A Visible Hand: The Fed's Involvement in the Check Payments System*

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Should the hand be visible or invisible? In these days of deregulation, many think the invisible hand of free market forces is preferable to the visible hand of government intervention. Thus the trucking, airline, and telecommunication industries have all been deregulated in recent years to foster the competition believed necessary for efficiency in the marketplace. Even the heavily regulated banking industry has also shared in this process. Under the Depository Institutions Deregulation and Monetary Control Act (1980), the Federal Reserve must now competitively price its services—including check collection and clearing. In fact, some have argued recently that the Fed should relinquish its operating role in the payments system entirely; they maintain that the private sector is well equipped to provide these services. (See, for example, Reynolds 1983.)

At the turn of the century, however, the private banking sector was widely acknowledged to have produced an inefficient and counterproductive arrangement for collecting checks beyond the local level. The invisible hand wasn't working.[1] This failure to provide an adequate solution for collecting out-of-town checks efficiently was one reason that the Congress, as part of its banking reform measures developed between 1908 and 1913, gave the Federal Reserve System both a regulatory role and an operating role in check clearing and collection.

The purpose of this paper is to review the original decision to put the Fed into the check payments system: What was wrong with the check collection system before the Fed? What prevented the private banking sector from adequately addressing the problems? What did the reformers who framed the Federal Reserve Act of 1913 hope to achieve by giving the Fed an operating role in the check payments system? And how successful were the Fed's attempts to achieve its objectives during its early years? (The question of what the appropriate Fed role in the check payments system should be today is not dealt with here.)

Our examination of documents from the period (roughly the 1850s through 1920s) leads us to conclude that some form of government intervention in the check payments system—the visible hand—was warranted at the time. But the Fed's involvement in the payments system was a limited success, for it failed to achieve its two main objectives: (1) creating a unified national check-clearing system in which all banks would participate and (2) establishing a payments system where all

*This paper is a substantially abridged version of the authors' Working Paper 309, "Federal Reserve Involvement in the Check Payments System: Origins, Intent, and Results" (Duprey and Nelson, forthcoming). Readers interested in the fuller version can obtain a copy on request to the Research Department.

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[1]Some might argue that free market forces had been stymied from the start by the hand of government through prohibitions against branch banking. This resulted in the creation of tens of thousands of independent unit banks, which contributed to the problem.

banks remitted payment for their checks at face value. We conclude that although the Fed came close to meeting its objective of universal par payment, it failed in its objective to establish a unified national clearing system, largely because it underestimated the stiff opposition and competition that would come from the correspondent banking system. Still, the Fed deserves credit for initiating a national clearing system.

The Check Payments System Before the Fed: 1850–1913

During the second half of the nineteenth century, demand deposits (checking accounts) began to replace currency (coin and paper notes) as the most popular means of making payments. The use of checks required that funds be transferred between banks. Thus, as the volume of checks to be collected grew rapidly, the banking industry was challenged by the problem of effectively dealing with this burgeoning volume. The collection of local checks was a fairly straightforward process, but the collection of out-of-town (or *intercommunity*) checks proved a difficult problem for the banking system.

Local Check Collection

Local check collection before the 1850s mainly consisted of bilateral collection arrangements among a community's banks (see Chart 1). In New York City, for example, each bank would daily send an agent to present for payment checks drawn on half of the local banks and to receive checks drawn on the agent's bank. Each bank would record the face (*par*) value of the checks exchanged. At the end of the week, the banks would settle the net balances, if any, due to or from the other banks and send the agent out to pay or receive the difference.

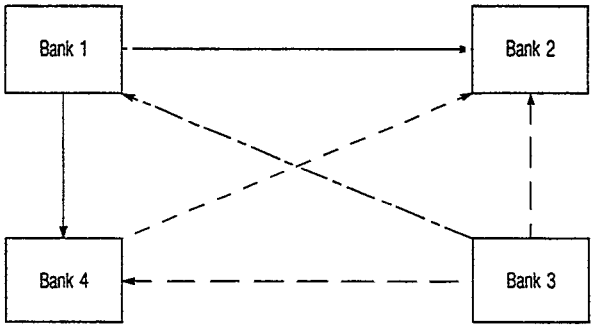
This setup worked fairly well when only a few banks were involved. But in a major financial center like New York City, which by 1853 boasted 52 banks, bilateral collection arrangements proved cumbersome. Bank agents were hard pressed to visit 26 banks each day, and each bank had to record up to 51 daily accounting transactions.

To streamline the collection process, the country's first local *clearinghouse* was introduced in New York City in 1853. This was a centralized meeting place for collecting and clearing checks.[2] Each day, member banks, who shared the clearinghouse's operating expenses, sent their agents to the clearinghouse to present checks drawn on other member banks to the manager. The checks were quickly sorted by bank, their full amounts entered in the clearinghouse ledger, and the checks themselves returned to the agent of the bank on which they were drawn. Then the debits and credits were totalled and a single net balance for each bank was either paid to or collected from the clearinghouse (see Chart 2).

