COPY X-6438

FEDERAL RESERVE BANK
OF
ST. LOUIS

December 2, 1929.

Mr. Walter Wyatt,
General Counsel,
Federal Reserve Board,
Washington, D. C.

Dear Mr. Wyatt:

I am enclosing copy of my suggestions to Governor Martin on the inquiry contained in Governor Harding's letter.

(1) - I cannot find any legal obstacles which would preclude the taking of such collateral in special cases.

(2) - I cannot find anything in the wording of the amendments which would prohibit the taking of such collateral;

(3) - In the face of the vote on the Weed resolution, it cannot be said that it was the intent that our recommendation should include such a prohibition;

(4) - Each bank was left free to take or not take such collateral and not violate the intent of the policy recommended.

In our discussions, I think all of us had in mind member banks only, since the EARLY case arose out of a member bank case, and, the decision in the STORING case we were considering general collateral of a member bank with the Reserve bank. However, Regulation 'J' applies alike to member and non-member par banks, and, in my discussion in the report to Governor Martin, I have considered both classes as included.

I think I can see clearly why Mr. Weed's suggestion could be followed in his and other similarly situated districts but could not be safely adopted in other districts like ours; and, whilst the adoption of such a policy in one district - when not followed in another - might cause the latter some embarrassment in a particular case in explaining why when it had the same right it had not taken the same precaution. Nevertheless, I do not believe one district should be prohibited from taking the collateral because some other district did not feel justified in so doing.

In addition to the foregoing reasons for not taking the collateral in the 8th District, we have MISSOURI and ARKANSAS by Judicial decisions, KENTUCKY by practice, and, INDIANA by Statute, allowing preference on transit items in the case of State banks, so that the loss to the owners of transit items in this District has been a negligible quantity. Therefore, I would not like to recommend that we adopt a policy in this District of taking such collateral.

Very truly yours,

(S) Jas. G. McConkey,

Counsel.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

FEDERAL RESERVE BANK OF ST. LOUIS

COPY

X-6438-1

November 15, 1929.

Mr. Wm. Mc C. Martin, Governor,
Federal Reserve Bank of St. Louis,
St. Louis, Missouri.

Dear Mr. Martin:

RE:- Interpretation of Conference Policy re Check Collection Topic for Governors' Conference.

Attached is copy of a letter X-6409-b from Governor Harding of the Federal Reserve bank of Boston to Governor Young of the Federal Reserve Board relative to the Board's letter X-6389 attached hereto, and, copy of a letter X-6409-a from the Board's Counsel to Counsel of the Federal reserve banks. Governor Harding inquires whether the policy outlined in the Board's letter would prohibit banks making special arrangements in special cases to take collateral to insure the payment of transit items, particular reference being made to paragraph 4 of Section V of Regulation 'J' as amended, and, which is as follows:

> "(4) Checks received by a Federal reserve bank on its member or non-member clearing banks will ordinarily be forwarded or presented direct to such banks and such banks will be required to remit or pay therefor at par in cash, by bank drafts acceptable to the collecting Federal reserve bank, by telegraphic transfers of bank credits acceptable to the collecting Federal reserve banks, or by authorizing the collecting Federal reserve bank to charge their reserve accounts or clearing accounts."

At the Conference of Counsel, we had before us the EARLY case involving the right to charge at any time the member banks' account with the unremitted for cash letters, and, STORING vs. FIRST NATIONAL BANK of MINNEAPOLIS case involving the right to use the general collateral furnished by the closed member to pay unremitted for cash letters.

After a general discussion, it was found that Counsel for four of the Reserve banks favored the following of the rule as laid down in these cases - this plan was (for convenience) designated Policy A. Counsel for the other eight Reserve banks objected to this plan, and, offered another plan designated Policy B. With this division before us, the following Resolution was offered:

> "RESOLVED, That it be the sense of this conference that uniformity among all the Federal reserve banks in the treatment of reserve balances, collateral accounts and the cash surrender value of capital stock in relation to outstanding cash items, is desirable and that whether the policy outlined by Messrs. Ueland and Wallace on the one hand or the policy outlined by Mr. Stroud on the other hand be adopted,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

FEDERAL RESERVE BANK OF ST. LOUIS

the action of all of the Federal reserve banks in relation to the matter under discussion should be of one accord."

