baltimore bank.

Applying, therefore, the provisions of the Federal Reserve Act to this stage of the transaction, if the Wilming-

ton bank intends to use its Federal reserve bank in collecting the check in question, the Federal Reserve Board may fix the amount that this bank may collect for the service of collection.

If the Wilmington bank intends to collect this item through one of its correspondents other than its Federal reserve bank, the Federal Reserve Board may make any necessary investigation to determine whether the Wilmington bank is charging more than its actual expense for this service. For example, under the power vested in the Board to call for special reports from member banks, it might require member banks to report to the Board in detail charges made for collecting out-of-town checks and might require examiners to make similar reports. Should the Wilmington bank send this item to the Federal reserve bank of Richmond for collection the Board may, by regulation, determine the amount to be paid by the Wilmington bank to the Federal reserve bank for the service of collection. It can not, however, require the Baltimore bank to pay for this service since the contract of the Baltimore bank with its depositor, Richard Roe, is to pay his checks when presented at its banking house in Baltimore. The charges paid by John Doe, the depositor, to the Wilmington bank and by the Wilmington bank to the Federal Reserve Bank of Richmond, must cover the expense of transferring the funds from Baltimore to Richmond by way of the Federal

Reserve Bank. Under the subject of clearances, under the statute, this expense will be considered.

In order that the subject of interdistrict clearances may be illustrated, let us assume that Richard Roe has purchased New York exchange and remitted this exchange to John Doe in Wilmington. In this case Richard Roe has paid to the Baltimore bank the value of this exchange. That is to say, he has paid, according to the statute, what it actually cost the Baltimore bank to transfer a part of its funds to New York in order to create a credit balance with a New York bank. John Doe then deposits with his Wilmington bank a check or draft drawn by the Baltimore bank on a New York bank. He desires the proceeds credited to his account in Wilmington. If the Wilmington bank sends this check to the Federal reserve bank the Federal Reserve Board may fix the charge that the Wilmington bank may collect from John Doe; the charge that the Federal Reserve Bank of Richmond may collect from the Wilmington bank, and may, by regulation, adjust the question of expense as between the Federal Reserve Banks of Richmond and New York. For example, the Federal Reserve Bank of Richmond in this case would send on the item in question to the Federal Reserve Bank of New York which would collect it from its member bank and credit the proceeds to the account of the Federal Reserve Bank of Richmond. The Federal Reserve Bank of New York on the other hand would send its items against

members of the Federal Reserve Bank of Richmond for collection and credit. If the credit balance in New York to the account of the Richmond bank is greater than the balance standing to the credit of the New York bank with Richmond, it will be necessary to transfer funds from New York to Richmond and the Board must make rules and regulations governing the transfer of such funds.

When this becomes necessary it must be remembered that in creating this net credit balance with New York, the Richmond bank has theoretically at least, under the provisions of the Act, collected from the member bank depositing the items for collection the expense of the transfer of these funds from New York, - while the New York bank has received no consideration for its services in the matter and must look to the Federal Reserve Bank of Richmond to pay to it its proportionate part of the charge for this service. As a consequence, it would seem to be logical and in accordance with the theory of the Act to require the Federal reserve bank having a net credit balance with another Federal reserve bank to pay the actual expense of transfer of funds, and the regulations prescribed by the Board may reasonably be based upon this theory. How these expenses may be minimized by the use of Federal reserve banks and the Federal Reserve Board as clearing houses, will be discussed under the subject of clearance.

..... C L E A R A N C E S .....

In applying the provisions of the Act to a concrete case, an individual transaction has been used to illustrate the relative rights of the several parties involved at the various stages of the transaction. The principles involved are easily understood when we have a single transaction to deal with. Difficulties arise and confusion result, however, from the fact that the banks necessarily have a large number of reciprocal transactions as the rights as between the banks can be adjusted only by considering the net result of a very large volume of transactions. By way of illustration, when the Wilmington bank receives on deposit from John Doe the New York draft referred to in the case hereinbefore considered, it may at that time be under the necessity of transferring to New York funds to make its credit balance good for other purposes. It may at that time owe in New York a debit balance in which case instead of incurring any expense in transferring funds from New York to Wilmington for the credit of John Doe, this draft may actually save the Wilmington bank the expense it would otherwise be under the necessity of incurring in order to pay the balance due to its New York correspondent.

Just when a bank will need to transfer funds must depend upon the net result, therefore, of its various transactions with other banks.

Under the system in effect, prior to the passage of the Federal Reserve Act, the complications resulting from the net work of reciprocal and inter-related transactions among the many thousand banks in the United States can hardly be overestimated, and it would be a difficult task to attempt to arrive at any reasonable basis for charges involved in the transfer of funds from place to place if such charges are to be founded on the actual expense that each intermediary bank incure. In one case the collection of an item may, as illustrated, result in an actual saving while in another it may result in requiring the bank first receiving the deposit to ultimately transfer funds to some point more distant than the point against which the item is drawn.

As explained by Congressman Glass in remarks above quoted from one of the fundamental purposes of the provisions under consideration is to "eliminate the amazing wastefulness incident to many independent collection organizations by substituting one compact collection system". It is by the use of this compact collection system that the expense involved may ultimately be determined with reasonable certainty and may unquestionably be materially reduced.

