ARMY INDUSTRIAL COLLEGE.
Washington, D.C.

(Course, 1926 - 1927)

FUNCTIONS OF A COMMERCIAL BANK.

Lecture by

Mr. Joshua Evans, Jr.,
Vice-Pres., District
National Bank, Wash., D.C.

November 15, 1926.

INTRODUCTORY REMARKS - COL. I.J. CARR.

Gentlemen:

We have been studying the Business Administration Course for the purpose of giving the students a view of high-lights of industrial and commercial life. We are planning for industrial mobilization and we have to know the Army side of it from beginning to end; we also have to know something of the industrial end so we can intelligently talk to manufacturers and producers with a view of carrying out their program in time of war. We have also studied the functions of the War Finance Corporation in its relation to essential industry in time of war and to banks who supported those essential industries.

We are now at a point in our studies of what functions our commercial banks have in the way of supporting manufacturers in carrying out their normal, everday work.

Mr. Joshua Evans, Jr., Vice President of the District National Bank, Washington, D.C., has taken some of his valuable time and has very kindly consented to talk to us a few moments on that subject.

Gentlemen - Mr. Evans.

FUNCTIONS OF A COMMERCIAL BANK.

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Colonel Carr & Officers of the Army Industrial College.

It is not my purpose to make a speech to you but I wish to talk to you in a conversational way on the subject which has been assigned to me and which I interpret as commercial banking in relation to manufacturing.

First it might be well to dwell on the different types of bamking. In the main there are two leading types in practice in this country - commercial banking and investment banking. There might be added to that savings banking but strictly speaking savings banking is a form of investment banking. In short, the investment banker mobilizes the credit or funds of the country which are available for long time use. In other words the savings of the country are gathered together, sent for by the investment banker and he, in turn, puts those funds to work in the form of capital - capital requirements of industry and commerce.

The commercial banker deals with the liquid funds - those of the country which are put into the banks for a short time pending their use in business of various types. You all know what seasonal business means; at certain times in the year the manufacturer has to stock up for the winter trade; he needs money to help him arrange to buy on the most advantageous basis, he borrows that money for a period of time, 60-days, 90-days or 4-months, on the theory that by the end of that time he will have gotten in his stock of goods, sold it and received sufficient funds to liquidate the loan.

The investment banker, on the other hand, puts his funds out on long or short term bonds, or will provide capital in the way of stock issues for industry and manufacturers.

We perhaps speak of commercial banks now in a way that is not just proper from the general point of view because nearly every class of bank, since the operation of the Federal Reserve System, can (under certain conditions) go into that system and thus partake of many if not all of the privileges.

We find that our financial systems are doing most every class of banking they can; they seek the various kinds of deposits; they not only take the money we term for temporary use, payable on demand, but will take long term deposits, payable in 6 months or a year, and saving deposits which are put in for a short time. But in effect I suppose the savings banks have, in recent years, been increasing constantly so the banker has come to regard a large proportion of his saving deposits as being statutory; thus the commercial becomes an investment banker.

You might separate the Mutual Savings Banks which are known so well and have done so much for the country in New England as being apart from the ordinary savings bank you see now. For instance, we have a Commercial Bank here in Washington, a National Bank in Detroit, which do practically a commercial business straight through. In the West the Security Trust and Savings Bank of Los Angeles, one of the three big banking institutions of California, has a deposit of two hundred and fifty million dollars, but a large proportion of the business of that bank is commercial although it started out as a savings bank and trust company.

The two points I want to make very clear to you are that there is a distinct difference, and every banker if he pretends to be a commercial banker understands that commercial credit should not be used for capital purposes, and by that we mean for the building of plants, purchasing of equipment and land - anything that is of a fixed nature. Commercial credit should not be used for that purpose. In other words, when a merchant or manufacturer comes to a commercial bank to borrow money he should go with a capital stock sufficiently firm to show that the funds he wants to get from the commercial bank are for temporary use only, for operative purposes and on the theory that they will be to tide the manufacturer over a turn-over period, to assist in the purchase of his raw materials. But this is not always the case. If the record of the manager of the corporation is in the matter of capacity such that his judgment is demonstrated and his ability to carry a proposition through proven, then the bank will take a little chance on letting him have the money for operating purposes. However, let us take a practical case. A manufacturer comes into the bank and wants $50,000, says he has an order to fill and he will require raw materials up to a certain amount, money for pay roll purposes over the period, and makes a pretty good statement to the banker that he will need so

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much money to carry this order through, and wishes to know how much the bank will give him. He will present a financial statement to the banker and the first thing the banker will do is to look at the cash on hand, the accounts receivable, ascertain whether those accounts are good, whether they are past due, and if so why; and aim to find out the integrity of those assets as to whether they will be paid upon maturity and will find the average life of those assets. In that way we can visualize the position of the customer at the end of the period for which he desires to borrow. The next item claiming our attention will be his merchandise or inventory, the amount actually finished and on his shelves; whether any of it is old, trying to eliminate that portion. In other words get the item down to a point where we know whether or not it will be sold in the regular course of business. Those are the liquid accounts, cash accounts, bills receivable, inventory and merchandise in process or in finished form.

