BANK COLLECTIONS AND PAR CLEARANCE

Despite increasing liberalism in other fields, our American courts seem determined to compel banking practice to conform to established doctrines of law and steadfastly refuse to adapt the law to sound banking practice. As one might expect, any such medieval legalistic principle cannot be carried to its logical conclusion. The existence of banking customs cannot be wholly ignored. Their partial and reluctant recognition has led to some strange inconsistencies in the law of bank collections and has confronted the banks with some curious problems of law evasion.

In the case of Federal Reserve Bank of Richmond v. Malloy (1924, U.S.) 44 Sup. Ct. 296, the United States Supreme Court reiterated the apparently rigid rule that a bank acting as collection agent of commercial paper is under a duty to the holder to receive cash in payment, and accepts an exchange draft at its peril. The court by way of dictum admits that if the custom were without exception to transmit the proceeds of checks (not cleared through clearing houses or the books of the Federal Reserve Banks) by receiving drafts of the drawee upon some other banks, it might be permitted to control. But this ray of hope is considerably dimmed by the court's curious assertion that "there is nothing to prevent the sending bank from requiring the drawee to remit currency as a condition upon which the check may be satisfied." Yet only recently the same court in American Bank & Trust Co. v. Federal Reserve Bank of Atlanta noted some of the reasons why drawee banks have come to rely on the custom of paying their obligations by means of drafts. That case arose out of the attempt of the Federal Reserve Banks to effectuate universal par clearance. Country banks have strenuously resisted par clearance

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because a large part of their profits consists of the small exchange charges which they arbitrarily deduct from the amount of every draft remitted by them at a distance in payment of checks drawn on them and which it is the purpose of par clearance to eliminate. Another important source of income is the interest paid on the deposits in city banks against which they draw these drafts. In trying to bring them to terms the Federal Reserve Bank of Atlanta struck a double blow. It undertook to collect checks over the counters of recalcitrant banks, thus forcing them to pay in cash the face value of the checks. This eliminated the exchange charge, and it also deprived the banks of interest by compelling them to maintain large amounts of cash in their own vaults. The Supreme Court enjoined the Reserve Bank from collecting checks "except in the usual way." True, the undenied allegations of the bill declared that the Reserve Bank was accumulating checks on the country banks and presenting them in large and irregular batches in order to compel them to keep on hand an excessive amount of cash; and when on retrial the allegations were denied by the Reserve Bank and not sustained by the evidence, the relief sought in this respect was denied. But in denying the relief the court stressed the point that the Reserve Bank had formally declared itself willing to receive in payment of such items a draft of the drawee, if solvent, on any other solvent bank. Certainly in that case the court realized that compliance with the rule against taking payment of checks in bank drafts was at least undesirable.

Oddly enough another feature of the same struggle for par clearance which exposed the obsolescence of the rule of the Malloy case may carry within it the germs of a remedy. Before the state banks had won their contention in the courts the legislatures of several agricultural states came to their rescue by providing that drafts on these banks whenever presented by or through a

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Federal Reserve Bank might be paid in exchange, and less exchange charges. The constitutionality of the North Carolina statute was sustained in Farmers' & Merchants' Bank of Monroe v. Federal Reserve Bank of Richmond (1923) 262 U.S. 649, 43 Sup. Ct. 651. So far as these statutes permit the payment of checks in exchange drafts, they are to be unqualifiedly approved. They raise, however, some questions as to the legal responsibility of banks which now receive such drafts in payment of commercial paper. As against a principal who must be taken to know the disability of his agent to require cash, obviously it is no longer negligence not to collect cash. It is equally clear that the agent would not be justified in receiving every sort of draft offered by the drawee. Certainly it could not take a draft which it knew to be worthless. But must it be free from negligence in not knowing the draft to be worthless? Must it be reasonably certain that the draft is good? If it were not for the rules of protest and notice, the problem would be relatively simple. A check might be treated like a promissory note without endorsers; a worthless draft given by the drawee might be regarded as conditional payment, its dishonor leaving the holder all his original rights against the drawer and other parties. This rule might well be applied in cases where protest and notice had been waived or in the rare cases in which the worthlessness of the second draft, as, for instance a check on another institution in the same city, could be discovered in time to protest the first one. In deciding cases which may arise under these statutes the law of bank collections may be forced into line with banking practice. As a practical solution of the problem, the Federal Reserve Banks will simply contract themselves out of all responsibility. They will merely add one more to their already long list of exemptions from liability. And the member banks will just as rapidly change the set of conditions upon which they receive checks for collection. As to the original collecting bank's ability to

