X-4029

To - Federal Reserve Board April 12, 1924

From - Mr. Wyatt, General Counsel. Subject: Revised Draft of Regulation "J"

All of the Federal reserve banks have replied to the Board's circular letter of March 8, 1924 (X-3989) requesting suggestions with reference to the proposed Regulation J, Series of 1924, and such replies are attached hereto.

I have carefully considered all the suggestions made in these letters and have prepared and submit herewith a revised draft of Regulation J which incorporates all of such suggestions except those discussed below. None of the changes affect the broad policy of the regulation.

Mr. Bullen, Deputy Governor of the Federal Reserve Bank of Boston, suggests that whenever the publication of a complete series of the regulations is undertaken it would be well to transfer that portion of Regulation J which refers to deficiencies in reserves, to Regulation D and that Regulation D should be given a new caption - "Reserves." Mr. Bullen thinks this would be a more logical grouping of the regulations and I agree with him. I have not incorporated this change in the present Regulation J, however, for fear that it might cause some delay in the promulgation of the new regulation. I believe that when the new Regulation J and the proposed new Regulation H are finally adopted it would be well to issue a complete new edition of the Board's regulations, in order that the entire regulations may be included in one pamphlet so as to avoid the confusion and inconvenience which would result from the necessity of referring to several different publications. This would not involve much extra expense because the present regulations are plated and would not have to be set up in type and proof-read. If the Board decides to do this I think it might be well to adopt Mr. Bullen's suggestions at the time the new regu-

lations are issued and this could be done with very little trouble and without any change in the substance of the Board's regulations. It would merely amount to a transfer of part of the regulations from one place to another.

Mr. Jay suggested that a provision should be inserted in Section 6 of Regulation J relating to penalties for deficiencies in reserves, which provision should cover that provision of the law which forbids a member bank to make new loans or pay any dividends while its reserves are deficient. He says that the present provisions of Regulation J with reference to penalties for deficiencies in reserves sometimes give rise to the impression that such penalties are in lieu of this requirement of the law and that the Board therefore has waived this requirement of the law. Such an impression, however, is absurd on its face, because the Federal Reserve Board has no power to waive this provision of the law. Furthermore, it is quoted in Section 6, and I do not see how the present regulation with reference to deficiencies in reserves could possibly give rise to any misunderstanding. It would seem that the incorporation of such a provision in that section would amount to an unnecessary repetition of the terms of the law. It is believed, however, that if and when the Board transfers the provisions regarding deficiencies in reserves to Regulation D it would be well to rearrange the quotation from the law and when that is done it might not be inappropriate to adopt Mr. Jay's suggestion and insert a section in the new regulation which would cover the subject of new loans and dividends while the reserves are deficient.

Mr. Wills, Federal Reserve Agent at Cleveland, has suggested that the Board insert in Section III (3) of Regulation J, the words "unless otherwise notified" or "until further notice," so as to qualify the requirement that Federal reserve banks shall not receive on deposit or for collection any check on any nonmember

bank which cannot be collected at par in funds acceptable to the Federal reserve bank. Mr. Wills says:

> "The reason for this suggestion is the possible effect of an absolute regulation which makes it mandatory upon a Federal Reserve Bank not to accept any check of the character described. I am wondering whether a milder statement might not serve the purpose of the regulation and still not convey notice to remitting nonmember banks that they may abandon their remitting and feel perfectly safe that the Federal Reserve Bank at no time and under no conditions would reinstate its over-the-counter presentation."

I think there is much merit in Mr. Wills' suggestion and that it is worthy of very careful consideration, since it might have the effect of reducing the number of withdrawals from the par list. I believe, however, that it is not in accordance with the present policy of the Board which I understand is to make it perfectly clear that the Federal Reserve System has definitely abandoned the collection of checks over the counter and therefore will not attempt to collect any checks on nonmember banks which will not remit in funds acceptable to the Federal reserve bank except where such checks can be collected through other banks in the same town or city. If the Board desires to adopt Mr. Wills' suggestion I think the best form would be to insert the words "until further notice" at the beginning of Section III (3).