Them we come to the fixed assets. They are, as I said before, those in the nature of land, buildings and equipment. The commercial banker does not give so much weight in granting credit to the fixed assets because, particularly with the manufacturer, in many instances the value of a manufacturing plant in the event of failure or depression in business is reduced very much as to the value of the real estate. That is not true in every instance because some plants are converted.

That, in the main, is the position that many bankers take. We do not want to go into partnership with you in business but we do want to let you have money to pay back before your stockholders come in to get their share, and when there is trouble anything left for the stockholders will come out of the fixed assets of the business.

On the other side we will scrutinize very closely the accounts payable and notes payable upon merchandise as they always give the first signal to the banker that he must be very cautious about lending money to the man who gives notes for merchandise or materials. Those notes have a maturity date and when a man gives a note for materials or merchandise in many instances he gives it with the understanding that if he gives a reasonable payment the obligation will be renewed. In actual practice these notes get in the hands of bankers and they are the first to know the condition of the man's business. The signer of the note, if he gives it to a third party, has very little to say as to what he will do when the obligation matures, and long years of practice has made this a banking maxim - When a man begins to borrow outside of his bank and pay on notes for the purpose which ordinarily his banker should furnish him, he cannot expect to get the consideration which the banker would give him otherwise.

If the accounts payable are large or present an amount where the cash and accounts receivable are greater in amount than can be reasonably expected to liquidate between them, the banker sits up and takes notice and makes a very close inquiry. If the actual cash, bills receivable and inventory foot up to $200,000, the accounts payable are not extraordinary, the moderate amount of notes payable and these current assets, as we call them, will tie the current liabilities, accounts payable and notes payable, then the banker will take up that statement as being "A-1".

We do not know just exactly who invented the basis or had occasion to state that as the line of protection we should have, "Two-to-one liquid assets against current liabilities"; nevertheless that has been the basis upon which bankers have been doing business for a good many years.

For instance, at first we look to see if the current assets will tie the current liabilities. If the ratio is less than two-to-one, and if we can find anything better, we are not interested in the paper. The importance of this ratio can be realized when the Federal Reserve Banks generally will not accept for rediscount any paper of a borrower of a member bank when that ratio is less than one and one-half times the liability or below one-to-fifty.

If you are interested in your study of preparation in the event of war, it might be well to touch upon the practice of the banks at that time. Of course when war time comes the whole banking scheme is changed because everybody gets into war business and the banker will be more liberal in his views. The manufacturer is ordered by the Government to produce $1,000,000 worth of equipment or munitions for the purpose of the war. He comes into the bank and the banker takes a little different viewpoint than under ordinary conditions, because he will get down to the bottom of the business and if he can get reasonable assurance that the Government will turn over to the bank the money against the delivery of the merchandise or munitions, machinery, etc., (whatever the Government is buying), the banker will be a little more liberal - particularly if the corporation has had a long period of success demonstrating the capability of the management.

In banking we have three factors in granting credit - three seeds: Character, Capacity and, third, Capital. It has been said that J. P. Morgan laid great stress upon the first one as being the underlying principle of good banking. Of course it is a great satisfaction to the bank to know it is dealing with a man who values his word quite as highly as a bond. Then we come to the capacity; when a man has demonstrated his ability to conduct a business successfully, that he knows how to buy, to look ahead, then we would be much more liberal and make loans even below the figures of 1 to 50. As a matter of fact we might make the loan when it approaches a basis for giving credit to the fixed assets because our faith in the borrower would be such that we would feel that the risk of his not succeeding in a particular case would be so small that we would be justified in taking the position.

There has come into banking in recent years the finance companies which call themselves the commercial bankers but, as a matter of fact, they are not commercial bankers. They do not take deposits but gather their capital through the sale of preferred and

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common stocks. When they offer to loan to the manufacturers they usually seek out the man who has gone beyond the point where he can borrow from his bank because the cost to the borrower, through the finance companies, generally runs from thirteen to eighteen percent. On the other hand the companies set up an excellent argument that they make it possible for the borrower in many instances to discount his bills and we all know that in some mercantile lines the profit in the business really is the discount on bills that is earned by having the cash ready.

These finance companies are doing this, to a great extent, with manufacturers where their capital is not sufficiently large and it is not usually possible for them to obtain the necessary capital without giving up the control of the enterprise. We assume a case where the manufacturer has no bank credit or else so small that it will not help him. He goes to a finance company and says, "Here is an order I have from a good house. We will have you purchase the raw materials for us to work with; furnish the money for operating purposes; and we will secure you immediately by an assignment not only protecting you so far as we can for the materials which you buy, letting that protection run into the finished product, but will also assign the account of the purchaser to you, have him send his check to you in payment and if there is anything left over, you pay that to us.

A great deal of the business of the country today is done on that basis, in the automobile business, in the selling of practically all of the modern household improvements, payments thereon being as low as fifty cents a week. There is a question now as to whether we have not gone too far in installment selling and the bankers are somewhat divided in opinion as to how far away from a firm foundation we are getting by permitting the building up of the figures brought about by the installment selling.