If the Board is to accomplish what the framers of the Act intended, it would seem that when it has offered to member banks the services of the compact collection system

provided for by the Act at a fixed expense, banks declining or failing to avail themselves of the use of such system should not be permitted to charge a higher rate for services performed through the use of some other system. In other words, assuming that the charges to be fixed by the Board will represent the actual cost of the transfer of funds involved in the collection and remittance of checks and drafts, these charges should be construed to constitute the actual expense that any member bank need incur in making such collections.

EXPENSE OF CLEARANCES UNDER THE FEDERAL  
..... RESERVE SYSTEM .....

While the system provided by the Federal Reserve Act will eliminate a great deal of the expense which results from the use of a large number of individual collection agencies, it will be more or less difficult for the Board to arrive at any definite conclusion as to the actual expense involved until a reasonably large proportion of the member banks utilize the services of the Federal reserve banks as clearing houses, and as a necessary consequence it will be difficult for the Board to fix the charges which should be collected by member banks from their customers and the charges which member banks should pay to the Federal reserve banks for the services rendered in making collections. This is the problem which at present

confronts the Federal Reserve Board. It has offered to all member banks the privilege of clearing through the agency of Federal reserve banks, and has established a practical method for the transfer of funds at a minimum cost in adjustment of accounts as between the several Federal reserve banks. It can not require member banks to clear through Federal reserve banks by adoption of any regulation to this effect and can only accomplish this result when it is enabled as a result of experience to fix charges which may be imposed where member banks collect through Federal reserve banks and may then restrict the charges which may be imposed by member banks collecting through other agencies. When this can be done member banks may be induced to utilize the services of Federal reserve banks as clearing houses by reason of the relatively small collection and exchange charges that will be offered by the Federal reserve banks.

The difficulty in providing for a mandatory system of clearances through Federal reserve banks grows out of the fact that the depositor or the member bank receiving the deposit must be called upon to defray the expense involved in the transfer of funds and the Board can not require the member bank against which the item is drawn to bear any part of this expense or to keep on deposit with the Federal reserve bank a credit balance against which items



may be charged. If this could be accomplished the expense of collection will be reduced to a minimum since in such case a member bank receiving for credit or collection a check or draft from one of its customers could deposit such check or draft with its Federal reserve bank and could receive immediate credit and the Federal reserve bank could then charge the check or draft to the account of the member bank against which it is drawn, provided, of course, that the member bank against which it is drawn is located in the same district. If drawn against a member bank of another district the Federal reserve bank receiving it on deposit could immediately charge up this item to the Federal reserve bank of the district in which the member bank against which it is drawn is located.

In the first instance no transfer of funds would be involved except the transfer of any surplus standing to the credit of the member bank making the deposit. In the second case, in addition to the transfer of surplus funds standing to the credit of the member bank making the deposit there would result from time to time the necessity for the transfer of funds from one Federal reserve bank to another where the credit balance created as between Federal reserve banks proved to be in excess of the needs of the Federal reserve bank owning such credit.

It is clear, therefore, that in order for the Federal Reserve Board to fix the charges prescribed by the Act it is necessary that it should first have the benefit of

experience in the operation of the system and that the charges fixed arbitrarily without the benefit of such experience would not result in accomplishing the objects in contemplation of the framers of these provisions of the Federal Reserve Act. The Board is, therefore, confronted with the practical proposition of whether or not it is now in a position to undertake to fix the charges prescribed by the Act. It may reasonably be assumed that as a result of the development of the new system provided by the Federal Reserve Act, the expenses of operation may from time to time be modified and reduced.

It is manifest that some action on the part of the Board is necessary to induce a larger number of the member banks to avail themselves of the benefits of the system and since the Board has had the benefit of a limited experience in the matter which may be considered sufficient to justify the promulgation of the rules and regulations contemplated by the Act, it is respectfully recommended

..... RECOMMENDATIONS.....

- (1) That the Board request of the several Federal reserve banks a statement showing the expense incurred in the transfer of funds resulting from the collection and remittance of items cleared through such Federal reserve banks.

(2) That, using this information as the basis of charges to be fixed, the Board prescribe in each district

- (a) The charge to be collected by member banks from their customers for the collection and remittance of checks or drafts drawn on other member banks in the same district.
- (b) The charge to be paid by member banks to Federal reserve banks for services rendered in collection of checks or drafts drawn against member banks in the same district.
- (c) The charge to be imposed against Federal reserve banks for the remittance of net debit balances to other Federal reserve banks where such other Federal reserve banks have a credit in excess of their needs.

(3) That the Federal Reserve Board require by regulation that every member bank shall post in its banking house the names of all other member banks which have availed themselves of the services of the Federal reserve bank as a clearing house, such list to include the charges for collecting checks or drafts drawn against such member banks.

(4) That all member banks shall be required to post in their banking house a list of those member banks which have failed or refused to utilize the services of the Federal reserve bank as a clearing house, such list to be accompanied by a statement that checks or drafts drawn against any such member banks may be received for collection and deferred credit only and to specify the charge to be made for the service of collecting such items,

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- (a) If the Federal reserve bank is utilized for the purpose of making such collection, and:
- (b) The maximum that such banks may charge if the collections are made through any other agency

(5) That all member banks be required to make a report to the Federal Reserve Board simultaneously with the reports of condition made to the Comptroller of the Currency showing the rates charged for collection and remittance of checks and drafts and the rates charged for exchange sold on banks in other cities.

The purpose of these recommendations is to bring to the knowledge of the customers of the several member banks that checks and drafts may be collected with less expense to such customers if the services of the Federal reserve banks are utilized, and to restrict member banks to the actual expense involved where such collections are made through other agencies.

Respectfully submitted,

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