Mr. Randolph, Counsel to the Federal Reserve Bank of Atlanta, has suggested the addition of the following clause to Section V:

> "A Federal Reserve Bank will at all times be protected in conclusively presuming that any national or state bank which is permitted to remain open, and to transact its business, by the Federal or State authorities having supervision thereover, is solvent and is a suitable instrumentality to be utilized in collecting checks or other items, whether drawn on itself or on other banks."

He explains his reasons for this suggestion as follows:

> "It seems to us that the Federal Reserve Banks should be authorized by a regulation which would be binding upon all members of the system, to rely upon the conclusive presumption that any bank which is permitted to remain open is in a solvent condition, and is a suitable instrumentality to avail of in the collection of checks; otherwise the Reserve Banks (naturally being more or less familiar with the affairs of their member banks), must assume a possible liability in handling in the usual way checks drawn on members known to be in a weakened condition, or else, by refusal to handle such items in the usual way, perhaps precipitate failures which they are trying to avert."

I have not incorporated this suggestion in the revised draft of Regulation J because I doubt that the Board will care to adopt it, since it seems to go too far in limiting the liability of Federal reserve banks and in absolving them of all responsibility of conducting their business in a business-like way. It might give the impression that the Federal reserve banks are entirely too "hard-boiled" and might even result in legislation requiring the Federal reserve banks to assume more responsibility in the collection of checks. Furthermore, the new section V(3) inserted in the revised draft of this regulation affords the Federal reserve banks considerable additional protection against this sort of liability and certain other changes in the regulation have been made for the same purpose. If, however, the Board decides to adopt Mr. Randolph's suggestion, it will be very easy to insert it in Section V.

Mr. Martin, Federal Reserve Agent at St. Louis, has suggested that the term "exchange draft" be defined in a foot-note just as the term "checks" is defined. In my opinion this suggestion should not be adopted, because it would have the effect of limiting the authority of Federal reserve banks to accept exchange drafts in payment of checks forwarded for collection and in that way would increase their liability under the doctrine of the Malloy case, thereby defeating one of the principal purposes of the new regulation.

Governor Young of the Federal Reserve Bank of Minneapolis, suggests that the word "nonmember" should be eliminated from Section III (3), so that the section would forbid Federal reserve banks to receive on deposit or for collection any check drawn on any bank (member or nonmember) which cannot be collected at par in funds acceptable to the Federal reserve bank. He is afraid that the Federal reserve bank would be liable for negligence if it forwards a check to the drawee bank when the Federal reserve bank knows that such drawee bank is in a precarious condition and he says that it is often impossible to present such checks over the counter, which is the only safe way of collecting them under such circumstances. He says, however, that the Federal reserve bank can protect itself against such liability with reference to checks drawn on nonmember banks by dropping such banks from the par list and refusing to handle any further checks on them when they are in a precarious condition. This, of course, can be done under Regulation J in the form tentatively adopted by the Board. As to member banks, Mr. Young also admits that he is protected to a considerable extent by the fact that he is able to charge off the amount of dishonored checks from the reserve account of such member banks and also by requiring additional collateral from such member banks, which collateral is held not only as security for rediscounts of that bank but also for any other liability of such member bank to the Federal reserve bank. He says that on February 29, 1924, the Federal Reserve Bank of Minneapolis had approximately $250,000 in dishonored drafts of closed nonmember banks which were in payment of transit items and about $400,000 of such drafts of member banks, and that, "The $400,000 of dishonored drafts from closed member banks, we are perhaps liable on a portion of the amount, but we are so fortified in most cases with additional collateral that was pledged for any and all obligations of the bank to us, that the eventual loss,

even though we are found negligent, will only be a small portion of the amount." These facts would seem to show that the liability of the Federal reserve bank, if any, for sending items direct to member banks which are known to be in a precarious position is not so great after all. Furthermore, it is believed that the new Section V (3) and certain other changes incorporated in the attached revised regulation, including the specific authority to send such checks direct to the drawee banks at any time, would afford a Federal reserve bank sufficient protection against losses of the kind contemplated by Governor Young.