Charts 1 and 2

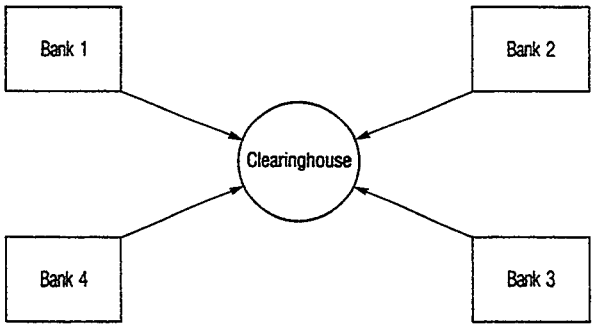
Bilateral Collection Compared With the Clearinghouse

Chart 1 A Bilateral Collection Arrangement Among Four Banks



Note: Total transactions = $(n^2 - n)/2$, where n = number of banks.

Chart 2 A Clearinghouse Arrangement Among Four Banks



Note: Total transactions = n, where n = number of banks.

[2]The distinction between check *collection* and check *clearing* needs to be clarified. The *collection* of checks refers to the presentment of checks at the banks on which they were drawn and the remittance (payment) for these checks. The *clearing* of checks refers to the offsetting of claims for payment among a group of banks to determine a single net balance for each bank; the net balance is then due to or from a central clearing agent representing all group members.

The efficiency of the clearinghouse arrangement was readily apparent (compare Charts 1 and 2). It reduced the number of check exchanges and settlements, the amount of bookkeeping, and the cost and risk of transporting currency between banks. Not surprisingly, New York City's clearinghouse system caught on rapidly: similar local clearinghouses sprouted in other cities, and by 1913 their number had expanded nationally to 162.

Intercommunity Check Collection

At the intercommunity level, virtually all collecting of out-of-town checks was handled through bilateral arrangements between banks. Although some banks simply mailed checks directly to the banks on which they were drawn, most relayed checks through an intermediary, or *correspondent.*

An elaborate system of correspondent bank relationships had developed to provide banks with a number of mutually beneficial services. Typically, one of the correspondents in a relationship was a *city bank.* Usually located in major financial centers, city banks sought deposits from other banks in order to increase their lending power and to earn more revenues and profits from loans. To attract deposits from other banks, city banks paid interest (about 2 percent) on interbank demand deposits and provided a number of services, including investment advice, credit ratings, and check collection. The other correspondent was typically a *country bank.* Usually smaller institutions that were located outside financial centers, country banks maintained deposits at city banks to meet legal reserve requirements, to have an account for making intercommunity payments by bank draft, to earn interest on deposits, and to obtain city bank services—primarily check collection.[3]

The existing intercommunity check collection system was criticized by its contemporaries for a number of defects, including the practice of not paying the par value of checks sent for remittance (*nonpar payment*) and practices that contributed to inefficiency.

☐ *Nonpar Payment*

One practice criticized by some bankers and defended by others was that of nonpar payment by imposing *remittance charges* on checks sent to banks for payment. These charges, typically a percentage of the amount of the check returned, were most often made by country banks on their own checks mailed to them for payment from out-of-town. Geographic isolation made it easier for many of these banks to engage in the practice.

An example may clarify what this practice entailed. Say that a city bank's customer deposits an out-of-town check for $1000. The city bank credits the customer's account for the full value of the check and then mails the check to the check writer's bank for collection. But the check writer's bank imposes a remittance charge, returning only $999 to the city bank. Not wishing to irritate its customer, the city bank decides to absorb the cost of the remittance charge. Or, not wishing to absorb the cost, it deducts a $1 collection fee from its customer's account. The country bank's practice of imposing a remittance charge has cost either the city bank or its customer $1.

Customary banking practices at the time dictated that a check presented at the counter of the bank on which it was drawn must be paid at par; however, if a check arrived by mail, that bank could impose a remittance charge in paying the check. For many country banks, remittance charges were a significant source of revenue: some bankers estimated that these charges provided as much as 20 to 50 percent of net earnings of the average country bank (U.S. Congress 1913b, pp. 198, 2252).

Critics of remittance charges, often city banks, found the practice to be unfair and inappropriate. Remittance charges of up to $3 per $1,000—not uncommon at the time—were regarded as excessive in relation to the actual costs banks incurred in remitting payment for checks. Critics also noted that the charges were often applied haphazardly and at quite arbitrary rates. Banks that imposed remittance charges (*nonpar banks*) were seen as taking unfair advantage of banks that remitted at par. Furthermore, some critics argued that remittance charges made the wrong party bear the cost—the check depositor rather than the check writer.

☐ *Inefficiency and Delays*

One source of inefficiency in the existing system for collecting out-of-town checks was the nonpar payment practice just discussed. Critics of the day particularly faulted one outcome of this practice: the *circuitous routing* of checks. Often the roundabout process was the result of efforts to avoid remittance charges by finding a correspondent that had an agreement to collect checks at par from the check writer's bank. Out-of-town checks could proceed through a chain of a dozen different correspondent banks before finally reaching the

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[3]Correspondent relationships were not exclusively those between city and country banks. City banks established and maintained relationships with other city banks for many of the same reasons that country banks did.

bank on which it was drawn. In a number of reported instances, checks meandered for hundreds of miles and several weeks to a final destination relatively near the sending bank.

