AN ANALYSIS OF THE SUBJECT OF AN "EXCHANGE" CHARGE ON CHECKS.

-----oOo-----

(1) Until the Federal Reserve Act went into effect and, indeed, until November 17, 1916, when the final transfer of reserves was made, it was permissible under the National Banking Act for banks to count as part of their legal required reserves funds redeposited in banks in other cities. There were only three cities in the country where this was not permitted, to-wit: New York, Chicago and St. Louis; and those cities, being Central Reserve cities, their national banks were not permitted to count as reserve, deposits which they held in other cities. Next in rank to these three Central Reserve cities, there were fifty-three reserve cities. Banks in any of these cities could keep a part of their reserve deposits in their own vaults, and a part in Central Reserve cities. Banks in all the other cities, towns and villages in the United States, known as non-reserve city banks, or country banks, were permitted to redeposit three-fifths of their reserves in any Reserve or Central Reserve city bank. Incidentally it should be point-

ed out that the term country bank does not mean a small bank necessarily. Many large cities, for example, Buffalo, New York, are nonreserve cities, and banks in those cities, however big, are spoken of as country banks.

(2) Under the operations of this system banks in Central Reserve and Reserve cities competed actively for country bank deposits, paying interest on these deposits and performing other services of value for the country banks.

(3) One of the recognized evils of the old national banking system which the Federal reserve system sought to remedy, was the duplication of reserves, and the payment of interest on reserve deposits, which compelled the banks holding those reserves to use the funds actively. As a result of this, in times of stress, the country bank was not always able to secure funds from its city correspondent. Hence, one of the main objects of the framers of the Federal Reserve Act was to avoid this duplication of reserve deposits by creating central banks which would receive the reserves from the banks of their respective districts, paying at the same time no interest on these reserves, thus largely removing the necessity for investing

these funds, which it was intended should be conserved and employed chiefly as a basis for the extension of credit to member banks and, through them, to the public in times of need.

(4) Incidental with the growth of the National Banking System and in part due to some of the cumbersome features of their note-issuing power, a system of bank checks came into general use. Indeed, there is no country in the world which has developed the bank check so far and so completely as has the United States. While the bank check is specifically the order by a depositor in a bank to pay to a named payee a certain specified sum of money, it has come to perform nearly all the functions which bank notes perform in other countries, furnishing at the same time the added advantage of giving the debtor a receipt for the money paid. It must be obvious to any man of affairs that the development of the check system in the United States in the last fifty years has been one of the most important, satisfactory and useful by-products of our business activity. Nothing must be done to hamper it, for it must be remembered that from ninety to ninety-five per cent of the purchases and sales in this country are effected by check without the use of either

specie or bank notes.

(5) One of the objects of the framers of the Federal Reserve Act, as already explained, was the transfer of the reserves from national banks in Reserve and Central Reserve cities to specially created banks, known as Federal reserve banks, of which there are twelve. This done, the authors of the Act permitted a considerable reduction in reserves, a safe expedient under the circumstances. It was apparent, however, that an incidental, though very necessary function of these reserve banks must be to act as clearing houses for the transfer of funds from one section of the country to another, and for handling the vast system of check collection. In the last year a fair beginning has been made and the checks upon all national banks, some seven thousand six hundred in number, and upon an even greater number of State banks and trust companies, may be collected at par through Federal reserve banks. The charge for performing this service varies now from 1¢ to 2¢ per item, and should be further reduced as the work develops. The bank depositing its checks is given immediate credit for the gross deposit which is made available as soon as it can be collected. While the introduction of this system of check clearing has met with much favorable comment it

has been the cause of a very vigorous protest from many country bankers who claim that they have been deprived of a charge for "exchange", that is, a collection fee. It is proper, therefore, to study exactly what this charge is and how it operates. In order to analyze it fairly we must consider it from opposite points of view.

THE CITY MERCHANT'S POINT OF VIEW.

(a) The customer of the city bank is affected in the following manner: When he deposits checks which have been sent to him in payment for articles sold, he is told by the teller of the city bank there is a deduction of a certain fixed percentage on this and that check, ranging in the past from, say, 10 cents per thousand to $2.50. There is nothing on the face of the check to show what deduction would be made, and the recipient of a check had nothing to indicate the amount of the charge except the paying teller's word that a certain deduction was right and proper. The explanation usually made by the paying teller of the city bank was that he was charging the customer only the exact amount which the country bank deducted from the face of its check. If the city merchant complained to his country client he might be told that other city merchants accepted country checks and that if he objected the buyer would go elsewhere.

THE COUNTRY MERCHANT'S POINT OF VIEW.

(b) Let us see how the country merchant looks at it. The country merchant may possibly be interested in the bank: If not actually interested, he is likely to be the friend and neighbor of the banker; the banker might also be paying him 3%, 4% or 5% interest on his deposit , and when the country merchant receives letters from the city merchant complaining of deduction for collection, the country banker suggests just the sort of response which has been referred to in the foregoing. While it is not agreeable to assume that the country merchant intentionally pays the bill due the city merchant with "short change" yet, it has been repeatedly argued by defenders of the system of deduction from checks for collection, that the city merchant charges enough more for his goods to cover the deduction for collection of checks and that therefore a deduction is justifiable. Thus, we are forced to two conclusions, first, that the country merchant to some extent connives at defrauding the city merchant, and second, that the city merchant, recognizing the fraud, adds to the price of his goods enough to cover the deduction. The cost of the deduction, therefore, by the banker, falls upon the merchants, but in the end on the ultimate consumer as a part of the cost of distribution.

THE CITY BANKER'S POINT OF VIEW.

(c) The city banker is not opposed to the collection or exchange charge, partly because he is able, to some extent, to pass it on to his customer, but, chiefly because, even if he is not able to so pass it on, he uses this payment to his country bank correspondent as a bait to secure country bank deposits. The service rendered is susceptible of close analysis. The city banker pays interest on the country bank deposits and also pays the deduction which the country banker makes for remitting for his checks. This so-called "exchange" charge the city banker analyzes most carefully, and rightfully demands compensation for the service he renders and the money he pays in interest on balances. The city bank handles the country account only so long as its value, by reason of its size and earning capacity, is sufficient to compensate for the interest he has paid the country bank, plus exchange charges, and all other expenses.

THE COUNTRY BANKER'S POINT OF VIEW.

(d) The country banker, very naturally, looks at the subject in a different way. First, he feels very strongly that the city banker has opportunities for making money which are superior to those in the country, and therefore he has a grievance. He has not the same facilities for closely analyzing the cost of doing business, and would not be justified in creating such facilities. The result is that, while tenaciously holding to the profits made by charging "exchange" - that is, a deduction from the face value of his own checks presented through city correspondents - he often fails to appreciate that the city banker is not rendering this service for him free, but is doing it only when he carries a compensating balance. Thus it is that country banks have unwittingly carried far greater balances with city banks than they were required under the law to keep, and have carried these balances at, say, 2% interest, when the money was needed at home, and could have been profitably employed at home to help local enterprise at 4%, 5% and 6%. Furthermore, not infrequently the city banker, glutted with funds upon which he was paying interest, has often been compelled to send his money into the same district from which it originated and lend it in competition with the country banker. The country banker has undoubtedly reason to feel that he should receive some compensation, when he is required to remit cash to pay his own checks rather than offsetting items. If the flow of business is such that he is able to pay checks drawn on him by checks received by him, but drawn on the city, he can feel that "one hand washes the other", but if he must pay, say 1/3 or 1/2 of his daily balances by remitting currency, which of course rarely happens, he is justified in feeling that he should receive some compensation, and the compensation should be enough to cover the expense of remitting the currency and perhaps also the expense of replenishing that stock of currency thus depleted. This statement is on the assumption that in some country districts there is a tendency for currency to flow away from the country to the city, and that this must be made good by shipments of currency from the city to the country. As a general thing, the interior, because it represents the production of raw materials, is receiving city checks and drafts to pay for its produce. Thus country communities, generally speaking, receive in checks and drafts somewhat more than they pay out for purchases in the city. There can be no doubt as to the justice of allowing the country banker compensation where he is thus situated, and the Federal Reserve Board has that power. The question which has arisen has been wholly how this compensation shall be provided for. In the past it has been accomplished by charging the customer of the payee bank in the city, whereas, many students of the question take the position that the charge should be made against the drawer or maker of the check. But the country banker will say that this will put a tax upon the maker of the check, which he will resent, and he will show his resentment by withdrawing his deposit with the country bank, and thereafter keep it with the city bank. The public is interested, in a correct and equitable adjustment of the question. If it is fair, as above outlined, that the country banker should receive compensation for maintaining his balance of trade with the city by paying for the shipment of currency, then the question to be decided is how shall that compensation be provided. If a small tax is put upon the maker of the country check sent to pay a distant bill, he will perhaps cease to use his checks to pay city accounts. In other words, he will use his country bank account, if at all, only to pay his neighbors in the country, and, if he wants to pay a bill in the city he will either pay it with a check drawn on a city bank, or go to his country bank and get a draft upon a city bank, for which the country banker may make a charge if he sees fit.

