Fiftieth Anniversary of the Federal Reserve System—Early Problems of Check Clearing and Collection*

The use of checkbook or deposit money was firmly established in this country by the time the Federal Reserve Banks began operations in 1914. Five years earlier a National Monetary Commission study estimated that 95 per cent of the deposits received by banks was in the form of checks. The system of clearing and collecting checks nevertheless left much to be desired.

In most major cities the banking community had established adequate facilities for clearing and collecting local checks. But problems arose when checks had to move from one city or region to another. Many banks levied exchange charges on these out-of-town checks—"nonpar collection". These charges were defended on the ground that payment of out-of-town checks involved costs, including maintenance of out-of-town balances with other banks and the shipment of currency.

In an effort to avoid such charges, banks would often send checks to banks with which they had par collection agreements (collection at face value), rather than to the banks on which the checks were drawn. In extreme cases, the results were ludicrous. For example, Governor W. P. G. Harding, one of the original members of the Federal Reserve Board, gave the following illustration:

> I recall an instance where a national bank in Rochester, New York, sent a check drawn on a bank in North Birmingham, Alabama, to a correspondent bank in New York City, by which it was sent to a bank in Jacksonville, Florida, which sent it for collection to a bank in Philadelphia, which in turn sent it to a bank in Baltimore, which forwarded it to a bank in Cincinnati, which bank sent it to a bank in Birmingham, by which bank final collection was made.[1]

Such circuitous routing was costly for the banking system as a whole, since the intermediate banks were burdened with unnecessary expenses in the handling of checks. Moreover, some bank customers, confident that checks would wander around for a week or more, drew checks on nonexistent deposits in the expectation of depositing the money before the checks were presented.

After the new Reserve Banks opened for business, the necessity of establishing an efficient national clearing and collection facility was quickly recognized, and par collection became one of the System's major operational goals. To achieve this end, the costs regarded by banks as justi-

* The ninth in a series of historical vignettes appearing during the System's anniversary year.

[1] W. P. G. Harding. *The Formative Period of the Federal Reserve System* (Boston, 1925), p. 51.

fication for exchange charges had to be minimized or eliminated. Since each member bank had to maintain a balance (reserve account) with its Reserve Bank, checks could easily be paid by debiting these accounts, thereby reducing the member bank's need for correspondent balances and cutting the related costs. Thus, with the creation of the Federal Reserve System and its centralization of reserve balances, one important reason for exchange charges was eliminated in the case of member banks.

The Federal Reserve Banks, nonetheless, moved only cautiously toward the goal of actually requiring par collection. By June 1915, each Federal Reserve Bank had established a system of par check collection for its members. But participation in these clearing systems was voluntary, and by the end of 1915 only 25 per cent of the member banks had agreed to par collection.

In 1916 the Reserve Banks began to absorb the charges on currency shipments from member banks to cover reserve deficiencies caused by check clearance. This eliminated a second cost justification for exchange charges. Thereupon and in the same year the Federal Reserve Board adopted a regulation requiring member banks to pay at par all checks drawn upon themselves and presented by the Reserve Banks.

To broaden the par collection system further, Congress amended the Federal Reserve Act in 1917 to permit a nonmember bank to use the System's collection facilities, provided it maintained a clearing balance at its district Reserve Bank and paid at par checks received from the Reserve Bank.

These early efforts to establish a national par collection system were quite successful. By 1921, all member banks and 91 per cent of some 20,000 nonmember banks were paying checks at par. Today, in addition to the 6,100 member banks, there are 5,800 nonmember banks clearing at par, 125 of which keep clearing balances at a Reserve Bank. There are still some 1,600 nonmember banks which do not remit at par.