Mr. Logan moved, as an amendment to the Resolution, that all of the Resolution after the word "desirable" be eliminated. The amendment was unanimously carried. (Page 2 of the Minutes.) Policy B. favored by Counsel for eight of the Federal reserve banks was then presented, and, after a general discussion resulting in some changes in its verbage, Mr. Agnew moved its adoption.

Mr. Weed, of Boston, moved as a substitute that a reservation be included therein giving the right to any Federal reserve bank in special or exceptional cases to charge unremitted for cash letters to collateral taken for that specific purpose. Mr. Weed's motion was lost by a three to five vote of the eight Counsel favoring Policy B.

Mr. Agnew's original motion then carried by a vote of eight to four - Messrs. Weed, Logan and Stroud explaining that they voted for Policy B plan with the understanding that the report of the Committee was not intended to carry with it any implication that a Federal reserve bank might not in special cases make arrangements to insure the payment of transit items. Counsel for Philadelphia, Richmond, Chicago and Minneapolis not voting - presumably for the reason that they were not in accord with Policy B with or without the reservation.

The real question before the Conference until Mr. Weed's substitute motion was confined to the advisability of using any of the member banks' reserve, capital stock or general collateral for the payment of transit items. Mr. Weed's substitute motion raised the question of the right of the Reserve banks to take special collateral in particular cases to insure the payment of transit items, and, while Mr. Weed's substitute motion lost by a vote of 3 to 5, nevertheless, Policy B plan, as recommended, was adopted as expressing the views of the majority, with the explanation of the three favoring the Weed substitute that they voted for the report with the understanding that the report of the Committee is not intended to carry any implication that a Federal reserve bank may not make special arrangements to insure the payment of transit items in special cases. It would, therefore, follow that no implication against taking collateral in a special case was intended when Policy B was adopted as representing the views of those voting in favor of the policy. Further, it is reasonable to assume that if the four Counsel who favored policy A had voted they would have joined the three on the reservation clause, making a total of seven of the twelve Counsel favoring such a reservation, and, the motion to adopt Policy B without the reservation would have lost by a vote of five to seven. Therefore, Policy B as recommended by the Conference of Counsel approved by the Conference of Governors and adopted by the Board was not intended to prohibit a Reserve bank in a special case to take collateral to insure the payment of transit items.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

FEDERAL RESERVE BANK OF ST. LOUIS

ADVISABILITY OF TAKING SUCH COLLATERAL.

Now as to the advisability of taking special collateral to insure the payment of transit items, this raises a more difficult question than the interpretation of the meaning intended in Paragraph 4 of the Regulation.

I can find no legal obstacle to a Federal reserve bank in its agency relation taking such collateral to insure the payment of transit items, and, whilst a uniformity in all Reserve banks is desirable, nevertheless, when we attempt to formulate a plan to govern all districts alike, and, wherein the controlling factors in the several districts are so unlike in many respects, a uniform ruling to be followed seems impracticable.

For example, in the Boston and New York or other thickly populated districts where the member and the non-member clearing banks and the non-member par banks to which items must be sent through the mails, the banks are larger and stronger than in the sparcely settled agricultural districts and the instances are fewer where they would have to take such protection to secure the payment of transit items. Whereas, in the agricultural districts, we have a much larger number of small member, non-member clearing banks, and par banks, all in about the same but none too liquid condition, and, if we required collateral from one, to be consistent, we would have to call for the collateral from a much greater percentage of such banks than would Reserve banks in the more thickly populated districts, and, doubtless, these requirements would lesson the number of our par non-member banks.

