

**THE FEDERAL RESERVE
CHECK COLLECTION
SYSTEM, A THESIS**

Published @ 2017 Trieste Publishing Pty Ltd

ISBN 9780649344314

The Federal Reserve Check Collection System, a thesis by Gordon B. Anderson

Except for use in any review, the reproduction or utilisation of this work in whole or in part in any form by any electronic, mechanical or other means, now known or hereafter invented, including xerography, photocopying and recording, or in any information storage or retrieval system, is forbidden without the permission of the publisher, Trieste Publishing Pty Ltd, PO Box 1576 Collingwood, Victoria 3066 Australia.

All rights reserved.

Edited by Trieste Publishing Pty Ltd.
Cover @ 2017

This book is sold subject to the condition that it shall not, by way of trade or otherwise, be lent, re-sold, hired out, or otherwise circulated without the publisher's prior consent in any form or binding or cover other than that in which it is published and without a similar condition including this condition being imposed on the subsequent purchaser.

www.triestepublishing.com

GORDON B. ANDERSON

**THE FEDERAL RESERVE
CHECK COLLECTION
SYSTEM, A THESIS**

THE FEDERAL RESERVE CHECK
COLLECTION SYSTEM

56

A THESIS
IN FINANCE
PRESENTED TO THE FACULTY OF THE GRADUATE SCHOOL OF THE
UNIVERSITY OF PENNSYLVANIA IN PARTIAL FULFILLMENT
OF THE REQUIREMENTS FOR THE DEGREE
OF DOCTOR OF PHILOSOPHY

GORDON B. ^{of the} ANDERSON

PHILADELPHIA
1917

Pennsylvania Univ. Libr.
with
5-5-1927

THE FEDERAL RESERVE CHECK COLLECTION SYSTEM

In framing the Federal Reserve Act considerable attention was directed to the subject of collecting out-of-town checks. Sections 13 and 16 of the Federal Reserve Act referring to the clearing and collection functions of the Federal Reserve Banks provide as follows:

"Section 13.— . . . Any Federal Reserve Bank may receive from any of its member banks, and from the United States, deposits of current funds in lawful money, national-bank notes, Federal Reserve notes, or checks, and drafts payable upon presentation, and also, for collection, maturing bills; or solely for the purposes of exchange or of collection, may receive from other Federal Reserve Banks deposits of current funds in lawful money, national-bank notes, or checks upon other Federal Reserve Banks, and checks and drafts, payable upon presentation within its district, and maturing bills payable within its district."

"Section 16.— . . . Every Federal Reserve Bank shall receive on deposit at par from member banks or from Federal Reserve Banks checks and drafts drawn upon any of its depositors, and when remitted by a Federal Reserve Bank, checks and drafts drawn by any depositor in any other Federal Reserve Bank or member bank upon funds to the credit of said depositor in said reserve bank or member bank. Nothing herein contained shall be construed as prohibiting a member bank from charging its actual expense incurred in collecting and remitting funds, or for exchange sold to its patrons. The Federal Reserve Board shall, by rule, fix the charges to be collected by the member banks from its patrons whose checks are cleared through the Federal Reserve Bank, and the charge which may be imposed for the service of clearing or collection rendered by the Federal Reserve Bank.

"The Federal Reserve Board shall make and promulgate from time to time regulations governing the transfer of funds and charges therefor among Federal Reserve Banks and their branches, and may at its discretion exercise the functions of a clearing house for such Federal Reserve Banks, or may designate a Federal Reserve Bank to exercise the functions of a clearing house for its member Banks."

The Federal Reserve Act, as originally passed, did not provide

P.H.

01-3-28-Drive.

a technically adequate system for the collection of checks, with the result that the Federal Reserve Board recommended to Congress an amendment recasting the phraseology of Section 13, which was adopted in August 1916. The wording above is that of the law as then amended. The greatest change effected by the amendment was the elimination of the requirement that only checks and drafts upon "solvent member banks" might be deposited with a Federal reserve bank. It was manifestly impossible at the time a check was received by a Federal Reserve Bank to be certain that it was drawn upon a solvent bank. The Federal Reserve Bank, moreover, was protected against loss by the depositing member bank's endorsement on each check.