Critics of the day also noted that even when checks were being sent to destinations via fairly direct routes, there was much unnecessary duplication of facilities and efforts. By failing to consolidate or "bunch" parallel sendings, banks wasted labor, postage, and other resources.

Delays in remittance resulted not only from circuitous routing but also from the remitting bank's failure to pay promptly once it had received a check. Country banks often deliberately slowed payment in order to keep funds as long as possible. The effect of slowed remittance was simply a transfer of income—that is, increased costs to city banks in the form of lost interest on uncollected funds exactly offset by gains to country banks from the use of the funds. But delays in remittance also increased the risk that a check writer's bank might become insolvent before making payment, and this enlarged risk was borne by collecting banks and their depositors.

Private Remedies: 1890–1907

That the existing system for collecting intercommunity checks had problems was readily apparent to members of the banking community. Less apparent, however, was how to remedy the problems. Activity by bankers to tackle check collection problems intensified in the 1890s, a time when bank earnings were subject to unusual pressures. At that time, the growth of individual checking accounts was accelerating at a much higher rate than in previous decades, partly since personal checks were becoming more widely used in out-of-town transactions. The volume of out-of-town checks processed for collection by city banks had reached the point where check collection dominated city bank operations.

Among the private banking sector's efforts to remedy the problems, two main approaches can be distinguished, both sponsored by city clearinghouse organizations. One approach attempted to offset the high costs of intercommunity check collection by imposing standardized collection fees to be paid by depositors of out-of-town checks. The other attempted to reduce the costs of intercommunity collections by extending the local clearinghouse technology to the regional level. These two approaches tended to have opposite effects on the personal check as a payments medium. The one discouraged use of the personal check for out-of-town payments because it increased collection costs; the other encouraged its use by improving its acceptability. To a great extent, conflicting interests within the private banking sector ultimately prevented it from implementing efficient solutions to the problems of intercommunity check collection.

Standardizing Collection Fees

One response by city bankers to relieve cost pressures from the growing volume of out-of-town-checks was to impose standardized collection fees for depositing such checks. By doing so, the bankers hoped to achieve two ends: first, to offset the cost of country banks' remittance charges with collection fees; second, to eliminate city banks' competitive practice of absorbing remittance charges as a way of offering "free" check collection privileges to attract customers.

The local clearinghouse organization provided the means by which standardized fees could be imposed and enforced. A standard schedule of fees was adopted, detailed in the clearinghouse bylaws, and signed by all member banks. Generally, the rules divided the country into zones with specified fees for checks from each zone. The immediately surrounding trade area and a few related financial centers were set up as a discretionary zone within which checks could be collected without charge or at an independently determined rate.

Arrangements of this sort sprang up in the mid-1890s, including ones by clearinghouses in St. Louis, Kansas City, Omaha, Baltimore, Houston, and Denver. But the most significant of these arrangements occurred in 1899, when New York City's clearinghouse adopted standardized collection fees. These arrangements resulted in the loss of some correspondent bank customers, who could no longer receive par credit for out-of-town checks deposited in their accounts. In addition, city merchants who primarily received out-of-town checks as payment were particularly unhappy about being charged for checks they deposited.

Also in 1899, a conference of clearinghouses met to discuss the possibility of coordinating collection charges on out-of-town checks throughout the country. To study this matter further, the Clearinghouse Section of the American Bankers Association (ABA) was eventually formed in 1906 and continued to meet annually, but their attempts to promote standardized charges nationwide failed to gain wide acceptance.

Although a national system of standardized collection fees might have eliminated much of the circuitous routing of checks that resulted from attempts to avoid remittance charges, proposals for such a plan failed to

gain acceptance by other major city clearinghouses. Furthermore, the proposals tended to reinforce nonpar payment practices and to favor the system of bilateral collection arrangements (either by direct mail or through correspondent networks), with its multiple sendings of bundles of checks and remittances and with its multiple interbank balances.

Extending the Clearinghouse Technology

The other principal action taken by city clearinghouses to remedy the problems of intercommunity check collection was to extend the local clearinghouse technology to the regional level. Proposals had even been made for linking regional clearing systems into a national one. To some bankers, extending the clearinghouse idea beyond the local level seemed the next logical step in the evolution of the payments system. Under such a development, the personal checking account would perform even better as a form of circulating currency superior to bank notes and other paper money. Theoretically, this development seemed desirable in the name of technological progress.

The bankers who proposed regional clearing arrangements were, of course, motivated less by theoretical ideals than by more immediate and practical needs. As remittance charges, handling costs, and collection delays increasingly cut into their earnings, city bankers began to consider the economies of extending local clearinghouse arrangements to out-of-town check collection. During the 1880s and 1890s, bankers addressed at local, state, and national meetings the problems posed by intercommunity checks. ABA meetings and national banking journals provided a forum for discussing a nationwide organization for regional clearing. Many proposals emerged from these discussions, though few concrete results.