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make such a contract with all of its principals, some interesting problems of offer and acceptance arise, and it is probable that there are occasional instances in which the bank could not shake off all liability.

But that portion of these statutes which purposes to obviate par clearance by permitting the deduction of exchange charges was prompted by a short-sighted policy. Exchange fees exacted for services which are not rendered are a useless drain on commerce, a waste motion; but their elimination, generally conceded to be highly desirable, has been most difficult to put into practice. Even member banks at first refused to remit at par voluntarily and had to be required to do so. Nor after Congress permitted to non-member banks the advantages of collection through the Federal Reserve System, could these banks be induced to give up their exchange charges. The Reserve Banks determined to collect at par regardless of opposition or temporary expense, as is illustrated by the American Bank & Trust Co. case. Whenever the opposition persisted in remaining unconvinced, their effort was effectively blocked. At present attempts to achieve a universal par clearance system by coercion of unwilling banks have been abandoned. The protest against the change, however, is that of the subliminal competitor always loudly voiced on the introduction of new, more efficient conditions. If it is true, as the objectors insist, that they cannot exist without their unearned profits, then at least they should be recognized as parasitic and maintained as such.

The building up of a smooth efficient system of commercial transfers and clearances has been one of the most valuable contributions of the Federal Reserve. The decision in the Malloy case will not induce a return to clumsy expensive methods of transferring funds. Nor will the decision in the Farmers' Bank case permanently deter par clearance. Universal par clearance is essential to efficiency and it is not likely that the Federal Reserve Banks will be satisfied with an incomplete system.

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FEDERAL RESERVE BOARD

WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE TO
THE FEDERAL RESERVE BOARD

X-4082
June 10, 1924.

SUBJECT: Withdrawal of authority to effect exchanges, replacements and redemptions of United States paper currency as fiscal agents.

Dear Sir:

There are enclosed herewith for your information a copy of a letter addressed to the Board by Mr. Winston, Under Secretary of the Treasury, under date of June 10 and a copy of the Board's reply of the same date.

You will note that Mr. Winston advises the Board that, owing to the failure of Congress to pass the Second Deficiency Bill, the Treasury is without funds with which to defray the expenses of shipments of unfit United States paper currency from the Federal Reserve Banks to the Treasury and the expenses of shipments of new United States paper currency from the Treasury to the Federal Reserve Banks until July 1, 1924, and that because of this situation the Treasury has temporarily discontinued the fiscal agency functions of the Federal Reserve Banks in effecting exchanges, replacements and redemptions of United States paper currency until July 1, 1924. You will also note that this has no bearing on shipments of Federal reserve bank notes, Federal reserve notes and national bank notes.

Mr. Winston requests the Board to advise you of the Treasury's position in this matter, but, inasmuch as the authority of the Federal Reserve Banks to perform such functions as fiscal agents of the Government emanated from the Treasury Department, the Board feels that notification of the withdrawal of such authority should also emanate from the Treasury Department and has so notified Mr. Winston.

The Board feels that, upon the withdrawal of this fiscal agency function, the Federal Reserve Banks should discontinue exchanging, replacing and redeeming United States paper currency until this function is restored, since this is purely a Governmental function which the Federal Reserve Banks can no longer legally perform. When applications are made to the Federal Reserve Banks for the exchange, replacement or redemption of such United States paper currency it is suggested that the

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Federal Reserve Banks advise the applicants that their authority in this respect has been temporarily withdrawn by the Treasury due to the failure of Congress to appropriate funds to defray the expenses thereof and that it will be necessary for the applicants to ship such currency direct to the Treasury for exchange, replacement or redemption.

Of course, irrespective of its authority as fiscal agent, a Federal Reserve Bank has the same right as any other bank in the ordinary course of its banking business to exchange one form of currency for another. No difficulty should be experienced in meeting the denominational demand for currency, except perhaps with respect to $1 bills, in which event the reserve banks can pay out such $1 bills as they have on hand, irrespective of the standard of their fitness and also partially meet the demand for $1 pieces by paying out standard silver dollars.

Very truly yours,

D. R. Crissinger,
Governor.

(Enclosures)

TO ALL GOVERNORS OF FEDERAL RESERVE BANKS.

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THE UNDERSECRETARY OF THE TREASURY

WASHINGTON

June 10, 1924.

My dear Governor Crissinger:

The second deficiency bill failed of passage before the close of Congress Saturday. This bill carried a deficiency appropriation necessary to permit shipments of United States paper currency for the last three weeks of June. The Federal Reserve Banks are acting under instructions of the Treasury in receiving unfit currency, forwarding it to the Treasury in Washington, and receiving in exchange new currency so far as available. I accordingly wired them that since the appropriations were insufficient, if they desired new currency it could only be furnished if they wished to pay the expense of shipment. I expressly stated that this had no bearing on shipments of Federal Reserve notes, Federal Reserve Bank notes, and National Bank notes. When the subtreasuries were in existence, it had been the practice on shipments of paper currency from banks to the Treasury or to the subtreasuries, that the bank making the shipment paid the expenses of sending in the unfit currency and of transporting the new currency. When the subtreasuries were abolished, as a matter of convenience the Treasury authorized the Federal Reserve Banks to receive for it unfit currency and to pay out for it new currency, and the Treasury then paid the expense of shipments from and to the Federal Reserve Banks. Since funds for this expense are no longer available and will not be until the beginning of the next fiscal year on July 1st, the Treasury has been obliged to withdraw these agencies temporarily and

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return to its original practice.

It is, of course, unfortunate that the deficiency bill did not pass but the Treasury is faced with a condition which it cannot remedy, and unless the Federal Reserve Banks are willing to assume this expense, shipments of new currency to the Federal Reserve Banks will cease until July 1, 1924. I trust, therefore, that your Board will advise the Federal Reserve Banks of the Treasury's position and your views in respect thereto.

Very truly yours,

(signed) Garrard B. Winston

Garrard B. Winston,
Under Secretary of the Treasury.

Hon. D. R. Crissinger,
Governor,
Federal Reserve Board.

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June 10, 1924.

Honorable Garrard B. Winston,
Under Secretary of the Treasury,
Washington, D. C.

Dear Mr. Winston:

The Board has received your letter of June 10th and notes that, because of the failure of Congress to pass the Second Deficiency Bill, the Treasury is without funds with which to defray the expenses of shipments of unfit United States paper currency from the Federal reserve banks to the Treasury and the expense of shipments of new United States paper currency from the Treasury to the Federal reserve banks until July 1, 1924, and that because of this situation the Treasury has temporarily discontinued the fiscal agency function of the Federal reserve banks in effecting exchanges, replacements and redemptions of United States paper currency until July 1, 1924. It is also noted that this has no bearing on shipments of Federal reserve bank notes, Federal reserve notes and national bank notes.

Inasmuch as the Federal reserve banks act as the fiscal agents of the Government in performing these functions, the Board assumes that you have notified the Federal reserve banks of the withdrawal of their authority to effect exchanges, replacements and redemptions of United States paper currency as fiscal agents of the Government.

In view of the withdrawal of this fiscal agency function, the Federal reserve banks will have to discontinue exchanging, redeeming and replacing United States paper currency until this function is restored, since this is purely a Governmental function, which the Federal reserve banks can no longer legally perform.

Very truly yours,

(Signed) D. R. CRISSINGER

Governor.

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