There is a far more important and vital objection to Mr. Young's suggestion, however, which lies in the fact that under the terms of Section 16 as interpreted by the Supreme Court of the United States in the par clearance cases, Federal reserve banks are required by law to receive on deposit from member banks or from Federal reserve banks, checks and drafts drawn on any member bank or clearing member bank, and if Section III (3) were amended as suggested by Governor Young, it would forbid Federal reserve banks from doing something that they are required by law to do. This being so, such a regulation would be absolutely void and of no effect and of course could not afford the Federal reserve bank any protection whatever. If Governor Young desires to ignore this requirement of the law and refuse to handle checks on member banks which are in a precarious condition he could do so just as well under the regulation as it is now written as he could under the regulation amended in accordance with his suggestion, since the Board has no more authority than he has to disobey the law or take any action inconsistent therewith. If the Board attempted to do so it would not give him any more authority than he now has to refrain from handling such checks. For these reasons I did not incorporate Governor Young's suggested change in the present draft of the regulation.

Governor Calkins of the Federal Reserve Bank of San Francisco suggests that the words "their accounts with" should be eliminated from Section III (2) since it seems doubtful to him whether authorization obtains for direct routing between member banks and Federal reserve banks of different districts for the account of the sending bank and that consequently the effect of this should be to have such sendings for the account of the Federal reserve bank of the district in which the sending bank is located. Governor Calkins' point is not entirely clear, but it seems to me that his recommendation involves a distinction without a difference. Where one Federal reserve bank receives a check from a bank located in another district and credits it to the account of the Federal reserve bank in the other district, such other Federal reserve bank would naturally credit the check to the account of the member bank which forwarded it for collection, regardless of whether or not this phrase is contained in the regulation. The regulation as now drawn, therefore, conforms most closely to the actual practice and it would seem better not to adopt this suggestion.

Governor Calkins also suggests that old Section V (4), new Section V (5), be amended so as to authorize the sending of checks payable in another district to the branch of the Federal reserve bank or direct to the drawee bank for the account of the Federal reserve bank of the drawee bank's district, in order to shorten the time necessary to collect such checks and eliminate circuitous routing. This suggestion has much merit, but it would make quite a radical change in the present method of handling such checks and would lead to such legal and practical complications as to make it inadvisable in my opinion to adopt such suggestion until after very careful study and a thorough discussion at a Governors' Conference. A more important objection to this change is that it might subject Federal reserve banks

to additional legal liability and thus defeat one of the principal purposes of the new Regulation J which is to limit the liability of the Federal reserve banks in handling checks for collection. If the regulation should be amended so as to authorize a Federal reserve bank receiving checks on a bank in another district to send such checks at its option either to the drawee bank direct or to the Federal reserve bank of the drawee's district, it would place the burden upon the Federal reserve bank to decide which is the better course to pursue in each case, and if the Federal reserve bank should elect to send a check to the Federal reserve bank of the drawee's district rather than direct to the drawee bank and such sending should result in a delay in presentation of such check and the drawee bank should fail before the presentation but after the time it could have been presented if sent direct, the Federal reserve bank might be charged with negligence because it failed to adopt the most expeditious manner of collection. Where the bank is only authorized to send such a check to the Federal reserve bank of the drawee's district, however, it would be protected in complying with the Board's regulation and would not be forced to make a decision which might result in a loss.

In addition to the changes suggested by the various Federal reserve banks, I have made a few other changes in the regulation, some of which are original with me and some of which were suggested by Messrs. Wallace and Stroud, Counsel for the Federal Reserve Banks of Richmond and Dallas, respectively. The most important of these is the new Section V(3) which was inserted because it is believed that it constitutes a clearer and more specific authorization to accept bank drafts in payment of checks forwarded for collection, and more completely protects the Federal reserve banks against liability growing out of the doctrine of the Malloy case.