In 1899, however, the first significant regional clearinghouse operation in the country was established by Boston's clearinghouse association to cover most New England banks. (Proposals for such an arrangement had been studied by the association as early as 1877.) Although Boston's plan achieved great economies, it fell short of the ideal of a unified par clearing system for several reasons.[4] Ideally, all banks within the region would have participated and all nonlocal checks would have been sent to and received from a single clearing center. But as a concession to existing correspondent banking interests, Boston's system retained some features of the prior correspondent collection network. In practice, clearinghouse members continued to collect checks directly from their own country correspondents while bringing other out-of-town checks to the regional clearinghouse, where they were sorted and sent to their respective country banks. Moreover, Boston's regional clearinghouse collected only from, not for, the region's country banks. And finally, not all out-of-town checks were remitted for payment at par, for over 10 percent of the country banks refused to forego their remittance charge practices.

The Boston plan's success in implementing the nation's first regional par clearing system, partial though it was, provoked interest among other cities throughout the country. In 1905, Kansas City's clearinghouse introduced a roughly similar plan, though without any par remittance requirement. By 1912, about a dozen regional clearinghouses had been established.

Despite the fact that none of these regional arrangements achieved a complete and unified clearing plan, considerable savings in the costs of check collection were reported. For example, before its regional system was implemented, Boston's 31 clearinghouse members mailed about 7,000 daily collection letters to 625 New England country banks. After the regional clearinghouse was established, the member banks' mailings were substantially consolidated. The clearinghouse daily sent each of the 625 New England country banks a single collection letter containing all checks drawn on each except those received by their Boston correspondents. Each Boston correspondent also sent separate collection letters to its own country correspondents. In all, the number of daily collection letters sent from Boston to New England country banks totalled under 1,300—about a fifth of the number sent before the regional clearinghouse was established. Instead of remitting checks on a weekly or biweekly basis, the country banks made daily remittances of a single payment to the Boston clearinghouse. These economies encouraged the acceptability of country bank checks in New England. From a national perspective, however, the regional clearinghouse movement made only limited headway, even though the evidence indicated such a system was capable of great economies.

Why the Private Sector Failed

Why was the private banking sector unable to correct the recognized deficiencies in its handling of out-of-

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[4] We base our notion of what constitutes an ideal regional system largely on the London clearinghouse system implemented for banks throughout England and Wales in 1858. For a description of that system, see Duprey and Nelson, forthcoming.

town check collection? The answer seems to be that many bankers did not perceive participation in a universal par clearing arrangement to be in their best interests. Conflicting interests among various segments of the banking community—city versus country banks, city banks versus city competitors, and New York City versus other financial centers—hindered the cooperation required to implement a complete system of regional and interregional clearings. These conflicting interests centered largely around three issues.

The first was the issue of par payment. Because many country banks derived a substantial portion of their income from remittance charges, they vigorously opposed the loss of part or all of this income. And their opposition to par payment represented one of the barriers to establishing unified regional clearing. Although par payment wasn't an inevitable part of regional clearing, it was integral to some previously established regional clearinghouses and was a possible outcome of any new clearing arrangement. Moreover, country banks felt they might be the underdogs in a regional clearing system dominated by large city banks—banks that generally stood to gain by the elimination of remittance charges.

The second issue involved competition among correspondent banking centers for country bank deposits. A system of regional clearing was likely to cause reshuffling of correspondent bank balances within financial centers as well as between them. Many financial center bankers, fearing that their correspondent accounts would shift away, were unreceptive to the organization of regional clearing systems. For example, a 1906 banker's address (Berger 1906, pp. 94–95) cites the likely loss to New York City of correspondent accounts held in Albany, Baltimore, and Philadelphia as a reason for the three cities to oppose the establishment of regional par clearing systems across the country.

The third issue was that of opposition to the use of personal checks for intercommunity payments—opposition mainly on the part of some financial center bankers, particularly those in New York City. Many city bankers condemned the use of personal checks for out-of-town payments because of the high costs of labor, postage, and other resources required for collection. Many of them preferred to see the traditional bank draft used as a means of intercommunity payment because it made fewer inroads on their profits. Since regional clearinghouses would have the effect of encouraging the use of personal checks, some key city bankers were unsympathetic to the introduction of regional clearinghouses.

Because of these conflicting interests within the banking community, many observers at the time were pessimistic about the prospects for the private sector's success in solving the problems of inefficient collection and nonpar payment. It seemed highly unlikely that established banking interests would voluntarily surrender their traditional correspondent relations (Wexler; quoted in U.S. Congress 1913a, p. 615). Although Boston's regional clearing plan, incomplete though it was, might eventually have caught on more widely, winning national support for an integrated system of regional clearing would have been a "very slow process" (Preston 1920, p. 568). For these reasons we think that a unified national clearing system with universal par payment would have been unlikely to develop without government intervention.

The Government Gets Involved: 1908–1913

The possibility that the government might become involved in reforming the check payments system was not totally unexpected. Some bankers were beginning to think government intervention might be required to break the logjam of private banking interests that prevented the extension of the clearinghouse technology to the national level.[5]

The immediate impetus for government action in banking reform was the Banking Panic of 1907. Although reform centered on the issue of preventing future panics (by concentrating reserves in more central locations, channeling reserves to banks in need, and creating an elastic currency), a peripheral concern was the private banking sector's failure to develop an efficient national clearing mechanism for intercommunity checks.

