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ARMY INDUSTRIAL COLLEGE.  
(Course, 1927 - 1928)

FUNCTIONS OF A COMMERCIAL BANK.

Lecture

Mr. Joshua Evans, V.P.,  
District National Bank,  
Wash., D. C.

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INTRODUCTORY REMARKS - COLONEL IRVING J. CARR, S.C.

Gentlemen:

This morning we are going to continue our course in business administration from the standpoint of banking. As I have told Mr. Evans, we have already touched somewhat on the Federal Reserve System, through the courtesy of Mr. Robert Fleming, President of the Riggs Bank. Now we would like to learn something of commercial banking, its relation with the manufacturer, how it can aid the manufacturer in turning out more contracts, and in meeting his obligations. As a matter of fact, we want to learn how a commercial bank makes loans; what backing it has to have; what, in general, is the industrialist's end of banking.

We have studied the organization of the War Finance Corporation to a certain extent. We know that it is a corporation formed to aid essential industries in time of war. The War Credits Board was one formed to approve loans to contractors, under Army and Navy contracts, and one of its duties was to go to a factory desiring a loan and survey it. This was for the purpose of finding out if that manufacturer could deliver the goods.

We are, therefore, very much interested in ascertaining what aid the manufacturer must have in delivering the goods, and also whether he can deliver the material he claims he can.

Mr. Evans is Vice President of the District National Bank in Washington. He was here last year and gave us a most interesting talk which we appreciated very much. Our contact with men of his experience is very essential to our course in order that we will not become narrowed as Army officers are inclined to do.

I take great pleasure in introducing Mr. Evans.

FUNCTIONS OF A COMMERCIAL BANK.

Colonel Carr and Gentlemen:

This talk will not be a set speech but will take form of a conversational discussion in which you will play the part of the borrower and I will endeavor to act as the banker.

I have had my eyes opened a little after recently reading what I said last year, and think I ought to improve on that talk. Therefore, I am going to get away entirely from technicalities and in the main deal with practical subjects and practical problems.

First, however, I think it would be well for us to have a general understanding of the three types of banking. We have commercial banking; investment banking and savings banking systems in this country. The operation of the Federal Reserve Act and its provisions make it possible for the commercial banker, savings banker and investment banker to be interchangeable in their activities.

The orthodox, commercial bank is the bank that deals mainly with the short time credits. It endeavors to corral all of the funds that it can get and then loan that money to merchants, manufacturers, industrial operators, jobbers and all classes of borrowers who are actively engaged in business, to the end that their borrowings from the bank will be for short periods enabling them to obtain funds with which to carry through an operation. A manufacturer may

want to fill a large order and finds that it will take him three months to put the order out. He may have a half million dollars; the order may be for a hundred thousand dollars. During the time necessary to complete the order he will have pay rolls to meet; he will have raw materials and certain other expenses of operation to keep up. While he may get a small payment at the time the contract is entered into, generally speaking he does not get his money until actual delivery of the goods. Even then he may not get the money in full but a promise to pay. The commercial bank is the "man" who will step in and meet that breach - furnish the money as necessary to carry on the operation of the firm to its finality.

Commercial banks, however, do some investment banking but I am not going to dwell upon that phase at all, but tell you only of strictly orthodox, commercial banking - the type of business you will be handling. You will deal with the merchants, manufacturers, and industrial operators who are creating something that is to be sold to you and then start immediately on some other order. There will be many of these activities going on at one time, and the theory is that the output of a plant will be so diversified that one contract will overlap another. Under these conditions there is not much danger of stagnation in the completion of one operation and the waiting for another identically the same.

The investment banker is the type of banker who endeavors to furnish the fixed capital, the commercial banker furnishing the operating capital or operating funds. Take the manufacturer who

desires (or a corporation) to go into a manufacturing business. The first thing they need is a plant. They have a piece of real estate and build their plant on it. They cannot expect to get any money from the commercial bank with which to build as well as buy their machinery. That is done frequently, but is not a commercial banker's regular job - his function is to furnish money after the group is ready to go into operating business. Perhaps the manufacturer will go to the investment banker and say, "I have a hundred thousand dollars subscribed here and want to build a plant. It may cost me from \$250,000 to \$500,000." He asks the investment banker what he can do towards floating the stock. The underwriter of the bank will look over the caliber of men who are scheduled to comprise the management. If those men have demonstrated their ability to carry on successfully an enterprise such as is proposed, the investment banker will then go into the matter more seriously. Whenever he finds the set-up will warrant, he will underwrite the issue of stock or the issue of bonds necessary to create the plant and get operation under way.

After the plant has opened and is ready for operation it then gets orders. It may have some of its own capital left over from the expense of building. Ordinarily in capitalizing an industry it is desirable to have some capital left for operating expenses for a period so that when a man goes to a bank to borrow money to carry on the enterprise he will have some evidence of what has been accomplished up to that time.