It is possible to finance the cost of an article from the time the raw materials are turned into the plant until the finished product is actually paid for by the consumer. The acceptance corporation of today will finance the manufacturer and, in turn, the dealer. The dealer of the automobile will execute certain papers when the cars are delivered, giving the acceptance corporation a lien on the car, the amount actually paid over and above the purchase price is about ten percent. If a car will sell for $900.00, the dealer would put up $100.00 and the acceptance corporation will take care of the balance. When the car is sold the purchaser of the car will go either direct to a finance company which will finance the retail sale or to the dealer who will take him to a finance company and arrange for the sale of the $900.00 car for $1200.00; to that would be added insurance, financing charges, etc., running the total up to about $1275.00. The cash paid would be about thirty-three and one-third percent - some times as low as twenty-five percent. The dealer is then able to get from the finance company who finances the retail purchase a sufficient amount to liquidate his indebtedness to the acceptance corporation and give him a little bit to pay the salesman's commission. The finance company, in turn, will take their paper to the bank and the bank on the strength of the company's statement will give them a certain amount of credit.

That is not, strictly speaking, the high type of commercial paper although it liquidates itself monthly and in actual practice we find that the automobile paper is well selected upon which monthly paymentstare to be made, because as monthly payments are made the paper gets a little bit better for, in theory, the car will ot depreciate.

Assuming that the paper is well selected and the reputation of the finance company is good, approximately fifty percent of the cases that are handled are taken by chance, particularly where the finance charges are higher than the average. This same practice could be followed throughout with refrigerating machines, washing machines, electric sweepers, and various other labor saving devices as well as remodelling of houses, installing electricity, etc. The finance company has in almost every instance gone into the field to help speed up the selling and operating of nearly every line of business activity.

That is about all on the subject, in a general phase, so if you will ask a few questions perhaps we can touch on points more interesting to you.

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OPEN DISCUSSION - CLASS.

QUESTION.

Will you tell us how a line of credit works?

ANSWER.

It is the practice of banks to give to their commercial borrowers a line of credit. There are only a few banks who will not do this. A line of credit is established in this manner.

The borrower comes into the bank and perhaps presents a statement that he is not satisfied with banking relationships across the way and will do business with this bank providing he can get a line of credit. His statement shows assets and liabilities which, of course, give his net worth. Then there should be, which is all important, an operating statement showing the gross receipts of the business over the previous years and, on the other side, the distribution of those receipts, how much spent for the purchase of raw materials, merchandise, labor, insurance, etc., all chargeable against the business, also allowances of the net profits. We get that operating statement for as many years back as we can, or a statement of the net earnings of the business for five years. It may be that we know in a general way and will not inquire particularly into that phase. It is generally known that the firm in question made money but we endeavor to ascertain and put down in concrete form the history of the business. We will take that statement and working along that line get a commercial report upon the business to obtain primary information about same. The value of a commercial report is greatest in that respect in the financial horizon because if a man has been in business over a period of years and there has been anything wrong in his management, if he has failed to meet his obligations in a proper way, the credit house usually has a record of same even as far back as ten or fifteen years. That is a very important question in the initial stage of the current report in respect to the practice of paying bills. It is of value but the information can usually be better ascertained by direct contact with the people from whom the customer makes his purchases. He will give a list of references and we check those up. We will find that his statement shows that his liquid assets are two-for-one; $200,000 in current assets and $100,000 in current liabilities which can be promptly discharged out of those assets, and his capital is $100,000 or more. We would give him a line of credit that would permit him to stay within this two-to-one ratio. However he would have to have a very fine business and there would have to be some substantial amount in the fixed assets because we do not like to loan as much as the capital. If the net worth was the difference between the current assets and current liabilities, in this particular case the net worth would be $100,000. We would say, "We will give you a line of credit of $50,000". The answer might be "That is no better than I am getting across the street". If his history had been satisfactory and we felt that the conditions would justify it we would go as high as $100,000 but it is not likely.

There is another feature in the establishing of a line of credit. We go on the theory that if all our customers want to borrow money they have to keep some on deposit. We insist that the borrower keep in bank a balance of twenty percent of the amount that there is outstanding at any time. The best commercial customers will not only agree to a twenty percent balance during the borrowing period but will aim to carry a balance of ten percent when they are not borrowing.

QUESTION. Are there laws that restrict banks on the nature of paper that they accept?

ANSWER. In some states certain institutions are permitted to loan only on real estate or securities. The savings banks of New York and New England are only permitted to invest their funds in Government and negotiable securities and certain types of bonds known as safe banking investments, but generally speaking the laws do not prohibit the banks from loaning money as they please excepting the national banks are not permitted to make loans on real estate beyond a certain point. For instance, in certain cases we woould loan a proportion of our savings deposits on real estate when the value of the land and improvements is not less than two hundred percent of the loan. On a piece of property appraised at $100,000 we would be permitted to loan $50,000 for one year only. However there is an attempt now to have that restriction removed and permission given to banks for loaning on real estate for a period of five years. We can l an outside