In addition, the revision in phraseology made certain that the Federal Reserve Banks could receive from member banks' deposits consisting in whole or in part of checks drawn upon non-member state banks. This greatly increased the value of the collection system to the member banks, particularly when the majority in number of state banks remain outside of the system. There were on March 5, 1917, 7581 national banks, all of which are members of the Federal Reserve System, and over 20,000 state banks, of which only 40 were members. Since approximately one-half of the checks received by the member banks are drawn upon non-member state banks, it became necessary to make some provision for collection of such items.

Collections Under the National Bank Act.—Under the National Bank Act national banks were divided into three groups, first, the national banks in New York, Chicago and St. Louis, designated as central reserve cities; second, national banks in fifty-two cities, known as reserve cities; third, national banks situated in other places, known as country banks. The purpose of this classification was primarily to bring about a certain degree of concentration of banking reserves. The central reserve and reserve city banks as reserve agents, carried a portion of the reserve, known as the "deposited reserve", of other banks, commonly termed correspondents. The deposited reserve is built up almost entirely through the deposit of checks which are sent by the correspondents to

their reserve agents for collection and credit. It was the common practice to credit these checks to the correspondent's account immediately upon receipt whether or not the reserve agent was able to collect them at once. Sometimes a week or more was necessary for the actual collection of a check. The aggregate of these uncollected checks was known as "the float."

Under the national banking system this "float" was of large proportions, and was necessarily increased by the indirect routing of checks and the delay in remittances. In a great many cases the same checks served as a reserve, not only for the country bank, but for the reserve city bank, inasmuch as the latter would in turn, send them to central reserve city banks for deposit and collection. The country bank upon mailing the checks would immediately count them as part of its deposited reserve. The checks would not be received by the reserve city bank for a day or more, and then the reserve city bank would forward the checks to a central reserve city bank for collection, counting this deposit as part of its own reserve. The reserve agents gave the correspondent banks immediate credit for these items, sometimes charging them exchange for the collection service rendered, and on other occasions levying an indirect charge by deferring interest until the funds were actually in hand.

Although correspondent banks received immediate credit for checks, which they deposited with their reserve agents, on the other hand, the reserve agent receiving checks drawn upon its correspondents seldom charged these items immediately against their accounts, but sent them home for collection and allowed the correspondent bank sufficient time to remit. Frequently the country bank would charge the reserve agent exchange for the checks presented on their accounts, this charge presumably covering the cost of the service rendered in honoring the checks and remitting by draft. Where the reserve agent received checks drawn upon banks which were not included among its list of correspondents, the common practice was to collect these checks in one of two ways; first, to send such checks to one of its correspondents situated in the same town or in a nearby community; second, to send the checks to a correspondent situated at some point geographically near the bank

on which the check was drawn, which correspondent had indicated on its so-called "par list" that it would take checks drawn on banks at their face value in that town. This roundabout method of collection increased the delay incident to the collection of checks and consequently exaggerated the size of the "float." It has been estimated that from one-third to one-half of the deposited reserve with reserve agents, really consisted of checks which were at the moment in the process of collection.

It is obvious that uncollected checks do not constitute a legitimate bank reserve. One of the purposes of the Federal Reserve Act is to eliminate fictitious reserves of this character, and to substitute a tangible reserve that will be available when necessary. The reduction in the reserve requirements of member banks, therefore, has really been less than would appear by a comparison of the percentages, for it will to a large degree, be offset by the elimination of the "float", or the fictitious portion of the deposited reserve under the old system.