The evil of the present method of charging is that it confuses the situation, and makes it impossible clearly to determine the entire expense; and yet that the expense is borne by the ultimate consumer, or the general public, can not be doubted.

THE PUBLIC'S POINT OF VIEW.

(e) The general public, by which is meant the consumer, who is neither merchant, manufacturer nor banker, does not know a great deal about the subject. The individual receiving a check upon which a deduction is made by the paying bank knows nothing about the justice of the charge or propriety of the deduction. The further fact that he is being taxed a small amount on every article which he purchases is not appreciated by him. In fact the ultimate consumer's rights must be safeguarded for him because he is without organization or protection except that which the legislator affords him.

(6) The problem before the Federal Reserve Board is primarily to carry out the objects of the Federal Reserve Act. The twelve Federal reserve cities, each operating as a nerve center for an important area of country, connected together as they are by a central Gold Settlement Fund through which balances between them can be settled by wire, provides an ideal machine for check collection. Furthermore, it is a machine which can be enlarged and expanded by the establishment of branches, and collection agencies in the larger districts. The problem is two-fold. First, to create a machine which will operate as economically as possible, and there is every reason to believe that one can be created to operate very much more efficiently and economically than any that has heretofore existed. Second, to distribute expense with reasonable justice and equity. At the present time the Federal reserve banks are charging their member banks a service charge, varying from 1¢ to 2¢ per item. It is hoped soon to reduce this. It might indeed be arranged so that country banks be permitted to remit for checks sent to them for collection any offsetting items, such as checks drawn on other banks in the same Federal reserve district. When currency must be sent, the Federal reserve bank now pays

for the shipment of currency. There is some question whether, in view of the equities of the case, Federal reserve banks should not go further in helping out the country banker by a remission, for example, of charges in the case of checks sent direct by member banks to the Federal reserve bank, that is, upon all checks bearing only one bank indorsement. This would enable every country bank to offset (making due allowance for collection time) without expense the items sent against it. The payment of postage or express charges might properly be borne by the Federal reserve bank and, possibly the shipment of currency to the country bank might be borne by the Federal reserve bank when such shipment was necessary by reason of depletion due to the operation of what might be termed the "balance of trade". The whole question is one of very considerable difficulty, and is highly technical. It is so closely related to the question of reserves that it cannot well be disassociated from it, and it was for this reason that the Federal Reserve Board was inclined to think that the fairest and surest way of compensating country banks was by reducing the balances which they were compelled to keep with their reserve banks to a minimum figure. Coupled with the general provision of clearing all checks, the low reserve requirement becomes of great value to the country bank. Balances no longer need be kept in various cities far in excess of reserve requirements, and a bank is able to render a larger service in its own community and to offset its losses on exchange by earnings received from loaning its funds at home. However, if it appears that the country banks are still at a disadvantage, it may be said with some force that there is a great chance for profit by a reduction of excessive interest rates now commonly allowed to depositors. The Comptroller of the Currency and the Federal Reserve Board have always stood ready to help in the accomplishment of this much desired reform, for the reason that bank customers cannot hope for low interest rates on loans if banks continue the insane policy, usually the result of competition for deposits, of paying exhorbitant rates of interest for deposits.

F. A. DELANO.

Washington, June 16, 1917.