The National Monetary Commission: 1908–1912

Created by the Congress in 1908 to study ways of reforming the banking system, the National Monetary Commission, reporting in 1912, recommended the formation of a National Reserve Association (NRA). The NRA would consist of 15 branch banks and a board of directors from the banking community. The association's main functions would be to consolidate voluntarily contributed reserve deposits, to discount (buy) the commercial paper of members in need, and to provide

[5]For instance, the Philadelphia banker W. T. Berger (1906, p. 95) concluded that "it may be necessary to bring all banks of deposit under Federal control before the desired result can be brought about."

an elastic currency. The commission's study (U.S Congress 1912, pp. 7–8) also found the current payments system to be defective: "We have no effective agency covering the entire country which affords necessary facilities for making domestic exchanges between different localities and sections, or which can prevent disastrous disruption of all such exchanges in times of serious trouble."

To remedy problems in the payments system, the commission recommended that the NRA be required to transfer member bank balances between accounts at the same branch or different branches; that local associations of NRA members be permitted to form and operate clearinghouses; and that the NRA be empowered to require local associations to perform clearing services to facilitate payments between regions when the public interest needed these services. It should be noted that none of the commission's recommendations for payments system reform required par clearing, nor did they authorize the main NRA branches to engage in clearing operations, leaving clearing to the local associations instead. So the commission's recommendations could hardly be said to add up to a national clearing system.[6]

The commission's recommendations were embodied in a bill presented to the Congress in 1912 by Senator Aldrich, a prominent Republican who chaired the commission. But by then the Democrats controlled the House, and Woodrow Wilson's Democratic administration was soon to be elected. Not surprisingly, the commission's recommendations were never enacted.

The Federal Reserve Act of 1913

The Federal Reserve Act was the result of efforts begun in 1912 by a subcommittee of the House Committee on Banking and Currency. The subcommittee's work progressed to the point that Carter Glass, who chaired the subcommittee, and H. Parker Willis, who served as an adviser, were able to present a specific proposal to President-Elect Wilson by December 1912. Reworked during the next months in response to suggestions from President Wilson, Secretary of the Treasury McAdoo, and Chairman of the Senate Banking and Currency Committee Owen, the bill was finally passed by the Congress in December 1913.

The central ideas of the Federal Reserve Act shared some key features of the National Monetary Commission's proposals but differed in several ways. Rather than being branches of a single organization, the Federal Reserve Banks were semi-independent—a form of decentralization the Democrats preferred. Rather than being selected by the banking community, the Federal Reserve Board was government appointed, thereby alleviating suspicions that big bankers would dominate the new organization. More important, the act stipulated that bank reserves for meeting legal reserve requirements had to be kept in the form of vault cash and balances at Fed Banks rather than balances at correspondent banks in reserve cities. Banks were given three years to comply with this new reserve requirement, which was considered essential to give the Fed enough resources to effectively prevent panics and financial disorders.

The act's provisions for check collection went several steps beyond the National Monetary Commission's. Par clearing of checks was explicitly mentioned; check clearing at Fed Banks (not just local associations of member banks) was authorized; and member bank charges were to be regulated. Basically, the act made the following provisions:

- It required Federal Reserve Banks to receive from members, *at par value,* all checks and drafts drawn on other members.
- It permitted the Federal Reserve Board to require Fed Banks to serve as clearinghouses for their members.
- It required the Board to fix the fee that Fed Banks might impose for clearing services provided.
- It required the Board to establish regulations governing the transfer of funds among Fed Banks and the charges to be made for such transfers.
- It permitted the Board to either act as a clearinghouse for Fed Banks or designate a Fed Bank to do so.
- It required the Board to fix by rule the charges to be collected by member banks from customers whose checks were cleared through Fed Banks.

Note that these provisions did not, however, *require* check clearing operations but only *permitted* them. Moreover, they made no specific authorizations about how the Fed should handle nonmembers' checks.

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[6]One consultant to the commission's report, the Harvard specialist on Banking and Currency O. M. W. Sprague (1911, pp. 834–39), saw larger potential for NRA involvement in the payments system. Sprague argued that the NRA could become an efficient national clearinghouse by using its branches as links between local clearing associations. In addition, he thought the NRA could exert pressure on member banks to remit all checks at par.

From these provisions—and from the writings of the principal framers of the act (see, for example, Glass 1913, Willis 1914, and Owen 1914)—two key objectives for the Federal Reserve's check collection system are evident:

- The establishment of a national clearinghouse system in which all banks would participate.
- A check collection system in which all checks would be collected at par value.

These two objectives were the cornerstones of a universal par clearing system for the nation—a goal that the evidence indicates the framers of the act envisioned.

Two Roles: Operating and Regulatory

The framers of the Federal Reserve Act hoped to achieve their two key objectives by giving the Fed both an operating and a regulatory role in the payments system. The operating role permitted each Fed Bank to serve as a central clearinghouse for its members. Within a district, a member would send directly to its Fed Bank all out-of-town checks drawn on other members. The Fed Bank would immediately credit the member's reserve account for the checks' par value and immediately debit the accounts of banks on which the checks were drawn.

