1/4/29

FUNCTIONS OF THE COMMERCIAL NATIONAL BANK

Lecture by Mr. Joshua Evans, Jr.

Colonel Carr seemed to indicate that you are under great debt to me for coming down here to talk. As I have written to him and to the Assistant Secretary, I look upon this as an opportunity for service and each year as the occasion arises it gives me a better chance to improve and in making any improvement it redounds to my personal benefit and to our institution. Last year I suggested that I thought the best results could be obtained if, instead of trying to make a set speech, I talked to you largely in a conversational way, and that will be my practice today.

Banks may be divided into four groups - savings, commercial, trust companies and investment banks or investment houses. Strictly speaking, a savings bank gathers and invites the savings of the community and those savings are invested in mortgages, bonds and securities of a type which may be prescribed in the state or jurisdiction in which the institution operates. That type of bank under no circumstances should fail. It gathers the savings of the people and it is not supposed to go into commercial fields where business risks, or what we call economic business risks are taken. The method of investing its funds is one that requires rigid adherence to the type of security that is purchased. Time is given the bank in which to meet the demands od its depositors in the event the bank should require that time and consequently there is no occasion for the officers of the bank to buy or invest the funds in any class of securities that would produce more than the most conservative rate of interest. In New York some of the savings banks have increased their rates of interest from 4 to 4½% because they are feeling the call of the stock market and consequently their deposits have decreased in many instances rather than increased. Nevertheless, they still want to keep their investments backed by assets that wont melt away. In other words, they have mortgages mainly. They are making a study now as to whether, and to what extent, they might be permitted to buy Treasury stocks and possibly certain types of common stocks because the economists are beginning to take a different viewpoint as to the desirability or lack of desirability on the part of investors to putting money into the common stocks of industries and manufacturing concerns that are sound and where there is a large equity behind these stocks. You all read the newspapers and know what is going on in the market. For two or three years the bankers and economists have been wondering when stocks will reach the point that is entirely too high and the results in the stock market have been pretty much the same as those at the beginning of the war. When the war broke out exchange went against us and there was great apprehension on the part of bankers as to whether they should continue dealing in foreign exbhange. (Conversation bet. Mr. Jardine & Mr. Stillman deleted)

The commercial bank is a bank that is supposed to look after the commercial needs of the community. It gathers the deposits that it can get from all sources. It makes a play for the savings class because it has a savings department. It appeals to the investment class asking the investment group to put their money with it pending reinvestment. It goes out to the business man and induces him to carry a balance in the bank so that when he wants credit he can make a claim on the bank for assistance in that connection. We see the Commercial bank gets its money from all classes fo depositors but in the main it is expected to loan its money only to the class of borrowers who use the money for business operations and give the bank paper that will be self-liquidating because the commercial bank, as contrasted with the savings bank, must pay its deppsitors on demand. If all the deppsitors came into the bank at one time the bank would close that afternoon. It has been said that if 2% of the depositors of banks should at one time ask for their money the bank could pay it out with little difficulty. If 2% more should come in they would, by resorting to the deppsits which the bank had in the Federal Reserve Bank, be able to meet their demands but after that it would probably be the greatest panic that was ever seen. That illustration is made to show you how much the business of the country and its development depends upon faith - the faith that one business man has in another. 92% of the business of the country is transacted on credit. Credit is the faith that one man has in the integrety and capacity of the other fellow. Old J. P. Morgan is always quoted as saying he placed greater stress upon the charatter, capacity and capital - character of the individual, capacity meaning capability to conduct business, and capital, the original backing that you have in the way of plant or fixed assets. He said that of those three character was the most important. I question whether Mr. Morgan, were he alive today, would loan the stupendous sums of money that are demanded by individuals and corporations today on character alone. In these days when the big institutions deal in millions, capital in the way of fixed assets is the most important. That is what the banker would rely on - what the man has in substantial assets at the time he ask for his money.

The commercial bank must keep its assets liquid. It must have a larger amount of cash than is carried by the savings bank. It must have its bills receivable of short term and self-liquidating. In theory, when a man borrows $50,000. this is what happens. He says he needs $50,000. to stock up for Christmas and by the time the note falls due he will have sold the goods and have been paid for it and the money will be in the bank ready to discharge the obligation which comes due - say in 3, 4 or 6 months. In practice, the notes are renewed many time if there is a reasonable curtail, but then, in the types of investments the commercial bank will make, and every bank maintains in its portfolio some Government securities, these can be taken to the Federal Reserve Bank and realized upon just the same as commercial paper.

Then they will buy short-terms bonds, or outside paper - paper that is not affected by the business trend of the community and if deposits should go down they will call in first the outside paper - that paper the collection of which would not have any demoralizing effect upon the locality. If the deposits go down further they would convert some of the short term secutiries that they have. If there is still a futher decline they would rediscount some of their paper with the Federal Reserve Bank. Then, if it looks as if there is a business depression coming along they scan their assets and all banks have some that are frozen, and see what can be done to expedite liquidation of those assets. The commercial bank must keep its assets in liquid form quickly convertible into cash because the depositors have the right to call for their funds upon demand and they expect to get them, whereas the savings banks have 60 days notice.

Another class of financial institution is the trust company. That is a misnomer. Most trust companies today operate pretty much as commercial banks, that is, they do the class of business that is done by commercial bank but not to the extent. The trust company will have the greater portion of its assets invested in bonds, Government, municipal, utility, railroad and some industrial bonds and first mortgages on real estate. If it is doing a commercial business it will have a relative portion of its assets in commercial paper or in the notes of the mercantile class which may deal with it. The trust company's funds are usually payable on demand just the same as with the commercial bank. Trust companies also have savings departments. They issue certificates of deposit payable at definite, fixed times, three months, six months or a year. So to the extent that they have deposits of that nature they may be compared with the savings banks, because they reserve the same right on savings deposits as strictly savings banks, but generally speaking the institution that does not pay its savings depositors when they ask for the money or will not anticipate the payment of its certificates of deposit, notwithstanding they may not be due for some months - the institution that fails to hand the money out - is apt to be adversely advertised.

The fourth class of bank is what is known as the investment bank or investment house. This type of bank is the one that does not deal in assets of the quickly convertible nature. The seeker of capital goes to the investment house and says he wants to enlarge his business. He is doing a large volume of business and cannot borrow from the banks enough money to give him the necessary operating funds. Take an ice cream manufacturer. He is running along and has plenty of credit at the bank to take care of his ordinary needs. He does not require much borrowing because his business is on a cash basis but there comes an occasion when he must rip out his machinery and install an entirely new type. To do that he will require $200,000. He could buy his machinery on time and in the intervening time there would be a chattel mortgage against the machinery. He would much rather pay for his machinery in cash. The investment bank would say "You have assets of about $500,000. in real estate, buildings, etc., you have been making money and there is justification for enlarging your plant and we will buy the bonds. You can put out an issue of bonds and we will give you the cash right now and sell those bonds throughout the country." Or the bank might finance him through an issue of preferred stock.

Now comes the question of the position of the commercial bank when we get into war with our neighbors and there is a heavy demand made upon the banks for assistance in carrying out the needs incident to the requirements of war. I can best do that by going over the statement which you have before you and briefly stating the relation between the bank and the manufacturer or man in commercial business. The bank is in one sense in the same position as the business man or retailer. On the one hand the merchant deals in commodities of a certain nature and the bank deals in - not a tangible commodity, but in credit. The extent to which the merchant can obtain this credit from the bank hinges very largely upon the ability of the merchant to show three things. First, that he is making money - which indicates capacity. Second, that the management is in good standing and good character. Third, he must show that he has some definite tangible assets so that if the banker lends him some money and he puts that money in his pocket and does not try to increase these assets which he has, the bank will have something to fall back on. That is a very broad statement but the banker wants to know that if the liquid assets melt away there will be something left when the bankruptcy comes along.

If the manufacturer wants $100,000. the bank gives him a statement to fill out from his records. If the borrower says he does not know whether he can give the bank all that information the bank wants to know if he is having his accounts audited by a C.P.A. If he says no, the bank knows that his accounting system is bad. This attitude on the part of banks has prompted business houses to keep their accounts in such shape as to enable them to make statements at the end of each month. I understand that you have contact with the Harvard School of Business Administration. It is generally known that through the operations of the Harvard School they have worked out ideas and data that will enable a man in one class of business to measure his record with that of a composite group of successful men or corporations in that particular line and the gross earnings of the business is divided up into percentages and the costs of operations divided and percentages made, and one merchant can see that is is costing him so much for heat, rent, salaries, etc., and if he compares that with these figures gotten out by the Harvard School he can get some idea as to whether he is doing as well as the average man in his line. If he is not, it is up to him to find out why. The accounting systems of concerns doing any volume of business must be kept according to the latest business methods because the competition is so keen in all lines that unless you know that you are getting the most out of your energy and doing it as cheaply as some one else is doing it, you are apt to lag behind and find yourself in trouble.

We will look at the statement. Under total liabilities is an item Reserve, Capital Stock, Common Stock, Surplus. We look at the last three items - say, Capital Stock $100,000. Common Stock $100,000 and Surplus $100,000. We pay no attention to the item of Reserve - it may run along continually, such as Depreciation.) We see $300,000. net worth. That represents the net worth of the business. When a business borrows or obligates itself for sums in excess of its capital, the bank get wary and a real danger signal goes up when the demand obligations equal the net worth of the business. Then we come to current assets and current liabilities. If these current assets are $400,000. and the current liabilities are less than $200,000. that is alright. That is what is regarded as a desirable ratio. That merchant has a right to come in and ask for more money. Why the banks insist upon this question of having $2. in current assets for every $1. in liabilities no one seems to know, but experience has demonstrated that when a concern gets down to the point where its current assets are less than 1 and ½ times the current liabilities then there is a danger signal out and the lender should look for his money. As a matter of fact, the Federal Reserve Banks will not rediscount paper when the ration is less than 1½ to 1. When we have $2. in current assets to $1. in current liabilities we think the risk a good one.

Then we go further up on the paper and see what the cash on hand is - cash in the bank. Say the cash in bank is $100,000. A man ought to carry a balance in the bank of 20% of the money he expects to borrow. I do not know just why the banks require the balance to be 20% but it is generally accepted that a man, to feel entitled to credit from his bank, should maintain during the period that he is borrowing, an amount of money equal to 20% of what he has borrowed from the bank. This man (on the paper) has got $20,000. in cash on deposit. That balance justifies a loan of $100,000. and he then has $120,000. We find "Notes payable for merchandise" We find out whether in borrowing this money from us he is going to pay off these notes. If he is, then we can draw our own conclusions as to what he will do with the other. He has merchandise accounts past due and accounts past due. If it is a close corporation we say "you ought to convert your accounts payable into stock because as that creeps up you increase this item of current liabilities, for as soon as the liability matures it must be looked upon as a demand liability. If you have a mortgage on your plant and that mortgage is coming due in one year, the Federal Reserve Bank requires that it be put up in the current liability class. If we find he can pay off his notes for merchandise and pay off his accounts payable and still have some money left, there seems to be a logical reason for borrowing.

Merchandise finished, merchandise unfinished and raw materials represent the bulk of the current assets. If this merchant has no notes receivable that would show that his business has been falling off, unless he is doing a cash business and in that event he would not want to borrow much money and that prompts us to look into the record of the trend of business in that particular line. After a careful analysis we go ahead if we feel that after letting him have the money he can rebalance his asset side. If, on the other hand, the depositor shows the requisite amount of cash on hand and shows he has notes receivable from customers we will know the terms under which he sells. Then we can draw conclusions as to whether he is giving us a clear indication of what his business is. In general, if we loan $100,000 for 90 days, we would expect his assets to be of such type that when the 90 day period rolls around he would have converted his assets into cash or into such form that he could replace his note with cash or with paper of some one else. It might be that he had some of his customers on a three or four months basis and in that event he might have taken from his customers "trade acceptances". If his statement

That is, when a retailer buys from a wholesaler, he gives his "trade acceptance", so when his notes come due, he says "I do not have the cash, I have short term trade acceptances". We take those very readily.

If his statement stands up well, we tell him he can have $100,000/ and if conditions remain as usual, he can have $100,000. any time this year. That is "extending a line of credit" and is given when his statement continues and there is no radical change in assets or liabilities. In order that we may keep track of him we ask that he send us his statement at the end of each month. We do not always get them very promptly and the practice is not general but we are trying to encourage our customers to give us monthly statement.

How is the line of credit arranged? It is arranged when the dealings with the bank have been of a satisfactory nature and there is confidence in the character, integrity and capacity of the management and when the business will show a ratio of current assets to current liabilities over $1\frac{3}{4}$, and the balance carried in the bank is from 10 to 20% of the funds borrowed.

There is another aspect which enters into the equation. That is the type of business. Take the commission merchant who has a great deal of small business. Shipments come in from all parts of the country and he draws 2 or 3 hundred checks a day. Some of the institutions in New York have to set off a department just to handle the checks of th some of the companies there. In the case of the merchant who has a multiplicity of transactions, there is an activity in the account that is a definite cost for the bank to handle and we have our means of analyzing the activity. It costs us about 6 cents to handle every check that goes through our bank. That is the figure that most of the banks are working on here. As the volume increases that average might go down. On one account recently we felt that 3 cents was a fair cost.

There are some banks who will not give a line of credit. They say "You have been doing business here and you can rely on us but we will not give you a line of credit". That is rare, however, particularly in large banks, because where a man needs considerable financing to handle his business he wants definite assurance that as long as he is keeping up his end, he expects us to do the same. The fact that a bank must meet its demands for credit is another reason why it must have its assets of a liquid nature. There are often instances where a bank has refused to extend credit when the borrower has kept up his end and the borrower has suffered loss and the bank has been held liable. We must keep our assets in liquid form and be able to take care of the demands of our depositors and also the demands of our borrowers as well.

We sometimes find that when we send this statement out to our borrower he pays no attention to it. We do not want the borrower to feel that he must of necessity give us this information. The green form is the one we send out to individuals. It is really just to have something in the files where the borrower has stated he has definite assets. If he has made any manifestly gross misstatements we take legal action and the borrower may find himself in the penitentiary, if it is necessary to go that far.

Thank you for the courteous attention you have given me.

Q. Is there any limit to the amount of money a bank may lloan, or just how is it limited?

A. In extending credit a bank cannot loan, generally speaking, to any one borrower, mose than 10% of the capital & surplus of the bank. For instance, we have a capital of $1,000,000. and surplus of $800,000. We cannct loan more than $180,000. If we loan that much and the company had paper given it by its customers, it could bring the paper in and rediscount it. That is known as "customers' paper" and we can buy that to any amount because it is not looked upoh as a direct loan to the borrower. However, there are very few institutions that will loan more than 10% of their capital. In some jurisdictions the State banks are not restricted, but the national banks are restricted to 10%, having the leeway of customers paper.