We will assume that a man has a plant, such as the Steel and Ordnance Company across the river, and is in the war business. That

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That company has a well established plant with a capacity for turning out war ammunition. It receives a large order from the Government. One million dollars is needed to carry out this certain contract. What does the management do? The treasurer or the officer looking after the financial matters of the company will take his financial statement to his banker and show him the condition of the corporation. This statement will show the assets and liabilities as of a recent date. It must also show an operating account. If it is a new industry, of course, it will not be able to show the results of operation other than for a short period; if it is a corporation that has been in business for years, the bank will have in its files annual statements of this corporation and these statements will be transcribed in condensed form to a sheet that will show the operation of that company over a period of five years, exactly how much money it has made, etc. The banker will have enough information available to enable his loaning officers to judge the capacity of the management.

In granting credit there are two or three cardinal principles. The three factors on which the greatest stress is laid are character, capacity and capital. Those are what are termed the "Three C's" and are the foundation of commercial credit extension.

It is not necessary for me to describe character. You know that when a man's word is recognized to be as good as a bond you are dealing with a man in whom you can have faith. The next factor, then, is capacity - that is the ability of the management to succeed in the business in which engaged. When you have character and capacity com-

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bined you have gone a long way because, even though we lay down certain rules and limitations to be followed by banks, if character and capacity are one hundred percent we very frequently break away from the limitations followed by the best board of directors. The third in importance is capital. That capital may be in the form of cash in the bank, notes and acceptances due from the customers, other accounts receivable, inventory in the way of raw material, processes of manufacture and finished goods, etc. The plant is either clear or subject to mortgage. Against these assets you will have the liabilities - notes payable, accounts payable, expenses, accounts and notes due to partners and employees, deposits of money due to subsidiaries, etc.

On one hand the asset and liability statement is divided into the current items and on the other they are known as fixed assets. The ratio of current assets to current liabilities has a very marked effect upon the treatment from the credit standpoint. In extending credit, generally, the banker will not want to loan more than the capital stock or capital investment of the business, either in the case of an individual or a corporation. National banks are not permitted to have an obligation in excess of the capital stock.

Going back to our illustration previously mentioned, the Steel and Ordnance Company, with its capital stock of \$500,000, wishes to borrow a million dollars. We feel that is too much money to be borrowed, but it may be that the assets of the corporation are such that we would deviate from that rule. Assuming that it has a capital of at least a million dollars, we ask the company to what use it is going to put the million dollars. We look over its current assets

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and liabilities and find that the cash, accounts receivable, raw materials, materials in the process of manufacture and finished products aggregate two million dollars. The liabilities against those assets are one million dollars, which gives the current ratio of two to one. That is two dollars in current assets for every dollar in current liability. There must be a distribution of the assets in such form that the liabilities can be discharged without any hardship or sacrifice of the assets. We find that the cash on hand and the accounts and notes receivable are of such character and of such short-term of maturity as to enable the liquidation of the liabilities. Therefore, if a million dollars in current debts is shown, there should also be something in excess of a million dollars in cash and accounts and notes receivable, the theory being that liabilities are perhaps of a shorter average maturity date than accounts and notes receivable.

The protection, that is the reserve or the guarantee against liquidation, would be covered in the company's inventory of merchandise. When it is necessary to liquidate a merchant's inventory in order to pay current liabilities it is usually accomplished at a substantial sacrifice.

Assuming that we have a statement, in this instance, of two million dollar assets on one side and one million dollars in current liabilities on the other; the corporation has a capital of one million dollars and the plant is free. Then we would have a plant that had a book value of two million dollars. If it were mortgaged

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to the extent of a million dollars it would then have in its deferred or long term liabilities the mortgage of one million dollars, the net worth of the corporation being just equal the capital. If the plant were worth two million dollars, there would be one million dollars surplus. That would be a set up that would be inviting to any banker.

Let us see how wide a view the banker takes here. He has a concern which has had a record of successful operation over a period of years, the management being substantially the same during that period. Perhaps we may have a new corporation in which the management is in the hands of men who have demonstrated their ability. The corporation usually protects itself in the beginning, if it does not have a lot of capital, by having the lives of their "key men" insured for the benefit of the corporation. We find that the company already has two million in current assets and one million in liabilities. The bank says, "Go ahead. You need a million dollars to carry on this contract. We will give you the line of credit for a million". That money is not to be used all at one time, but the corporation would have the right to draw up to a million dollars over a period agreed upon. What does the bank expect in return? It does not expect the borrower to take that million dollars and use up his cash in the bank, but he must leave with the bank what we term a compensating balance. That compensating balance does not mean that it is taken in order to get a little extra interest on the loan, but if the bank agrees to furnish a certain amount of money over a certain period, so that the borrower's

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financial condition remains substantially unchanged during that time, then the borrower has to pay something for that. He must show a right to get that accomodation, or that commitment as we term it.