Two features of the envisioned clearing system are noteworthy. First, the practice of giving immediate credit was seen as a way to attract members to use the Fed's clearing service, since members were not strictly required to do so. Immediate credit would be particularly attractive to city banks, which frequently did not receive credit for out-of-town checks until after considerable delay. (Country banks, in contrast, would have their Fed accounts immediately debited before the cleared checks could even be returned to them for inspection; as a result, they did not find this feature so attractive.) The second feature for attracting members was par credit—that is, giving members the benefit of receiving full value for checks deposited in their accounts. Together, these two features were designed to attract a large flow of checks into the Fed system and draw state banks into membership.

Although the act authorized arrangements for the Fed to apply its clearing function on an interdistrict basis, the details for accomplishing this were left for later. Left undetermined were the specifics of how to route out-of-town checks between Federal Reserve Districts, whether or not to give immediate credit for interdistrict checks, and how to settle interdistrict balances among Fed Banks.

The Fed's regulatory role allowed the Federal Reserve Board to fix the collection charges that member banks could impose on customers for depositing or writing checks cleared by the Fed. The Board was also allowed to set the Fed's service fees to cover the operating expenses of check clearing.

Benefits of Fed Involvement

By involving the Fed in check clearing and in regulation, the framers of the act hoped the new payments system would correct the deficiencies of the prior check payments system, principally by improving the efficiency of check collection through a unified national clearing system and by eliminating nonpar payment abuses. But they also had a political agenda of strengthening the Fed's institutional role and effectiveness.

☐ *Unified National Clearing*

By establishing a single, unified clearing system for the nation, the Fed's framers intended to make the collection of out-of-town checks more efficient than under the prior system. Deposited checks would be sent to the Fed and routed as directly as possible to the banks on which they were drawn. Thus the number of intermediaries that a check passed through would be minimized. By dealing with a single agency rather than several, members would reduce the number of check shipments, accounting transactions, and settlement payments required. And since settlement would be handled by bookkeeping entries at Fed Banks, interbank payment via bank draft would be eliminated. In short, the amount of check handling, clerical work, and mailing expense would be substantially reduced for member banks.

By routing checks more directly to their final destinations, the Fed's clearing system would also reduce the time required to collect checks. This increased timeliness in collection would be an advantage for banks and businesses, enabling them quicker access to funds deposited as checks. Moreover, quicker collection time would reduce the risk to the check depositor of having a check bounce or the risk to the collecting bank of having a check depositor spend funds before they were sure of being collected.

☐ *Universal Par Payment*

By establishing a system with universal par payment, the Fed's clearing system was intended to eliminate remittance charges. Although city banks would gain from par payment, country banks would stand to lose money by no longer being able to impose remittance fees. Even though country banks might recover some of

their losses by charging customers a service or collection fee for writing out-of-town checks, the Fed's designers hoped that competition and regulation would keep these charges to a minimum. They also hoped that the benefits of eliminating remittance charges (plus those obtained from greater efficiency) would be passed along to the public via lower collection charges, primarily at city banks.

☐ *An Advanced Payments System*

Par payment, lower collection charges, and speedier collection would all make the personal check a more advanced, convenient, and acceptable means of payment for intercommunity transactions—a desirable goal, according to the framers of the Federal Reserve Act. They felt the Fed's involvement would speed the evolution of the payments system further away from currency toward demand deposits. Such a shift was seen as a benefit to the public, since paper currency was considered a higher-cost medium than the demand deposit.

☐ *A Stronger Central Bank*

The framers of the Federal Reserve Act also justified the Fed's involvement in the payments system because they hoped to benefit the Federal Reserve in another way—by making the Federal Reserve System a stronger institution so that it could meet its main objective of preventing future bank panics. They felt the Fed would be stronger if given a highly visible role in the day-to-day operations of the financial system. Without their clearing function, Fed Banks "would become merely the holders of dead balances carried for the member banks without any service to them; and, since the business public abhors an idle or unnecessary institution . . . it would not submit long to the needless burden created by such emergency institutions designed to 'put out financial fire' " (Willis 1926, p. vi).

Since the Fed Banks were the retainers of banks' legal reserves, the clearing function was important because it allowed reserves to perform double duty—meeting legal reserve requirements while serving as clearing balances. The framers of the act also felt that providing collection and clearing services would be a way to draw more members—larger membership being the means to strengthen the institution as well.

Problems of Implementation: 1914–1923

In November 1914, the twelve Federal Reserve Banks of the Federal Reserve System began operation. During the next decade the Fed's efforts to establish a national par clearing system shifted gears several times as problems and resistance were encountered. Although the efforts to develop a national clearing system were partly successful, they ultimately failed to meet the two key objectives the designers of the Federal Reserve Act had envisioned: a system with universal participation and with par collection.

The Voluntary Plan: 1915

The Federal Reserve System's first efforts to implement a check collection system began in mid-1915. This was a voluntary plan for check clearing within (but not between) Federal Reserve Districts. Participating members, who agreed to pay their own checks at par, could send checks drawn on other district participants to their local Fed. Once there, checks would be immediately credited to the reserve accounts of the sending banks and immediately debited or charged to the accounts of the members on which the checks were drawn.