Inauguration of the Federal Reserve Collection System.—The keystone of the Federal reserve system is the twelve Federal reserve banks, in whose hands will be centered the greater part of the reserves of the banks joining the system, known as member banks. The elimination of the old reserve agents is to be brought about gradually over a period of three years terminating in November 1917. Up to this time the member banks—comprising all the national banks and about forty out of the twenty thousand state banks—have been living under an anomalous arrangement, by which most of them are carrying their reserves in three places—in their own vaults, on deposit with the old reserve agents and on deposit with the Federal reserve banks. On and after November 16, 1917 (or earlier if an amendment recommended by the Federal Reserve Board is adopted) member banks can carry their reserves in only two places—in their vaults or on deposit with the Federal reserve banks. Thus the old reserve agents will be eliminated. It was obvious to the framers of the Act that with the elimination of the old reserve agents must come the creation of facilities which would perform the service heretofore rendered by such agents for the correspondent banks. The most important of these

services is the collection of out-of-town checks, frequently referred to as "foreign items."

The Voluntary Clearing System.—On May 15, 1915, the Federal reserve banks instituted a voluntary intra-district clearing system, which provided that the Federal reserve banks would charge immediately on receipt against the assenting member bank's account, subject to payment by such member bank, checks and drafts, payable upon presentation, deposited by other banks which had joined the system. Checks would be charged only against the accounts of those member banks which had assented to such action, from whence came the term "voluntary clearing system." Under this system each member bank had to provide sufficient funds to offset the items charged against its account. The portion of the reserve of the member bank, which the law required to be kept with the Federal reserve bank, was not to be impaired and whatever additional amount had to be kept on deposit to avoid such impairment, was to be determined by experience. Checks and drafts payable on presentation, drawn on any member bank in the district which had joined the collection system, were, subject to final payment, received for immediate credit to the depositing bank's account.

This plan is known as the reciprocal plan of immediate clearance. Each Federal reserve bank worked out its own method, based on the same general principle. At first it was purely an intra-district clearing plan, based on the principle of immediate debit and credit of items remitted to the bank for collection. Under this plan the member banks found it very difficult to gauge the excess balance, which they had to keep on deposit with the Federal reserve bank to cover items drawn on them. The Federal reserve banks, especially in the early stages of the system, had to be very lenient in the matter of deficiencies in reserves.

Comparatively few member banks took advantage of clearing their checks through the Federal reserve banks under the voluntary system. However, the large city banks cleared checks drawn on assenting banks with which they did not correspond, and in this way were able to dispose of some of their items more cheaply than under the old system. Despite the fact that the

Federal reserve banks absorbed all the costs involved, the voluntary plan of check collection was not a success. The member banks were still operating under a dual system of reserves. The reserve balances which the country banks carried with their old reserve agents still compensated the latter for the collection service rendered. Comparatively few banks agreed to the terms of the voluntary system, and the provision of the law since changed, which provided that only items on members of the clearing system could be handled, limited its usefulness. The need of including outside checks within the scope of operations, was obvious. Again, the bankers felt that the Federal reserve banks ought to assume the "float," but this, the Federal Reserve Board refused to sanction; pointing out that this would perpetuate the unsatisfactory procedure of making a large part of the deposits of the Federal reserve banks, float.

The serious inroads that would be made upon the deposits of the Federal reserve banks if they assumed the "float," can readily be demonstrated by an example. In the month from March 16, to April 15, 1917, the average daily collections passing through the twelve Federal reserve banks, consisted of 231,800 items, aggregating \$127,648,500. Of this \$67,360,500, or 52.7 per cent required from two to nine days for collection. Presuming, for the sake of illustration, that the average time of collection was three days, the "float" would, therefore, be in excess of \$200,000,000. The maximum deposits of the member banks with the Federal reserve banks reported in this period was \$758,219,000.

Inauguration of the Compulsory Collection System.—After the Federal reserve banks had operated the voluntary system of clearing for a year the Federal Reserve Board inaugurated the compulsory plan, which was put into operation July 15, 1916. In a statement to the press the salient features of the plan were stated as follows:

"(1) The Federal Reserve Banks will accept at par all checks from member banks, whether drawn against other member banks, non-member banks, or private banks. An exception is made at the outset in the case of checks drawn against non-member banks which can not be collected at par.