You can very readily see that a banker doing a commercial business will not have money to loan out unless his borrowers keep a certain portion of their loans on deposit. If all borrowers wanted loans at the same time the bank would not have sufficient money to loan to but a few, because if a statement is all right the bank will loan about five times the amount of the balance the applicant carries at that time. No one seems to know just who established this ratio, but it is one that we all try to maintain.

If at the beginning of the year the financial statement of a borrower is such that he would be entitled to credit up to one hundred thousand dollars during the year, the banker would allow credit to that amount. But, on the other hand, when a man is borrowing we expect him to have a balance of at least twenty percent of the amount requested/<sup>and</sup>when he is not borrowing we expect him to maintain some part of it, five to ten percent at least. In other words, if for one year a firm botrows nothing from us and carries a balance of only \$2,000. It then comes to us and says, "We want a hundred thousand dollars". We look at its account and reply, "You have been carrying a balance of two thousand dollars with us. You are, therefore, entitled to credit of \$10,000 to \$15,000 on the basis of the balance you have carried". We would be prone to make the extension of a hundred thousand dollars unless the financial set-up of the firm was so desirable that we would be "chopping off our nose to spite our face".

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If the Steel and Ordnance Company is going to make war material it will have a contract with the Government. Suppose it takes six months to complete the work. The bank will furnish the credit on ninety days notes with the expectation that when the Company gets its money from the Government the loans will be paid. Generally speaking, any manufacturer who has been successful gets good contracts and has current assets equalling a ratio of from one and one-half to two times his current liabilities. In such a case the manufacturer does not have to bother about securing enough money to carry on operations.

Those concerns, however, are not the ones with which you gentlemen will have any concern in time of war. Take the illustration of the Steel and Ordnance Company. They have no trouble in securing financial aid on a peace time contract. They might call up the bank and say, "We need a million dollars", and the banker would probably reply, "Go ahead. That will be satisfactory". When war comes on you have to put all the industries to work and plans therefor have to be ratified to some extent. Say you have an organization of unusual capacity but which, in order to fulfill war contracts, will require the extension of the plant on a broad scale. Either the War Credits Board or the War Finance Corporation steps in and helps the company in a manner in which a bank could not aid. The War Finance Corporation would be engaged in what is called long term financing.

The first thing that would have to be done is this. One of the concerns would bid for a large order or contract, and one of the Government's representatives would discuss it with the management thereof.

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The industrial concern might say, "Yes, we can handle this contract all right but certain things will have to be done. We will have to extend our plant for one thing. We can get enough money from our bank with which to start right now, but when it comes to getting all the capital needed the chances are we cannot do so unless we can get it through the Governmental assistance of the WarCredits Board or the War Finance Corporation".

When a manufacturer goes to a bank the banker would want to know to what extent he could turn out what the firm is expected to do. If it is a case of some type of product where exactness is required, or where a little failure or slip (such as the one of the Arms Company of Providence who made a lot of bullets for the Russian Government which did not fit the guns) then it would be a proposition on which the banker would not want to take very much risk.

The proportion of the risk which I have just commented upon has to do with the assets and liabilities involved, the two principal items which the banker uses in his statement when preparing the current ratio. If the banker gets paper that bears the required ratio, he need not bother about anything himself regarding the rediscounting thereof and obtaining the money. The Federal Reserve Bank will do the rediscounting for him. You can readily see the precarious position of the bank in times when it is necessary to extend unusual credit.

If a firm's statement bears that ratio and its operating account for the year (that is the profit and loss account) will show, on one

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side, the gross sales or the sources from which the gross income is derived as well as discount upon notes, income from investments, losses previously made, and income from other sources, then on the other side you will be able to ascertain what has been done with this income. In the case of a business house, the inventory at the beginning is taken; added to the inventory are purchases made during the period, giving a total of the goods which the company has to sell. Deduct from that total the inventory at the end of the period and that gives an item known as cost of goods sold. If the income from all sources exceeds the total of debits, then a profit has been made; if it is less the firm has suffered a loss.

If the business has been profitable the bank will make the loan or deal with the customer on the basis of his having a fine set-up, but if the business shows a loss we inquire very closely into what has occasioned the loss. We would ask for a complete audit. Any corporation of any size has its books examined by a Certified Public Accountant who is supposed to check over the records to determine that everything has been accounted for. An accountant of a recognized house does not think of making an examination without also making recommendations. If the bank finds that steps are being taken to overcome the deficiencies in the management, or the causes of loss, it would appear that the company had profited by what had happened; but if the previous year showed losses as well as the succeeding year, with no effort to overcome those deficiencies, it would not make any difference how much capital the business had - it would not be in a position to borrow money on a commercial basis.

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In this connection I wish to call to your attention a pamphlet, "Commercial Banking", by Mr. Stewart D. Beckley, Vice President, American Bank, San Francisco, Calif., that was promulgated some time ago by the Federal Reserve Bank of Philadelphia.

(Copy of pamphlet on file, Library, Army Industrial College).