Within a year the plan was judged a failure, largely due to the Fed's inability to attract enough member banks: fewer than 25 percent of the existing members joined the plan. Their reasons for not joining were various. Some refrained because they wanted to continue charging remittance fees. Others preferred to retain their city correspondents. Still others refused to join because the number of nonparticipating members and nonmembers was high enough to make participation ineffective.

As a result of the plan's failure, the Fed's Board concluded that the system needed to involve more members. They also decided that immediately crediting and debiting accounts was impractical: too often immediate debiting reduced or overdrew a member's reserve account, forcing the Fed to extend credit to cover the deficit or the member banks to anticipate overdrafts by keeping excess reserves.

The Broader Plan: 1916

In mid-1916, the Board initiated a more comprehensive plan for check clearing. The plan had the following features: First, Fed Banks would receive at par from members those checks drawn on other members, wherever located, and checks drawn on nonmember banks when such checks could be collected at par. Second, member banks were required to pay all checks at par. This second feature was not a voluntary matter: par remittance was mandatory. Third, rather than immediately crediting and debiting checks received, Fed Banks would employ an alternative accounting system of deferred crediting and debiting; that is, they would credit the accounts of the sending members at approxi-

mately the same time that the banks on which the checks were drawn could receive and acknowledge them. It was believed this procedure would minimize the likelihood of a member's reserve account being overdrawn as well as the amount of Fed float (checks in process of collection) generated by overdrafts. And finally, the Board would settle any indebtedness among Fed Banks arising from the handling of checks on a national rather than strictly regional basis. This would be accomplished by book entries in the Gold Settlement Fund, a fund located in Washington, D.C., into which Fed Banks had made gold deposits. Settling debts by book entry would reduce to a minimum any need to ship currency between Fed Banks.

In announcing this plan, the Board stated that while it was not possible at the time for Fed Banks to collect all checks on nonmember banks at par, steps would be taken as quickly as possible to achieve this result, an objective later termed *universal par collection.* By being able to collect all nonmember checks at par, Fed Banks would be able to serve members more adequately, and members would send all their check collection business directly to the Fed.[7] With full participation, the Fed would become a complete and more efficient members' clearing system in which all their out-of-town checks could be exchanged. It would still, however, fall short of a complete national clearing system, since nonmembers were not entitled to send their checks to the Fed for collection.

The immediate response to the plan was positive. By mid-August 1916, nearly 15,000 banks had agreed to remit at par those checks sent by the Fed for payment. Of these banks, about half were members required to pay par and half nonmembers who had joined voluntarily. However, over 13,000 nonmember banks still had not agreed to pay par. Moreover, many members continued to send all or a substantial portion of their check collection business to city correspondents rather than the Fed.

These shortcomings were a challenge to the Fed. To attract greater participation by members, the Board authorized Fed Banks to extend collection services to noncash items, such as maturing notes, bankers' acceptances, and other types of bills. To get nonmembers to pay their checks at par, the Board counted on competitive forces: "As any bank will be likely to lose desirable business when checks drawn upon it are at a discount, while checks drawn on a nearby competitor circulate at par, it is believed that in the near future checks upon practically all banks in the United States can be collected at par by Federal Reserve Banks" (FR Board 1917, p. 10). The logic behind this conviction was roughly this: (1) banks would charge their customers extra for the service of accepting and collecting checks drawn on nonpar banks; (2) bank customers would react by refusing to accept checks drawn on nonpar banks or by complaining to check writers about nonpar checks; and (3) check writers, in turn, would shift their accounts from nonpar to par banks.

Wishing to encourage the forces of competition and to expand the coverage of the Fed clearing system, the Board proposed an amendment (passed in 1917) to the Federal Reserve Act that would permit nonmembers to send their checks directly to the Fed for collection. The condition for gaining access to the Fed system was that nonmembers pay their checks at par and hold modest clearing accounts at Fed Banks. This last requirement was a burden that the Board believed could be more than offset if joining nonmembers closed the many correspondent balances they maintained for collection purposes and then placed the proceeds in local loans. In proposing this amendment, the Board opened up the prospect that the Fed would become a true national clearinghouse, one in which all banks exchanged their checks.

Progress toward this goal, however, was much slower than Fed officials expected. Members still depended on city correspondents to handle their checks. As for nonmembers, nearly 11,000 were still nonpar in mid-1918. Fed clearing accounts had almost no attraction for these nonpar banks, and competitive forces seemed to be ignoring the Board's reasoning: Some banks didn't charge their customers for depositing nonpar checks. Customers who were charged must not have complained to the nonpar banks' check writers—the cost of doing so may not have been worth the effort. And even if customers had complained, the writers of nonpar checks may not always have had an accessible par bank to which to shift accounts.

The Coercive Plan: 1918

In 1918, Fed officials decided to get tough. To encourage more widespread participation by member banks, they eliminated the Fed's check-handling service charge that had been imposed at the start of the 1916 plan and similarly eliminated most other Fed charges.

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[7]The Federal Reserve Act specified a three-year period for the transition from the old reserve system, in which balances at reserve city banks served as reserves, to the new system, in which only balances at Fed Banks could serve that purpose. November 1917 marked the end of the transition period, and the Board believed that at this time members would have an additional incentive for sending their checks to the Fed.

