April 1, 1920

X-1881

I have your letter of March 31st enclosing copy of a letter from the Commissioner of Banking of the State of Wisconsin. I am much obliged to you for giving me an opportunity of removing a mistaken impression that the Commissioner appears to have that banks in certain states have been given special privileges by the Federal Reserve Board by being permitted to continue their exchange charges while banks in other states are remitting at par.

I enclose for your information copy of a response made by the Board on January 26, 1920, to a resolution of the Senate, which explains at considerable length the position that has been taken by the Federal Reserve Board and the various Federal Reserve Banks in the matter of the country-wide clearing of checks. In this communication reference is made to the provisions of Sections 13 and 16 of the Federal Reserve Act and to the opinion of the Attorney General of the United States as to the intent of these sections. The Board is charged with the duty and responsibility of inaugurating a complete check clearing system throughout the United States; the Federal Reserve banks must receive at par from member banks checks upon whomsoever drawn which are payable upon presentation, and the so-called "Hardwick Amendment" to Section 13 authorizes both member and non-member banks to make "reasonable charges, to be determined and regulated by the Federal Reserve Board, 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."

In view of the opinion of the Attorney General, the Federal Reserve Banks do not feel authorized to pay any charges to banks for remittances for checks drawn upon them and sent for collection by the Federal Reserve Banks. While banks are still authorized to charge each other for such service, they are prohibited from charging the Federal Reserve Banks, which are required to receive from member banks at par all checks which are payable upon presentation. Thus it came about that the Federal Reserve Banks found themselves in possession of checks drawn upon non-member banks which they could not send to the banks upon which the checks were drawn for the reason that those banks had declined to remit at par, and it became necessary therefore, as the law does not provide any penalty upon non-member banks for refusing to remit at par, for the Federal Reserve Banks to begin a campaign of education to induce non-member banks to remit at par, or failing this, to provide themselves with some other means of collecting checks drawn upon non-assenting banks.

Exchange charges are based primarily upon the cost of making transfers of funds from one section or from one country to another. In our dealings with foreign countries exchange is in our favor or against us according to the balance of trade and the flow of credits, and under normal conditions the rate of exchange is governed by and approximates the cost of transporting gold. This cost includes carriers' charges, insurance, interest for time in transit, and loss by abrasion. So, in our domestic exchanges, the charge was based originally upon the cost of transferring funds from one point to another. Sixty years ago when our transportation facilities had not been fully developed and express rates

were high the average cost of our domestic exchanges was about 1½%, or $15 per $1,000. As our transportation facilities improved, as the country became more thickly settled and the flow of goods between the various sections became larger and more constant, the result was that balances could be settled through the medium of bank drafts without involving the shipment of currency in such large amounts, and exchange costs declined so that thirty years ago the maximum charge was generally about $2.50 per thousand dollars. During the past twenty-five years the actual costs of making domestic exchange have been decreasing steadily and the consequence has been that there has been a fall in the average charge made by banks, so that during the past ten years $1. per thousand dollars has been the maximum charge in many sections of the country, although in some of the less thickly populated and more remote sections higher rates have obtained.

Since the establishment of the Federal Reserve Banks the cost of transferring balances from one section of the country to another has been almost entirely eliminated. Each Federal Reserve Bank carries a portion of its gold reserve in a gold settlement fund which is kept in the Treasury at Washington, and there is a daily telegraphic clearing conducted by the Federal Reserve Board for all twelve banks and for their branches. The amount of gold in the fund is practically a stable quantity, but its ownership varies from day to day according to the debits and credits to the different banks. Transfers are made by the Federal Reserve Banks

for member banks, and also for non-member banks through the medium of member banks, by telegraph without any charge whatever to the member bank or its client, all costs being borne by the Federal Reserve Banks. Thus, a bank in Wisconsin or California, Maine or Texas, can secure an instantaneous transfer to any one of the twelve Federal Reserve cities or to the twenty cities where there are branch Federal Reserve Banks without any expense whatsoever, and the sum total of these transfers is settled daily through the gold settlement fund above referred to. The Federal Reserve Banks pay all costs of transporting currency to or from their member banks as well as transportation charges on currency sent them by non-member banks in payment of checks.

The total volume of transactions through the gold settlement fund in the year 1919 was approximately $74,000,000,000, and the total cost, including the expense of the leased wires, was about $250,000. This cost was borne by the Federal Reserve Banks and does not represent any expense whatever to the member banks or their customers. Thus it will be seen that the basic cost of making domestic exchange in the year 1919 was three-tenths of a cent for each $1,000 transferred. A charge of 10¢ per $100 on the amount cleared through the Gold Settlement fund would have involved an expense of $1. for each $1,000 transferred, or about $74,000,000 for the entire amount.