Further, in the Boston and New York and other thickly settled districts, practically all the banks are located in towns on main mail routes and within a short time schedule from the Reserve banks. Consequently, it would seldom occur that there would be more than one cash letter sent out before the returns from the previous cash letters had been received. Therefore, the amount of collateral to be required would be less than it would be in a sparcely settled agricultural district where a large number of the banks are located in the country, or in small towns off the main mail routes and where we have 3 to 5 day points, and, frequently, 3 or 4 cash letters will have been sent out before the receipt of the remittance for the previous cash letters could be received; consequently, the amount of collateral necessary would be out of proportion to the banks' ability to furnish it, and, if demanded, might place a small, liquid, solvent bank in a very embarrassing position.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

FEDERAL RESERVE BANK OF ST. LOUIS

Further, it has been our observation that when a member bank reaches a condition where it is getting into the danger zone, and we would feel justified in asking for collateral to protect the cash letters, it already has under rediscount with us practically all its eligible paper, and, if its rediscounts with us is as much as its capital and surplus it has deposited with us as extra collateral to secure its discount obligations and with its correspondent banks on advances made, practically all its liquid and most of its slow paper so that the only collateral these small banks could supply would be of very doubtful value, and, if we were to require the banks to put up with us liquid collateral sufficient to protect the average outstanding cash letters, we would, in a great many cases, be taking from the bank the only class of paper on which it could secure advances sufficient to carry it over a distress period, and, might thereby, be a party in some cases to forcing an otherwise solvent bank into liquidation.

Taking the foregoing reasons into consideration, I do not believe it would be desirable to follow such a procedure in the Eighth District however desirable it might be in some of the other districts.

Very truly yours,

(S) Jas. G. McConkey,

Counsel.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

COPY

X-6438-a

LAW OFFICE

UELAND AND UELAND
401 New York Life Building,
Minneapolis.

November 22, 1929.

Governor W. B. Geery :

Our comments on Governor Harding's letter of October 19th to Governor Young, and Mr. Wyatt's letter of November 7th, both dealing with the recent amendment to Regulation J follow:

1. Governor Harding states that a Federal reserve bank in collecting checks as agent may be, as a practical matter, under compulsion to forward checks to drawee banks in dubious circumstances. He urges that in such cases the Federal reserve bank is at liberty to protect itself as agent and its principals (the owners of the checks) by taking collateral. This argument from practical necessity was advanced at the joint meeting of governors and counsel in support of the view (which has now been put on the shelf) that the Federal reserve clearing houses should furnish as much security as practicable to the owners of checks.

2. The first question is, can the right asserted by Governor Harding be reconciled with the recent amendment of paragraph 6 of Section V of Regulation J? It is argued that Regulation J in its present form does not prohibit a Federal reserve bank from taking collateral in such cases. This argument may be paraphrased thus :

> A Federal reserve bank collects checks as agent. The reserve account, the Federal reserve stock, and the collateral held by the Federal reserve bank <u>in its own right</u> cannot be held as security for the liability of drawee banks to remit for or return checks to the Federal reserve bank.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

That much is settled by the amendment to Regulation J. But notwithstanding that amendment a Federal reserve bank may in a specific case require and take collateral to secure liabilities running to the Federal reserve bank as a collection agent for the owners of the checks.

3. In order to test the validity of this argument we will suppose such "a specific case". A drawee bank suspends payment without remitting for or returning checks forwarded to it by a Federal reserve bank. But the Federal reserve bank has taken a pledge of Liberty Bonds to secure such a remittance. Paragraph 6 of Section V of Regulation J as amended reads in part:

> "neither the owner or holder of any such checks *** shall have any right of recourse upon, interest in, or payment from, any fund, reserve, collateral, or other property of the drawee in the possession of the Federal reserve bank."

Now in the face of this very plain English can the owners of the checks assert successfully that they are secured by the Liberty Bonds? In our opinion, they cannot.

4. It is obviously the language of the Regulation and not the language employed in the majority resolution of counsel which will control the action of the courts. Hence a Federal reserve bank would hardly be justified in proceeding contrary to the meaning of the Regulation in reliance upon language used or reservations made at the conference of counsel. But if it were, how could it have been intended by the majority of counsel that the rights of security which the Federal Reserve Bank of Minneapolis had been asserting for years on behalf of its principals were illegal preferences (see paragraph 6 of the majority report), whereas the security which the Federal Reserve

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Bank of Boston now proposes to take is not only proper but its taking commendable? The right asserted by Governor Harding is not, in our opinion, consistent with the majority resolution adopted at the conference of counsel.