And taking a tougher approach to bring about universal par collection, Fed Banks began to accept all checks, even those drawn on nonpar banks that would not agree to remit at par. But the Fed, by law, could not pay remittance charges. To skirt these charges, the Fed took advantage of the standard practice that checks presented in person at a bank had to be paid out at par. In doing so, however, the Fed Banks incurred other expenses, namely, hiring agents or sending out their own employees to present checks directly to nonpar banks.

The Fed's more aggressive approach produced results: many more banks agreed to pay their checks at par. By the mid-1920s, only 2,300 nonmember banks continued nonpar payment. However, this tougher approach incited the opposition of a number of country banks. They successfully lobbied for state laws favoring nonpar practices and took the Fed to court as well. In several cases, court decisions restricted the Fed's use of agents to make over-the-counter presentation of checks, ruling that the Fed couldn't present checks in a manner designed to oppress or coerce by accumulating an unusually large number of checks to present or by indulging in practices inconsistent with customary bank methods (Spahr 1926, p. 288). In 1923, the Supreme Court ruled that state laws protecting nonpar practices were constitutional. The Court pointed out that the language of the Federal Reserve Act didn't actually require the Fed to accept all checks for collection, nor did it require the Fed to establish a universal par collection system. The Board had only interpreted the act's language in this way.

The Abandonment of Par: 1923

Shortly after the Court's decision, the Board formally abandoned its drive for universal par collection. It directed Fed Banks to discontinue the use of express companies and other nonbank agents to make over-the-counter presentations at nonpar banks. It also ruled that Fed Banks could no longer accept and collect checks drawn on nonpar banks. Instead, such checks would have to be handled through the correspondent system. With these changes, nonpar banking began a gradual comeback. At the end of 1923, there were nearly 3,000 nonpar banks, representing about 10 percent of all commercial banks and holding less than 3 percent of commercial bank assets. And by the close of 1928, their number had increased to nearly 4,000, representing 15 percent of all commercial banks and less than 4 percent of total assets.

The Fed's other goal, that of becoming the nation's clearinghouse with participation by all banks, was also fading from view. At the end of 1923, only about 1 percent of 19,600 nonmember banks sent their checks directly to the Fed for collection; instead, the checks were sent to city correspondents. Among members, participation was higher but still disappointing. A 1923 sample survey found that members located outside cities with Federal Reserve Banks and branches sent an average of only 16 percent of their out-of-town checks directly to the Fed for collection (Demmery 1924, pp. 292–94). The rest went to city correspondents, most of whom were member banks who made heavier use of Fed facilities, sending in for collection a portion of both their own checks and those received from member and nonmember country banks. Although this rerouting of checks boosted total Fed check volume, it represented a form of circuitous routing—a problem that was supposed to be eliminated by the Fed's check collection system.

So by the end of 1923, the Federal Reserve's system for out-of-town check collection had failed to take over the field, though it attained an important position. City banks had competed vigorously with the Fed to retain their correspondent relationships, a type of business that had proved profitable to them in the past. In return for keeping country banks' balances, city banks offered country banks an extensive line of services, ranging from investment advice and the management of surplus funds to the collection of foreign drafts. Some of these services were supplied without explicit charge, others for a fee. In contrast, Fed Banks did not offer as extensive a list of services and, on comparable types of services, could not offer terms as favorable as city correspondents. For example, city banks continued to give immediate rather than deferred credit on checks sent to them for collection by country banks, and they did not require checks to be presorted, as did the Fed. As a result of city banks' ability to out-compete the Fed, the check payments system became, and still remains, a dual system—part Fed, part correspondent banking networks.

Conclusion

From our investigation of how the government became involved in the check payments system, we conclude that the government's visible hand was warranted. Although the banking industry had recognized the problems of the correspondent system for intercommunity check collection and had attempted its reform, remedies to the problems would have involved losses to some banks and gains to others. As such, conflicting

interests within the banking community made a timely private-sector solution unlikely. When the government initiated its banking reform measures after the Panic of 1907, reform of the payments system was an appropriate part of that initiative.

The framers of the Federal Reserve Act of 1913 had two key objectives for the ideal national check payments system they envisioned: First, the collections system should be universal—that is, one in which all banks in the nation would participate. Second, the system would require par payment—that is, payment would be remitted for a check's full face value.

Attaining these key objectives turned out to be far more difficult than hoped. Neither a universal system nor par payment was achieved. The Fed did, however, enjoy some success in improving the efficiency of intercommunity check collection. Its new system extended the clearinghouse technology to a national level and made the personal check a more acceptable means of payment. The settlement of member banks' clearing balances by bookkeeping entry, rather than bank draft or currency, was certainly more efficient than the correspondent system. And although the Fed could not eliminate nonpar payment practices, it reduced the number of nonpar banks and probably helped limit abuses in their remittance charge practices.

So despite its partial success in attaining its framers' two key objectives, the Fed should still be credited (at par) for initiating a national clearing system. The government's visible hand in the check payments system provided the necessary impetus for achieving this milestone in the evolution of the payments system.

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