The intra-district clearings made by the Federal Reserve Banks, eliminating duplications, amounted to about $135,000,000,000, and the total expense of these transfers was borne by the Federal Reserve Banks.

Had the Federal Reserve Banks been obliged to pay for these transfers at the rate of 10¢ per $100, it will be seen that the total expense would have been $135,000,000, which amount is far in excess of the total earnings of the Federal Reserve Banks and therefore could not have been absorbed by them. If not absorbed, the charge would have had to have been transferred to the depositors of the checks, so it will be seen that a charge of 10¢ per $100 upon the business handled by the Federal Reserve Banks would have involved last year a cost to the commerce and industry of this country of at least $135,000,000.

However, the practice of making exchange charges, which began when there was a real justification for such charges because of the expense of transferring funds, had become so deeply rooted that most of the banks very naturally looked upon the charge as a normal and legitimate source of revenue and were reluctant to give it up. Until the Federal Reserve Act was amended in June 1917 the Federal Reserve Banks had no mandate for undertaking to collect checks on non-member banks at par, and their activities with respect to clearances were devoted mainly to the collection of checks on member banks. But after

the passage of the "Hardwick Amendment" with the proviso above quoted which is underscored, it became the duty of the Federal reserve banks to undertake to establish a complete check clearing system, including checks drawn on non-member banks as well as on members. There are approximately twenty thousand non-member banks in this country, and at the time the Act was amended, three years ago, a large majority of them were firmly committed to the policy of making an exchange or service charge for remitting for checks drawn upon them. It was clearly impracticable in the absence of some legislation penalizing banks which would not remit at par to establish a complete clearing system over night. It was therefore determined to begin a progressive campaign of education, along the line of least resistance.

A large majority of the banks in New England have been for the past twenty years remitting to the banks of the Boston Clearing House at par, and it was decided to establish in that district the first complete Federal reserve clearing system. A few banks in Vermont objected, but within a few months they all came into line. The system was then extended to the New York district. In a part of that district the opposition was more determined and it was necessary for a while to make collections on some of the banks through express companies. Then the system was extended to the Philadelphia district, and afterward to the Chicago, Cleveland, Kansas City and Dallas districts, as well as to certain states in other districts.

It was deemed wise not to force matters by making collections through the express companies or other agencies until the non-member

banks had had the whole situation fully explained to them and were given an opportunity of agreeing to make remittances at par. Then when a majority of the banks in a Federal reserve district had so agreed arrangements were made to collect on non-assenting banks by means of agencies, announcement then being made that the system was operative throughout the entire district or in particular states in a district.

There is pronounced opposition in Minnesota, and the Federal Reserve Bank of Minneapolis does not feel that the time is opportune for the announcement of a complete clearing system in its district. Northern Wisconsin is in the Minneapolis district and southern Wisconsin in the Chicago district, hence the apparent inconsistency referred to by the Commissioner. Northern Louisiana is in the Dallas district and southern Louisiana in the Atlanta district. The Dallas bank has perfected its clearing system while the Atlanta bank has not. In the Atlanta district, which embraces parts of Tennessee and Mississippi and all of Alabama, Georgia and Florida, there is very great opposition to the Federal reserve clearing system on the part of state banks. This opposition exists also in North and South Carolina, which are in the Richmond district. It is not so pronounced in the State of Virginia, and the Federal Reserve Bank of Richmond has announced that the clearing system is in effect as of April 1 throughout the State of Virginia, but it is not yet in effedt in the Carolinas, except as to member and assenting banks.

I enclose herewith copy of a law which has recently been enacted by the Legislature of Mississippi, from which you will see that banks

in that state are required to pay checks, by whomsoever presented, which come through another bank at the rate of $99.90 per $100. In view of this law it is impossible for the Federal reserve bank to enforce the will of Congress in the State of Mississippi. In Georgia a number of non-member banks instituted proceedings against the Federal reserve bank and secured a temporary injunction restraining the bank from collecting checks by making presentation through an agent for payment over the counter, and as under the terms of the "Hardwick Amendment" the Federal reserve bank cannot pay exchange to the banks upon which checks are drawn, it has no recourse except to decline to take such checks at all. In Alabama where the Federal reserve bank attempted to appoint agents to collect checks, it found in many cases that it was impossible to get anyone to accept the agency, and in one case where a reputable merchant was induced to accept the agency he gave it up after a few days because the local banks had convinced him that his business would suffer if he continued to act for the Federal reserve bank.

The Board is doing everything in its power to have the clearing system apply equally to all sections and to all banks. Including member banks there are about thirty thousand banks in the United States and twenty-seven thousand of them are now remitting at par. The three thousand which decline to remit are making a determined effort to defeat the purposes of the Federal Reserve Act with respect to a country-wide check clearing system, and unless Congress should be willing to enact some law making it decidedly to the interest of banks to remit at par, just as in 1865, by the exercise of its taxing power, Congress made it

to the interest of the state banks to retire their state bank notes, it is difficult to see how it is possible to accelerate the present rate of progress in the development of a complete nation-wide check clearing system through the Federal Reserve Banks.

In the foregoing I have endeavored to show (1) that there is no longer a basic cost to the banks of the country in making domestic exchanges, (2) that Congress has forbidden both member and non-member banks to make exchange or service charges against the Federal reserve banks, and (3) that the Attorney General of the United States has held that Federal reserve banks are not permitted to pay such charges.

I may add that the Federal reserve banks give non-member banks which agree to remit at par the option of paying by check on some convenient banking center or by shipment of currency at the expense of the Federal reserve bank. Stamped envelopes are always sent a non-member bank for use in making remittances. Non-member banks are not asked to perform any collection service; they are merely asked to waive personal presentation of checks drawn upon themselves by their own depositors and to pay them through the mails without making any charge, and the law appears clearly to direct them to do this.

Some of the banks, member banks as well as non-members, are asking their depositors to use a check which has imprinted upon its face some restrictive clause, such as "Payable only in exchange at current rates", or "Not payable in cash if presented for account of a Federal Reserve bank". I enclose for your further information forms of notices which are being

used by manufacturers and jobbers in various centers in returning checks to their customers which cannot be collected through a Federal Reserve Bank, and also copy of a letter which I am informed a well known shoe manufacturing concern is sending to its customers.

The legal proceedings against the Federal Reserve Bank of Atlanta, to which reference is made above, were brought in a State court. The case was transferred to a Federal court and was heard on its merits a few days ago, but up to this time no decision has been handed down. In any event, an appeal will probably be taken to a higher court - possibly to the Supreme Court of the United States - and it is probable that several months will elapse before a complete clearing system can be established in the Atlanta district.

Very truly yours,

(Signed) W.P. G. Harding.

Governor.

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HOUSE BILL NO. 651

(As approved by the Governor March 6,1920)

AN ACT TO PREVENT THE FEDERAL RESERVE SYSTEM FROM FORCING THE BANKS OF THIS STATE INTO WHAT IS KNOWN AS THE PARRING OF CHECKS, DRAFTS, BILLS, ETC:(COMMONLY KNOWN AS "CASH ITEMS"); AND FOR THAT PURPOSE MAKING IT MANDATORY ON THE BANKS OF THIS STATE TO CHARGE EXCHANGE ON SUCH "CASH ITEMS"; AND FIXING THE RATES OF SUCH EXCHANGE.

Section 1. Be it enacted by the Legislature of the State of Mississippi:

That for the purpose of providing for the solvency, protection and safety of the banking institutions of Mississippi, the established custom on the part of the banks of this state to charge a service fee (commonly called "exchange") for collecting and remitting, by exchange or otherwise the proceeds of checks, drafts, bills, etc., (commonly known among banks as "cash items") is hereby declared to be the law of this state; and the banks of this state, both state and national, shall continue to make such charge as fixed by custom when such "cash items" are presented to the payer bank for payment through or by any bank, banker, trust company, Federal Reserve Bank, postoffice, express company, or any collection agency, or by any other agency whatsoever; and the amount of such charge is hereby fixed at one-tenth of one per centum of the total amount of such "cash items" so presented and paid at any one time, and not less than ten cents on any one such transaction; provided, however, no such charge shall be made on checks or drafts given or drawn in settlement of obligations due the State of Mississippi or any subdivision thereof, or of the United States. And that no such charge can be made by banks for the collection of checks deposited with said banks, where the check is drawn on any other bank in the same municipality, city, town or village, this being the long established custom of such banks. And, provided that nothing in this act shall be deemed to be mandatory upon the banks to charge exchange on checks or drafts payable to a person in this state, and drawn on a bank, trust company or person within or without this state, but it shall be optional with such banks whether they shall charge exchange on checks or drafts payable to a person within this state, and drawn on a bank, trust company or person within or without this state.

Section 2. That no officer in this state shall protest for non-payment any such "cash item", when such non-payment is solely on account of the failure or refusal of any of said agencies to pay such exchange; and there shall be no right of action, either at law or in equity, against any bank in this state for a refusal to pay such cash item, when such refusal is based alone on the ground of the non-payment of such exchange.

Section 3. That if for any reason the courts should hold that the national banks in this state are not required to charge and collect such exchange, still this act shall remain in full force and effect as to all other banks in this state, and in the event of such holding by the courts, or the refusal of any national bank in this state to comply with this act, then it shall be optional with state banks located in the same municipality with a national bank or state banks which are members of the Federal Reserve System as to whether such charge shall be made.

Section 4. That this act shall take effect and be in force from and after its passage.