5. If Governor Harding's views are concurred in by the Board the language of Paragraph 6 of Section V of Regulation J could be revised, before it takes effect on January 1, 1930, so as to give the Federal reserve banks the desired latitude. To our minds the only question is whether this revision is advisable. In this connection we quote from our letter written to Mr. Wyatt under date of May 1, 1929:

> "If Regulation J is to be amended so as to make liabilities for unremitted for transit items unsecured liabilities, but with the option to the Federal reserve banks to take securities in special cases, then we hope that the exceptional cases in which securities may be taken will be defined with as great accuracy as possible. In the light of its own experience the Minneapolis bank would probably want to go as far in this direction as an honest interpretation of Regulation J would permit."

If in special instances a Federal reserve bank can exact security from a drawee bank, there is no legal reason which we are aware of why that security may not consist of any of the drawee bank's assets. The security may be in the form of a pledge of bonds or customer's notes. But it may equally be in the form of a secondary lien on collateral which the Federal reserve bank already holds in its own right, or, if you please, a secondary lien on the reserve balance at the time of suspension. We do not see why Governor Harding's bank could not exact one kind of security just as properly as it could

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

another. Indeed it would be less of a burden on the drawee bank if it were permitted to hypothecate assets already in the hands of its Federal reserve bank, than to require it to deposit two separate and distinct funds to be held as collateral by the reserve bank, one fund as security for obligations to the reserve bank in its own right, the other as security for the principals of the reserve bank. In the latter case the drawee bank would have to part with a greater amount of securities.

We understand Mr. Wyatt to suggest that any arrangement by which the same collateral is taken to secure indebtedness owing to the Federal reserve bank in its own right and at the same time to protect it against losses in its capacity as a collection agent would produce confusion or conflict between the selfish interests of a Federal reserve bank and its duties as a collection agent. We doubt whether this is so, but if it were, the same objection may be made to the proposal to permit a Federal reserve bank to create two distinct collateral funds. The question could always arise, why was so much collateral placed in the "bills payable" envelope and so little in the "collection agent" envelope, etc. etc.

6. Accordingly if Regulation J were amended so as to permit a Federal reserve bank to take security "in special cases", Federal reserve banks would find themselves limited only by the embarrassing question of what is "a special case". What is a special case? A conservative officer of a Federal reserve bank would probably consider that every bank which was not in an impregnable financial posi-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

tion was a special case.

7. With the right open to a Federal reserve bank to take security for their principals under special circumstances, we think a court might fasten on this as a basis for liability on the part of a reserve bank is a case where security might have been, but was not, taken. If the effect of Regulation J should be that security may be taken in exceptional cases, then an obligation to act in the exceptional case might well arise out of the fiduciary relationship which everyone concedes the Federal reserve banks occupy to their depositors. Hence an exception or reservation in Regulation J would create doubt and uncertainty, instead of clarifying the extent of the duty owed by the Federal reserve banks to their depositors, which everyone at the conference seemed to agree was the principal objective to be attained. A Federal reserve bank cannot foresee in advance how much checks received by it for collection on a given bank will aggregate at any one time. Taking collateral would be tantamount to a declaration by the reserve bank that it considered the drawee bank unsafe. This would prove embarrassing if the checks received on that bank exceeded the amount or value of the collateral. Likewise taking collateral in special instances would, we anticipate, give rise to charges of favoritism and discrimination on the part of the reserve bank, all of which would be unpleasant even though untrue.

As a uniform policy has now been adopted by the conference of Governors and approved by the Federal Reserve Board, our conclusions are as follows:

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

(1) It is our opinion that that policy as now expressed in Paragraph 6 of section V of Regulation J does not permit a Federal reserve bank acting as a collection agent to take collateral in special cases.

(2) It is our opinion that as long as this uniform policy is maintained it would create confusion and uncertainty as to the legal rights, duties, and liabilities of the Federal reserve to make exceptions or reservations which would permit taking collateral in special cases.

(Signed) A. Ueland
Counsel.

(Signed) Sigurd Ueland
Assistant Counsel.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis